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SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 19b-4

Proposed Rules

By

Public Company Accounting Oversight Board

In accordance with Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of the Proposed Rules

(a) Pursuant to the provisions of Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") is filing with the Securities and Exchange Commission ("SEC" or "Commission") proposed rules, Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* ("Auditing Standard No. 5"); Rule 3525, *Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting*; and conforming amendments to the Board's auditing standards. The proposed rules are attached as Exhibit A to this rule filing.

(b) Auditing Standard No. 5 would supersede the Board's Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("Auditing Standard No. 2"), upon its effective date.

(c) PCAOB-2004-03

2. Procedures of the Board

(a) The Board approved the proposed rules, and authorized them for filing with the SEC, at its Open Meeting on May 24, 2007. No other action by the Board is necessary for the filing of this proposed rule.

(b) Questions regarding this rule filing may be directed to Jacob Lesser, Associate General Counsel (202-207-9284; lesserj@pcaobus.org) or Sharon Virag, Associate Chief Auditor (202-207-9164; virags@pcaobus.org).

3. Board's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rules

(a) Purpose

In 2002, Congress passed the Act, which, among other things, established new provisions related to internal control over financial reporting. Section 404 of the Act requires company management to assess and report on the effectiveness of the company's internal control. It also requires a company's independent auditor, registered with the Board, to attest to management's disclosures regarding the effectiveness of its internal control. As directed by Sections 103 and 404 of the Act, the Board established a standard to govern the newly required audit by adopting Auditing Standard No. 2. The SEC approved Auditing Standard No. 2 on June 17, 2004.

Since Auditing Standard No. 2 became effective, the Board has closely monitored the progress registered firms have made in implementing its requirements. The PCAOB's monitoring has included gathering information during inspections of registered public accounting firms; participating, along with the SEC, in two roundtable discussions with representatives of issuers, auditors, investor groups, and others; meeting with its Standing Advisory Group; receiving feedback from participants in the Board's Forums on Auditing in the Small Business Environment; and reviewing academic, government, and other reports and studies.

As a result of this monitoring, two basic propositions emerged. First, the audit of internal control over financial reporting has produced significant benefits, including an enhanced focus on corporate governance and controls and higher quality financial reporting. Second, these benefits have come at a significant cost. Costs have been greater than expected and, at times, the related effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.

As part of a four-point plan to improve implementation of the internal control requirements, the Board determined to amend Auditing Standard No. 2. On December 19, 2006, the Board proposed for comment a new standard on auditing internal control, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would replace Auditing Standard No. 2. After careful consideration of the comments it received and input from the SEC, the Board has refined its proposals to provide additional clarity and further help auditors to focus on the most important matters. The Board adopted the revised standard on auditing internal control as Auditing Standard No. 5 to supersede Auditing Standard No. 2.

Under Section 10A(i) of the Exchange Act, as amended by Section 202 of the Act, all non-audit services that the auditor proposes to perform for an issuer client "shall be pre-approved by the audit committee of the issuer." Rule 3525 would further implement the Act's pre-approval requirement by requiring auditors to take certain steps as part of seeking audit committee pre-approval of internal control related non-audit services. These steps are intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect independence. Rule 3525 requires a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related non-audit services that are not otherwise prohibited by the Act or the rules of the SEC or the Board to: describe, in writing, to the audit committee the scope of the proposed service; discuss with the audit committee the potential effects of the proposed service on the firm's independence; and document the substance of the firm's discussion with the audit committee.

The conforming amendments update the Board’s other auditing standards in light of Auditing Standard No. 5, move information contained in Auditing Standard No. 2 to the Board’s interim standards, and change the existing requirement that "generally, the date of completion of the field work should be used as the date of the independent auditor's report" to "the auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion." This change is consistent with a recent change adopted by both the International Auditing and Assurance Standards Board and the AICPA Auditing Standards Board.

(b) Statutory Basis

The statutory basis for the proposed rules is Titles I and II and Section 404 of the Act.

4. Board's Statement on Burden on Competition

The Board does not believe that the proposed rules will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rules would apply equally to all registered public accounting firms and their associated persons. Moreover, Auditing

Standard No. 5 explains how to tailor internal control audits to fit the size and complexity of the company being audited.

5. Board's Statement on Comments on the Proposed Rule Received from Members, Participants or Others

The Board released the proposed rules for public comment on December 19, 2006. See Exhibit 2(a)(A). The Board received 175 written comment letters relating to its proposal. See Exhibits 2(a)(B) and 2(a)(C).

The Board has carefully considered all of the comments that it received. In response to the written comments received, the Board has clarified and modified certain aspects of the proposed rules. The Board's response to the comments it received and the changes made to the proposed rules in response to these comments are summarized in Exhibit 3 to this filing.

6. Extension of Time Period for Commission Action

The Board does not consent to an extension of the time period specified in Section 19(b)(2) of the Securities Exchange Act of 1934.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rules Based on Rules of Another Board or of the Commission

As described in detail in Exhibit 3 to this filing, certain aspects of the proposed rules are based on the SEC's guidance to management on evaluating internal control and related SEC rules, including the SEC's rule defining "material weakness" and its proposed rule defining "significant deficiency."

9. Exhibits

Exhibit A –	Text of the Proposed Rules
Exhibit 1 –	Form of Notice of Proposed Rule for Publication in the Federal Register
Exhibit 2(a)(A) –	PCAOB Release No. 2006-007
Exhibit 2(a)(B) –	Alphabetical List of Comments
Exhibit 2(a)(C) –	Written Comments on the Rules Proposed in PCAOB Release No. 2006-007
Exhibit 2(b) –	Transcript of Comments on Proposed Rules at Public Meeting
Exhibit 3 –	PCAOB Release No. 2007-005

10. Signatures

Pursuant to the requirements of the Act and the Securities Exchange Act of 1934, as amended, the Board has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Public Company Accounting Oversight Board

By: ______________________

J. Gordon Seymour
General Counsel and Secretary

Exhibit A – Text of the Proposed Rules

Auditing Standard No. 5 –
An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

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APPENDICES

Introduction

1. This standard establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of **management's assessment**[1/] of the effectiveness of **internal control over financial reporting** ("the audit of internal control over financial reporting") that is integrated with an audit of the financial statements.[2/]

2. Effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.[3/] If one or more **material weakness**es exist, the company's internal control over financial reporting cannot be considered effective.[4/]

3. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting. Because a company's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance[5/] about whether material weaknesses exist as of the date specified in management's assessment. A material weakness in internal control over financial reporting may exist even when financial statements are not materially misstated.

4. The general standards[6/] are applicable to an audit of internal control over financial reporting. Those standards require technical training and proficiency as an auditor, independence, and the exercise of due professional care, including professional

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1/ Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

2/ This auditing standard supersedes Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements,* and is the standard on attestation engagements referred to in Section 404(b) of the Act. It also is the standard referred to in Section 103(a)(2)(A)(iii) of the Act.

3/ See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f); Paragraph A5.

4/ See Item 308 of Regulation S-K, 17 C.F.R. § 229.308.

5/ See AU sec. 230, *Due Professional Care in the Performance of Work*, for further discussion of the concept of reasonable assurance in an audit.

6/ See AU sec. 150, *Generally Accepted Auditing Standards.*

skepticism. This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

5. The auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting.[7/]

Integrating the Audits

6. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.

7. In an integrated audit of internal control over financial reporting and the financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously –

- To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end, and
- To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

8. Obtaining sufficient evidence to support control risk assessments of low for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements. (See Appendix B for additional direction on integration.)

> Note: In some circumstances, particularly in some audits of smaller and less complex companies, the auditor might choose not to assess control risk as low for purposes of the audit of the financial statements. In such circumstances, the auditor's tests of the operating effectiveness of controls would be performed principally for the purpose of supporting his or her opinion on whether the

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[7/] See Securities Exchange Act Rules 13a-15(c) and 15d-15(c), 17 C.F.R. §§ 240.13a-15(c) and 240.15d-15(c). SEC rules require management to base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework (also known as control criteria) established by a body or group that followed due-process procedures, including the broad distribution of the framework for public comment. For example, the report of the Committee of Sponsoring Organizations of the Treadway Commission (known as the COSO report) provides such a framework, as does the report published by the Financial Reporting Council, Internal Control Revised Guidance for Directors on the Combined Code, October 2005 (known as the Turnbull Report).

company's internal control over financial reporting is effective as of year-end. The results of the auditor's financial statement auditing procedures also should inform his or her risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Planning the Audit

9. The auditor should properly plan the audit of internal control over financial reporting and properly supervise any assistants. When planning an integrated audit, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures –

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee[8/] or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;

[8/] If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;

- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and

- The relative complexity of the company's operations.

  Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Role of Risk Assessment

10. Risk assessment underlies the entire audit process described by this standard, including the determination of **significant accounts and disclosures** and **relevant assertion**s, the selection of controls to test, and the determination of the evidence necessary for a given control.

11. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

12. The complexity of the organization, business unit, or process, will play an important role in the auditor's risk assessment and the determination of the necessary procedures.

Scaling the Audit

13. The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its **control objective**s. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks. Scaling is most

effective as a natural extension of the risk-based approach and applicable to the audits of all companies. Accordingly, a smaller, less complex company, or even a larger, less complex company might achieve its control objectives differently than a more complex company.[9/]

Addressing the Risk of Fraud

14. When planning and performing the audit of internal control over financial reporting, the auditor should take into account the results of his or her fraud risk assessment.[10/] As part of identifying and testing entity-level controls, as discussed beginning at paragraph 22, and selecting other controls to test, as discussed beginning at paragraph 39, the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include –

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

15. If the auditor identifies deficiencies in controls designed to prevent or detect fraud during the audit of internal control over financial reporting, the auditor should take into account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit, as provided in AU sec. 316.44 and .45.

[9/] The SEC Advisory Committee on Smaller Public Companies considered a company's size with respect to compliance with the internal control reporting provisions of the Act. See Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, Final Report, at p. 5 (April 23, 2006).

[10/] See paragraphs .19 through .42 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* regarding identifying risks that may result in material misstatement due to fraud.

Using the Work of Others

16. The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* applies in an integrated audit of the financial statements and internal control over financial reporting.

17. For purposes of the audit of internal control, however, the auditor may use the work performed by, or receive direct assistance from, internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of internal control over financial reporting. In an integrated audit of internal control over financial reporting and the financial statements, the auditor also may use this work to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of the financial statements.

18. The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work. The auditor should apply paragraphs .09 through .11 of AU sec. 322 to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use.

> Note: For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding and knowledge that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the person's qualifications and ability to perform the work the auditor plans to use. To assess objectivity, the auditor should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the auditor plans to use.

> Note: The auditor should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the auditor.

19. The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk

associated with a control increases, the need for the auditor to perform his or her own work on the control increases.

Materiality

20. In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements.[11/]

Using a Top-Down Approach

21. The auditor should use a top-down approach to the audit of internal control over financial reporting to select the controls to test. A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the **financial statements and related disclosures**. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

> Note: The top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the auditing procedures.

Identifying Entity-Level Controls

22. The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

23. Entity-level controls vary in nature and precision –

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

[11/] See AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, which provides additional explanation of materiality.

- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.

- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

24. Entity-level controls include –

- Controls related to the control environment;

- Controls over management override;

  Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

- The company's risk assessment process;

- Centralized processing and controls, including shared service environments;

- Controls to monitor results of operations;

- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;

- Controls over the period-end financial reporting process; and

- Policies that address significant business control and risk management practices.

25. *Control Environment.* Because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company. As part of evaluating the control environment, the auditor should assess –

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the Board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

26. *Period-end Financial Reporting Process*. Because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following –

- Procedures used to enter transaction totals into the general ledger;
- Procedures related to the selection and application of accounting policies;
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements; and
- Procedures for preparing annual and quarterly financial statements and related disclosures.

  Note: Because the annual period-end financial reporting process normally occurs after the "as-of" date of management's assessment, those controls usually cannot be tested until after the as-of date.

27. As part of evaluating the period-end financial reporting process, the auditor should assess –

- Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;
- The extent of information technology ("IT") involvement in the period-end financial reporting process;
- Who participates from management;

- The locations involved in the period-end financial reporting process;

- The types of adjusting and consolidating entries; and

- The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.

  Note: The auditor should obtain sufficient evidence of the effectiveness of those quarterly controls that are important to determining whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion as of the date of management's assessment. However, the auditor is not required to obtain sufficient evidence for each quarter individually.

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

28. The auditor should identify significant accounts and disclosures and their relevant assertions. Relevant assertions are those financial statement assertions that have a reasonable possibility of containing a misstatement that would cause the financial statements to be materially misstated. The financial statement assertions include[12/] –

- Existence or occurrence

- Completeness

- Valuation or allocation

- Rights and obligations

- Presentation and disclosure

Note: The auditor may base his or her work on assertions that differ from those in this standard if the auditor has selected and tested controls over the pertinent risks in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.

29. To identify significant accounts and disclosures and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include –

[12/] See AU sec. 326, *Evidential Matter*, which provides additional information on financial statement assertions.

- Size and composition of the account;
- Susceptibility to misstatement due to errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;
- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- Existence of related party transactions in the account; and
- Changes from the prior period in account or disclosure characteristics.

30. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

31. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

> Note: In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts, disclosures and assertions that are not determined to be significant accounts and disclosures and relevant assertions.[13/]

[13/] This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (see AU sec. 312.39 for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed

32. The components of a potential significant account or disclosure might be subject to significantly differing risks. If so, different controls might be necessary to adequately address those risks.

33. When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements. Having made those determinations, the auditor should then apply the direction in Appendix B for multiple locations scoping decisions.

Understanding Likely Sources of Misstatement

34. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives –

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;

- Verify that the auditor has identified the points within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material;

- Identify the controls that management has implemented to address these potential misstatements; and

- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.

35. Because of the degree of judgment required, the auditor should either perform the procedures that achieve the objectives in paragraph 34 himself or herself or supervise the work of others who provide direct assistance to the auditor, as described in AU sec. 322.

36. The auditor also should understand how IT affects the company's flow of transactions. The auditor should apply paragraphs .16 through .20, .30 through .32, and .77 through .79, of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, which discuss the effect of information technology on internal control over financial reporting and the risks to assess.

(see paragraph 61 and AU sec. 316.50 for further discussion about predictability of auditing procedures).

Note: The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify significant accounts and disclosures and their relevant assertions, and the controls to test, as well as to assess risk and allocate audit effort as described by this standard.

37. *Performing Walkthroughs.* Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 34. In performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

38. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

Selecting Controls to Test

39. The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

40. There might be more than one control that addresses the assessed risk of misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

41. The decision as to whether a control should be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement to a given relevant assertion rather than on how the control is labeled (e.g., entity-level control, transaction-level control, control activity, monitoring control, **preventive control**, **detective control**).

Testing Controls

Testing Design Effectiveness

42. The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

> Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, 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. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

43. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

44. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

> Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.

45. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Relationship of Risk to the Evidence to be Obtained

46. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control.

The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

> Note: Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

47. Factors that affect the risk associated with a control include –

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls, especially controls that monitor other controls;
- The nature of the control and the frequency with which it operates;
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and

  Note: A less complex company or business unit with simple business processes and centralized accounting operations might have 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 might 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.

- The complexity of the control and the significance of the judgments that must be made in connection with its operation.

  Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

48. When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.

49. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing may provide sufficient evidence in relation to the risk associated with the control.

Note: Walkthroughs usually consist of a combination of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control and might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough and the results of those procedures.

50. *Nature of Tests of Controls*. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

51. The nature of the tests of effectiveness that will provide competent evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls, might provide sufficient evidence about whether the control is effective.

52. *Timing of Tests of Controls*. Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the date of management's assessment provides more evidence than testing performed earlier in the year. The auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness.

53. Prior to the date specified in management's assessment, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment, the auditor should test the design and operating effectiveness of those superseded controls, as appropriate. (See additional direction on integration beginning at paragraph B1.)

54. *Extent of Tests of Controls*. The more extensively a control is tested, the greater the evidence obtained from that test.

55. *Roll-Forward Procedures.* When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

56. The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors –

- The specific control tested prior to the as-of date, including the risks associated with the control and the nature of the control, and the results of those tests;
- The sufficiency of the evidence of effectiveness obtained at an interim date;
- The length of the remaining period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.

Special Considerations for Subsequent Years' Audits

57. In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary. This decision-making process is described in paragraphs 46 through 56.

58. Factors that affect the risk associated with a control in subsequent years' audits include those in paragraph 47 and the following –

- The nature, timing, and extent of procedures performed in previous audits,
- The results of the previous years' testing of the control, and
- Whether there have been changes in the control or the process in which it operates since the previous audit.

59. After taking into account the risk factors identified in paragraphs 47 and 58, the additional information available in subsequent years' audits might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.

60. The auditor may also use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28.

61. In addition, the auditor should vary the nature, timing, and extent of testing of controls from year to year to introduce unpredictability into the testing and respond to

changes in circumstances. For this reason, each year the auditor might test controls at a different interim period, increase or reduce the number and types of tests performed, or change the combination of procedures used.

Evaluating Identified Deficiencies

62. The auditor must evaluate the severity of each control **deficiency** that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.

63. The severity of a deficiency depends on –

- Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and

- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

64. The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.

65. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following –

- The nature of the financial statement accounts, disclosures, and assertions involved;
- The susceptibility of the related asset or liability to loss or fraud;

- The subjectivity, complexity, or extent of judgment required to determine the amount involved;

- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;

- The interaction of the deficiencies; and

- The possible future consequences of the deficiency.

Note: The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

Note: Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.

66. Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in controls include, but are not limited to, the following –

- The financial statement amounts or total of transactions exposed to the deficiency; and

- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

67. In evaluating the magnitude of the potential misstatement, the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

68. The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.

Indicators of Material Weaknesses

69. Indicators of material weaknesses in internal control over financial reporting include –

- Identification of fraud, whether or not material, on the part of senior management;[14/]

[14/] For the purpose of this indicator, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of the Act as well as any other members of senior management who play a significant role in the company's financial reporting process.

- Restatement of previously issued financial statements to reflect the correction of a material misstatement;[15/]

- Identification by the auditor of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting; and

- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

70. When evaluating the severity of a deficiency, or combination of deficiencies, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that a deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then the auditor should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

Wrapping-Up

Forming an Opinion

71. The auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies.

> Note: As part of this evaluation, the auditor should review reports issued during the year by internal audit (or similar functions) that address controls related to internal control over financial reporting and evaluate control deficiencies identified in those reports.

72. After forming an opinion on the effectiveness of the company's internal control over financial reporting, the auditor should evaluate the presentation of the elements

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[15/] See Financial Accounting Standards Board Statement No. 154, *Accounting Changes and Error Corrections*, regarding the correction of a misstatement.

that management is required, under the SEC's rules, to present in its annual report on internal control over financial reporting.[16/]

73. If the auditor determines that any required elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should follow the direction in paragraph C2.

74. The auditor may form an opinion on the effectiveness of internal control over financial reporting only when there have been no restrictions on the scope of the auditor's work. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement (see paragraphs C3 through C7).

Obtaining Written Representations

75. In an audit of internal control over financial reporting, the auditor should obtain written representations from management –

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;

b. Stating that management has performed an evaluation and made an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;

c. Stating that management did not use the auditor's procedures performed during the audits of internal control over financial reporting or the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting;

d. Stating management's conclusion, as set forth in its assessment, about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;

e. Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's evaluation, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;

f. Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material

[16/] See Item 308(a) of Regulations S-B and S-K, 17 C.F.R. §§ 228.308(a) and 229.308(a).

misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;

g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraphs 77 and 79 have been resolved, and specifically identifying any that have not; and

h. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

76. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit. As discussed further in paragraph C3, when the scope of the audit is limited, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including those obtained in the audit of the company's financial statements.

77. AU sec. 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter.

Communicating Certain Matters

78. The auditor must communicate, in writing, to management and the audit committee all material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting.

79. If the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors.

80. The auditor also should consider whether there are any deficiencies, or combinations of deficiencies, that have been identified during the audit that are **significant deficiencies** and must communicate such deficiencies, in writing, to the audit committee.

81. The auditor also should communicate to management, in writing, all deficiencies in internal control over financial reporting (i.e., those deficiencies in internal control over

financial reporting that are of a lesser magnitude than material weaknesses) identified during the audit and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that has been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization.

82. The auditor is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the auditor communicates deficiencies in internal control over financial reporting of which he or she is aware.

83. Because the audit of internal control over financial reporting does not provide the auditor with assurance that he or she has identified all deficiencies less severe than a material weakness, the auditor should not issue a report stating that no such deficiencies were noted during the audit.

84. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. In such circumstances, the auditor must determine his or her responsibilities under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[17/]

Reporting on Internal Control

85. The auditor's report on the audit of internal control over financial reporting must include the following elements[18/] –

a. A title that includes the word *independent*;

b. A statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;

c. An identification of management's report on internal control;

d. A statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on his or her audit;

[17/] See 15 U.S.C. § 78j-1.

[18/] See Appendix C, which provides direction on modifications to the auditor's report that are required in certain circumstances.

e. A definition of internal control over financial reporting as stated in paragraph A5;

f. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

g. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

h. A statement that an audit includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;

i. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;

j. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;

k. The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria;

l. The manual or printed signature of the auditor's firm;

m. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

n. The date of the audit report.

Separate or Combined Reports

86. The auditor may choose to issue a combined report (i.e., one report containing both an opinion on the financial statements and an opinion on internal control over

financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting.

87. The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8. We also have audited W Company's internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

[*Scope paragraph*]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria,* for *example, "criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

88. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph to the auditor's report on the financial statements –

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), W Company's internal control over financial reporting as of December 31, 20X8, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

The auditor also should add the following paragraph to the report on internal control over financial reporting –

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

Report Date

89. The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Because the auditor cannot audit internal control over financial reporting without also auditing the financial statements, the reports should be dated the same.

Material Weaknesses

90. Paragraphs 62 through 70 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement.[19/]

91. When expressing an adverse opinion on internal control over financial reporting because of a material weakness, the auditor's report must include –

- The definition of a material weakness, as provided in paragraph A7.
- A statement that a material weakness has been identified and an identification of the material weakness described in management's assessment.

[19/] See paragraph C3 for direction when the scope of the engagement has been limited.

Note: If the material weakness has not been included in management's assessment, the report should be modified to state that a material weakness has been identified but not included in management's assessment. Additionally, the auditor's report should include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. In this case, the auditor also should communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's assessment. If the material weakness has been included in management's assessment but the auditor concludes that the disclosure of the material weakness is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe the material weakness.

92. The auditor should determine the effect his or her adverse opinion on internal control has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements was affected by the adverse opinion on internal control over financial reporting.

Note: If the auditor issues a separate report on internal control over financial reporting in this circumstance, the disclosure required by this paragraph may be combined with the report language described in paragraphs 88 and 91. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.

Subsequent Events

93. Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors and obtain written representations from management relating to such matters, as described in paragraph 75h.

94. To obtain additional information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following –

- Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period,

- Independent auditor reports (if other than the auditor's) of deficiencies in internal control,

- Regulatory agency reports on the company's internal control over financial reporting, and

- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

95. The auditor might inquire about and examine other documents for the subsequent period. Paragraphs .01 through .09 of AU sec. 560, *Subsequent Events*, provide direction on subsequent events for a financial statement audit that also may be helpful to the auditor performing an audit of internal control over financial reporting.

96. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment, the auditor should issue an adverse opinion on internal control over financial reporting (and follow the direction in paragraph C2 if management's assessment states that internal control over financial reporting is effective). If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim an opinion. As described in paragraph C13, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

97. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date and before issuance of the auditor's report. If a subsequent event of this type has a material effect on the company's internal control over financial reporting, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report.

98. After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows –

A2. A **control objective** provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant assertion and states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented or detected by controls on a timely basis.

A3. A **deficiency** in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

A4. **Financial statements and related disclosures** refers to a company's financial statements and notes to the financial statements as presented in accordance with generally accepted accounting principles ("GAAP"). References to financial statements and related disclosures do not extend to the preparation of management's discussion and analysis or other similar financial information presented outside a company's GAAP-basis financial statements and notes.

A5. **Internal control over financial reporting** is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that –

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with

generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.[1/]

Note: The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal control over financial reporting.

Note: Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

A6. **Management's assessment** is the assessment described in Item 308(a)(3) of Regulations S-B and S-K that is included in management's annual report on internal control over financial reporting.[2/]

A7. A **material weakness** is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Note: There is a **reasonable possibility** of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS 5").[3/]

[1/] See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f).

[2/] See 17 C.F.R. §§ 228.308(a)(3) and 229.308(a)(3).

[3/] See FAS 5, paragraph 3.

A8. Controls over financial reporting may be **preventive controls** or **detective controls**. Effective internal control over financial reporting often includes a combination of preventive and detective controls.

- Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring.
- Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements.

A9. A **relevant assertion** is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

A10. An account or disclosure is a **significant account or disclosure** if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

A11. A **significant deficiency** is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

APPENDIX B – Special Topics

Integration of Audits

B1. *Tests of Controls in an Audit of Internal Control.* The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole*.

B2. To express an opinion on internal control over financial reporting as of a point in time, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

B3. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on internal control over financial reporting, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

B4. *Tests of Controls in an Audit of Financial Statements.* To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

B5. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the company's internal control over financial reporting, as discussed in paragraph B2. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

B6. *Effect of Tests of Controls on Substantive Procedures.* If, during the audit of internal control over financial reporting, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

B7. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

B8. *Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls.* In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum –

- The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.

- Findings with respect to illegal acts and related party transactions.

- Indications of management bias in making accounting estimates and in selecting accounting principles.

- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

B9. To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Multiple Locations Scoping Decisions

B10. In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk.

> Note: The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the company's consolidated financial statements.

B11. In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements. In lower-risk locations or business units, the auditor first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient evidence.

B12. In determining the locations or business units at which to perform tests of controls, the auditor may take into account work performed by others on behalf of management. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of locations or business units at which the auditor would otherwise need to perform auditing procedures.

B13. The direction in paragraph 61 regarding special considerations for subsequent years' audits means that the auditor should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.

B14. *Special Situations.* The scope of the audit should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The direction in this multiple-locations discussion describes how to determine whether it is necessary to test controls at these entities or operations.

B15. For equity method investments, the scope of the audit should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The audit ordinarily would not extend to controls at the equity method investee.

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not

be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AU sec. 722, *Interim Financial Information*. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

Use of Service Organizations

B17. AU sec. 324, *Service Organizations*, applies to the audit of financial statements of a company that obtains services from another organization that are part of the company's information system. The auditor may apply the relevant concepts described in AU sec. 324 to the audit of internal control over financial reporting.

B18. AU sec. 324.03 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, the auditor should include the activities of the service organization when determining the evidence required to support his or her opinion.

B19. AU sec. 324.07 through .16 describe the procedures that the auditor should perform with respect to the activities performed by the service organization. The procedures include –

a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and

b. Obtaining evidence that the controls that are relevant to the auditor's opinion are operating effectively.

B20. Evidence that the controls that are relevant to the auditor's opinion are operating effectively may be obtained by following the procedures described in AU sec. 324.12. These procedures include –

a. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in AU sec. 324.24b). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in AU sec. 324.24a) does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU sec. 324, the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

b. Performing tests of the user organization's controls over the activities of the service organization (e.g., testing the user organization's independent re-performance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).

c. Performing tests of controls at the service organization.

B21. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient evidence to support his or her opinion. In evaluating whether such a service auditor's report provides sufficient evidence, the auditor should assess the following factors –

- The time period covered by the tests of controls and its relation to the as-of date of management's assessment,

- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls, and

- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements, as described in AU sec. 324.16.

B22. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures.

B23. In determining whether the service auditor's report provides sufficient evidence to support the auditor's opinion, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10a of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

B24. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.

B25. The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors. As risk increases, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment,

- The significance of the activities of the service organization,

- Whether there are errors that have been identified in the service organization's processing, and

- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

B26. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures might include –

- Evaluating procedures performed by management and the results of those procedures.

- Contacting the service organization, through the user organization, to obtain specific information.

- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.

- Visiting the service organization and performing such procedures.

B27. The auditor should not refer to the service auditor's report when expressing an opinion on internal control over financial reporting.

Benchmarking of Automated Controls

B28. Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.

B29. If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.

B30. The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

B31. To determine whether to use a benchmarking strategy, the auditor should assess the following risk factors. As these factors indicate lower risk, the control being evaluated might be well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated is less suited for benchmarking. These factors are –

- The extent to which the application control can be matched to a defined program within an application.

- The extent to which the application is stable (i.e., there are few changes from period to period).

- The availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed.)

B32. Benchmarking automated application controls can be especially effective for companies using purchased software when the possibility of program changes is remote – e.g., when the vendor does not allow access or modification to the source code.

B33. After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be reestablished. To determine when to reestablish a baseline, the auditor should evaluate the following factors –

- The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations.

- The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls.

- The nature and timing of other related tests.

- The consequences of errors associated with the application control that was benchmarked.

- Whether the control is sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

APPENDIX C – Special Reporting Situations

Report Modifications

C1. The auditor should modify his or her report if any of the following conditions exist.

a. Elements of management's annual report on internal control are incomplete or improperly presented,

b. There is a restriction on the scope of the engagement,

c. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report,

d. There is other information contained in management's annual report on internal control over financial reporting, or

e. Management's annual certification pursuant to Section 302 of the Sarbanes-Oxley Act is misstated.

C2. *Elements of Management's Annual Report on Internal Control Over Financial Reporting Are Incomplete or Improperly Presented.* If the auditor determines that elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should modify his or her report to include an explanatory paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about a material weakness is not fairly presented in all material respects, the auditor should follow the direction in paragraph 91.

C3. *Scope Limitations*. The auditor can express an opinion on the company's internal control over financial reporting only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion states that the auditor does not express an opinion on the effectiveness of internal control over financial reporting.

C4. When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal control over financial reporting (paragraph 85 g, h, and i); to do so might overshadow the disclaimer.

C5. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report also should include –

- The definition of a material weakness, as provided in paragraph A7.

- A description of any material weaknesses identified in the company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraph 91.

C6. The auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

> Note: In this case, in following the direction in paragraph 89 regarding dating the auditor's report, the report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

C7. If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the audit, the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

C8. *Opinions Based, in Part, on the Report of Another Auditor*. When another auditor has audited the financial statements and internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion. AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements must participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

C9. When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by the other auditor. In these circumstances, the auditor's decision is based on factors analogous to those of the auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AU sec. 543.

C10. The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because management's assessment of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.[1/]

C11. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion on the company's internal control over financial reporting, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinion.

C12. *Management's Annual Report on Internal Control Over Financial Reporting Containing Additional Information*. Management's annual report on internal control over financial reporting may contain information in addition to the elements described in paragraph 72 that are subject to the auditor's evaluation.

C13. If management's annual report on internal control over financial reporting could reasonably be viewed by users of the report as including such additional information, the auditor should disclaim an opinion on the information.

C14. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. AU sec. 317, *Illegal Acts by Clients* and Section 10A of the Securities Exchange Act of 1934 may also require the auditor to take additional action.[2/]

[1/] See paragraph B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

[2/] See 15 U.S.C. § 78j-1.

Note: If management makes the types of disclosures described in paragraph C12 outside its annual report on internal control over financial reporting and includes them elsewhere within its annual report on the company's financial statements, the auditor would not need to disclaim an opinion. However, in that situation, the auditor's responsibilities are the same as those described in this paragraph if the auditor believes that the additional information contains a material misstatement of fact.

C15. *Management's Annual Certification Pursuant to Section 302 of the Sarbanes-Oxley Act is Misstated.* If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[3/] the auditor should follow the communication responsibilities as described in AU sec. 722 *Interim Financial Information*, for any interim period. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in AU sec. 722, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Filings Under Federal Securities Statutes

C16. AU sec. 711, *Filings Under Federal Securities Statutes*, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should apply AU sec. 711 with respect to the auditor's report on internal control over financial reporting included in such filings. In addition, the auditor should extend the direction in AU sec. 711.10 to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements to matters that could have a material effect on internal control over financial reporting.

C17. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on internal control over financial reporting in the securities filing, the auditor's consent should clearly indicate that both the audit report on financial statements and the audit report on internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

[3/] See 17 C.F.R. §§ 240.13a-14(a) and 240.15d-14(a).

Rule 3525: Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting

In connection with seeking audit committee pre-approval to perform for an audit client any permissible non-audit service related to internal control over financial reporting, a registered public accounting firm shall –

(a) describe, in writing, to the audit committee of the issuer the scope of the service;

(b) discuss with the audit committee of the issuer the potential effects of the service on the independence of the firm; and

Note: Independence requirements provide that an auditor is not independent of his or her audit client if the auditor is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Several principles guide the application of this general standard, including whether the auditor assumes a management role or audits his or her own work. Therefore, an auditor would not be independent if, for example, management had delegated its responsibility for internal control over financial reporting to the auditor or if the auditor had designed or implemented the audit client's internal control over financial reporting.

(c) document the substance of its discussion with the audit committee of the issuer.

Conforming Amendments to PCAOB Auditing Standards

AU sec. 230, "Due Professional Care in the Performance of Work"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures," section 230, "Due Professional Care in the Performance of Work" (AU sec. 230, "Due Professional Care in the Performance of Work"), as amended, is amended as follows –

a. Paragraph .10 is replaced with –

The exercise of due professional care allows the auditor to obtain *reasonable assurance* about whether the financial statements are free of material misstatement, whether caused by error or fraud, or whether any material weaknesses exist as of the date of management's assessment. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Although not absolute assurance, reasonable assurance is a high level of assurance. Therefore, an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) may not detect a material weakness in internal control over financial reporting or a material misstatement to the financial statements.

b. The term "financial statements" within the first sentence of paragraph .13 is replaced with the term "financial statements or internal control over financial reporting."

c. The second sentence of paragraph .13 is replaced with –

Therefore, the subsequent discovery that either a material misstatement, whether from error or fraud, exists in the financial statements or a material weakness in internal control over financial reporting exists does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with the standards of the Public Company Accounting Oversight Board (United States).

AU sec. 310, "Appointment of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, is amended as follows –

a. The third bullet point of paragraph .06 is replaced with –

Management is responsible for establishing and maintaining effective internal control over financial reporting. If, in an integrated audit of financial statements and internal control over financial reporting, the auditor concludes that he or she cannot express an opinion on internal control over financial reporting because there has been a limitation on the scope of the audit, he or she should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

b. The eighth bullet point of paragraph .06 is amended as follows –

Under Integrated audit of financial statements and internal control over financial reporting, the last sub-bullet point is replaced with the following –

> To the board of directors – any conclusion that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.

Under Audit of financial statements, the last sub-bullet is replaced with the following –

> To the board of directors – if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the audit committee is ineffective, that conclusion.

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision" (AU sec. 311, "Planning and Supervision"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to paragraph 39 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 9 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), as amended, is amended as follows –

a. Within the note to paragraph 3, the reference to paragraphs 22-23 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 20 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. Within the note to paragraph 7, the reference to paragraphs 24-26 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 14-15 of PCAOB Auditing Standard No. 5, *An Audit of Internal*

Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

c. The note to paragraph 12 is replaced with –

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 9 and 20 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* regarding planning considerations and materiality, respectively.

d. Within the note to paragraph 18, the reference to Appendix B, *Additional Performance Requirements and Directions; Extent-of-Testing Examples* of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B10-B16 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

e. Within the note to paragraph 30, the reference to paragraphs 147-149 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 6-8 and paragraphs B1-B5 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards – 1983" (AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), is amended as follows –

Within the note to paragraph 1, the reference to paragraphs 98-103 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 52-53 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows –

The last sentence of paragraph 16 is replaced with –

Furthermore, the predecessor auditor is not a specialist as defined in AU sec. 336, *Using the Work of a Specialist,* nor does the predecessor auditor's work constitute the work of others as described in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of*

Financial Statements, or paragraphs 16-19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), is amended as follows –

Within the note to paragraph 1, the reference to paragraphs 24-26 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 14-15 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), as amended, is amended as follows –

a. The note to paragraph 2 is replaced with –

   Note: Refer to paragraph A9 of Appendix A, *Definitions,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* for the definition of a relevant assertion and paragraphs 28-33 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* for discussion of identifying relevant assertions.

b. Within the note to paragraph 9, the reference to Appendix B, *Additional Performance Requirements and Directions; Extent of Testing Examples,* of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B10-B16 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

c. The last sentence of paragraph 33 is deleted.

d. The note to paragraph 65 is deleted.

e. The note to paragraph 83 is deleted.

f. Within the note to paragraph 97, the reference to paragraphs 104-105 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 54 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

g. The appendix at paragraph 110 is deleted.

AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"

SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), is amended as follows –

a. Within the note to paragraph 1, the reference to paragraphs 108-126 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 16-19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The note to paragraph 20 is deleted.

c. Within the note to paragraph 22, the reference to paragraph 122 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 18-19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations" (AU sec. 324, "Service Organizations"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to Appendix B, *Additional Performance Requirements and Directions; Extent-of-Testing Examples,* of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B17-B27 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements"[1/]

[1/] When the Board adopted Auditing Standard No. 2, it superseded SAS No. 60 in the context of an integrated audit of financial statements and internal control over financial reporting by paragraphs 207-214 of Auditing Standard No. 2. See PCAOB Release No. 2004-008, *Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements"* (Sept. 15, 2004). As a result of superseding Auditing Standard No. 2, paragraphs 78-84 of Auditing Standard No. 5, *An Audit of Internal Control Over*

AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements" is amended as follows –

a. The first bullet point before paragraph 1 is amended as follows –

The reference to paragraphs 207-214 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 78-84 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The first bullet point in paragraph 1 is replaced with –

A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

c. Paragraph 2 is replaced with –

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

d. The notes to paragraph 2 are deleted.

e. Paragraph 3 is replaced with –

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Note: There is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in paragraph 3 of Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*.

Note: In evaluating whether a deficiency exists and whether deficiencies, either individually or in combination with other deficiencies, are material weaknesses, the auditor should follow the direction in paragraphs 62-70 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Financial Reporting That Is Integrated with An Audit of Financial Statements, now supersede SAS No. 60 in the context of an integrated audit.

f. Paragraph 5 is replaced with –

If oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that circumstance should be regarded as an indicator that a material weakness in internal control over financial reporting exists. Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight in an audit of only the financial statements, if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that information in writing to the board of directors.

g. The last sentence of paragraph 9 is replaced with –

In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph 2 of this standard.

AU sec. 9325, "Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325"

AU sec. 9325, "Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325" is amended as follows –

The note prior to paragraph 1 is replaced with –

Note: In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph 2 of this standard. Within the example report within paragraph 4 of the interpretation, the third sentence is replaced with the definition of a material weakness in paragraph A7 of Appendix A, *Definitions,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), is amended as follows –

The first sentence of paragraph 41 is replaced with –

Events and transactions that occur after the balance-sheet date but before the date of the auditor's report (for example, a sale of an investment shortly after the balance-sheet date), may provide audit evidence regarding management's fair value measurements as of the balance-sheet date [7/]

7/ The auditor's consideration of a subsequent event or transaction, as contemplated in this paragraph, is a substantive test and thus differs from the review of subsequent events performed pursuant to section 560, *Subsequent Events*.

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), is amended as follows –

The note to paragraph 11 is replaced with –

Note: When performing an integrated audit of financial statements and internal control over financial reporting, paragraph 39 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* states "[t]he auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if there are relevant assertions related to the company's investment in derivatives and securities, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and service organizations whose services are part of the entity's information system.

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows –

a. Within the note to paragraph 5, the reference to paragraphs 142-144 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 75-77 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The second sentence of paragraph 9 is replaced with –

Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the representations should be made as of the date of the auditor's report.

AU sec. 9337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337"

AU sec. 9337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337" is amended as follows –

a. The last sentence of paragraph 4 is replaced with –

What is the relationship between the effective date of the lawyer's response and the date of the auditor's report?

b. Paragraph 5 is replaced with –

Interpretation – Section 560.10 through .12 indicates that the auditor is concerned with events, which may require adjustment to, or disclosure in, the financial statements, occurring through the date of his or her report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the date of the auditor's report as is practicable in the circumstances. Consequently, specifying the effective date of the lawyer's response to reasonably approximate the expected date of the auditor's report will in most instances obviate the need for an updated response from the lawyer.

AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows –

The second sentence of paragraph 2 is replaced with –

The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), is amended as follows –

a. Subparagraph c. of paragraph 10 is replaced with –

c. Review subsequent events or transactions occurring prior to the date of the auditor's report.

b. Paragraph 13 is replaced with –

Review subsequent events or transactions. Events or transactions sometimes occur subsequent to the date of the balance sheet, but prior to the date of the auditor's report, that are important in identifying and evaluating the reasonableness of accounting estimates or key factors or assumptions used in the preparation of the estimate. In such circumstances, an evaluation of the estimate or of a key factor or assumption may be minimized or unnecessary as the event or transaction can be used by the auditor in evaluating their reasonableness.

AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees"), as amended, is amended as follows –

Within footnote 1 to paragraph 1, the reference to PCAOB Auditing Standard No. 2 is replaced with a reference to PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508, "Reports on Audited Financial Statements"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to paragraphs 162-199 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 85-98 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* and Appendix C, *Special Reporting Situations,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. The sentence that reads "In addition, see Appendix A, *Illustrative Reports on Internal Control Over Financial Reporting,* of PCAOB Auditing Standard No. 2, which includes an illustrative combined audit report and examples of separate reports," is replaced with, "In addition, see paragraphs 86-88 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* which includes an illustrative combined audit report."

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 530, "Dating of the Independent Auditor's Report" (AU sec. 530, "Dating of the Independent Auditor's Report"), as amended, is amended as follows –

a. Paragraph .01 is replaced with –

The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Paragraph .05 describes the procedure to be followed when a subsequent event occurring after the report date is disclosed in the financial statements.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same date.

Note: If the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion on the financial statements, then the auditor's report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

b. Paragraph .05 is replaced with –

The independent auditor has two methods for dating the report when a subsequent event disclosed in the financial statements occurs after the auditor has obtained sufficient competent evidence on which to base his or her opinion, but before the issuance of the related financial statements. The auditor may use "dual dating," for example, "February 16, 20__, except for Note __, as to which the date is March 1, 20__," or may date the report as of the later date. In the former instance, the responsibility for events occurring subsequent to the original report date is limited to the specific event referred to in the note (or otherwise disclosed). In the latter instance, the independent auditor's responsibility for subsequent events extends to the later report date and, accordingly, the procedures outlined in section 560.12 generally should be extended to that date.

c. Within the heading before paragraph .03, the reference to "completion of field work" is replaced with "the date of the independent auditor's report."

AU sec. 543, "Part of Audit Performed by Other Independent Auditors"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 543, "Part of Audit Performed by Other Independent Auditors" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), as amended, is amended as follows –

Within the note to paragraph .01, the reference to paragraphs 182-185 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs C8-C11 of Appendix C, *Special Reporting Situations,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 560, "Subsequent Events"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 560, "Subsequent Events" (AU sec. 560, "Subsequent Events"), as amended, is amended as follows –

a. Within the note to paragraph .01, the reference to paragraphs 186-189 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 93-97 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The second sentence of paragraph .12 is replaced with –

These procedures should be performed at or near the date of the auditor's report.

AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report" (AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"), as amended, is amended as follows –

Within the note to paragraph .01, the reference to paragraph 197 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 98 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 711, "Filings Under Federal Securities Statutes"

SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), is amended as follows –

a. Within the note to paragraph 2, the reference to paragraphs 198-199 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs C16-C17 of Appendix C, *Special Reporting Situations,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The third sentence of paragraph 10 is replaced with –

The likelihood that the auditor will discover subsequent events necessarily decreases following the date of the auditor's report, and, as a practical matter, after that time the independent auditor may rely, for the most part, on inquiries of responsible officials and employees.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), is amended as follows –

a. The following is inserted after the first sentence of paragraph 3 –

The SEC also requires management, with the participation of the principal executive and financial officers (the certifying officers) to make certain quarterly and annual certifications with respect to the company's internal control over financial reporting.[2/]

[2/] See Section 302 of the Sarbanes-Oxley Act of 2002, and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), (17 C.F.R. § 240.13a-14a or 17 C.F.R. § 240.15d-14a), whichever applies.

b. The note to paragraph 3 is deleted.

c. The following is added to the end of paragraph 7 –

Likewise, the auditor's responsibility as it relates to management's quarterly certifications on internal control over financial reporting is different from the auditor's responsibility as it relates to management's annual assessment of internal control over financial reporting. The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

> Note: The auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting take effect beginning with the first quarter after the company's first annual assessment of internal control over financial reporting as described in Item 308(a)(3) of Regulations S-B and S-K.

d. The following lettered section is added to the end of paragraph 18 –

g. Evaluating management's quarterly certifications about internal control over financial reporting by performing the following procedures –

- Inquiring of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information;

- Evaluating the implications of misstatements identified by the auditor as part of the auditor's other interim review procedures as they relate to effective internal control over financial reporting; and

- Determining, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

e. Paragraph 29 is replaced with –

As a result of conducting a review of interim financial information, the accountant may become aware of matters that cause him or her to believe that –

a. material modification should be made to the interim financial information for it to conform with generally accepted accounting principles;

b. modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies; and

c. the entity filed the Form 10-Q or Form 10-QSB before the completion of the review.

In such circumstances, the accountant should communicate the matter(s) to the appropriate level of management as soon as practicable.

f. Paragraph 32 is replaced with –

If the auditor becomes aware of information indicating that fraud or an illegal act has or may have occurred, the auditor must also determine his or her responsibilities under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[1/]

[1/] See 15 U.S.C. § 78j-1

g. Within paragraph 33, the third sentence is replaced with –

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

Auditing Standard No. 3, *Audit Documentation*

Auditing Standard No. 3, *Audit Documentation* is amended as follows –

Within footnote 2 to paragraph 6, the reference to paragraphs 68-70 of Auditing Standard No. 2 is replaced with a reference to paragraphs 28-33 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* is amended as follows –

a. Within note 1 to paragraph 1, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. Within paragraph 2, the two references to Auditing Standard No. 2 are replaced with references to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

c. Within the note to paragraph 2, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

d. Within paragraph 4, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

e. Paragraph 9 is replaced with –

The terms *internal control over financial reporting*, *deficiency*, *significant deficiency*, and *material weakness* have the same meanings as the definitions of those terms in Appendix A, *Definitions,* of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

f. The first sentence of paragraph 10 is replaced with –

Paragraph 5 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* states "[t]he auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting."

g. Within the note to paragraph 10, the reference to Auditing Standard No. 2 in the first sentence is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and the last sentence is amended as follows –

More information about the COSO framework is included within the COSO report.

h. Paragraph 11 is replaced with –

The terms *relevant assertion* and *control objective* have the same meaning as the definitions of those terms in Appendix A, *Definitions,* of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

i. Paragraph 13 is replaced with –

In an audit of internal control over financial reporting, the auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.[2/]

[2/] See paragraph 42 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

j. Within the note to paragraph 17, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

k. Within note 2 to paragraph 18, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

l. Within paragraph 21, the last sentence is deleted.

m. Within paragraph 23, the reference to paragraphs 22 and 23 of Auditing Standard No. 2 is replaced with a reference to paragraph 20 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Additionally, the second sentence is deleted.

n. Within paragraph 24, the reference to paragraph 39 of Auditing Standard No. 2 is replaced with a reference to paragraph 9 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

o. Within paragraph 25, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

p. Within the note to paragraph 25, the two references to Auditing Standard No. 2 are replaced with references to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

q. Within subparagraph a. of paragraph 26, the reference to paragraphs 47 through 51 of Auditing Standard No. 2 is replaced with a reference to paragraphs 22-27 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

r. Subparagraph b. of paragraph 26 is replaced with –

Perform the procedures described in paragraphs 34-38 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* for those transactions that are directly affected by controls specifically identified by management as addressing the material weakness.

s. The note to subparagraph b. of paragraph 26 is deleted.

t. Within paragraph 27, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

u. The note to paragraph 28 is deleted.

v. Within paragraph 31, the reference to paragraphs 88 through 91 of Auditing Standard No. 2 is replaced with a reference to paragraphs 42-43 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

w. Paragraph 32 is replaced with –

Consistent with the direction in paragraphs 44-45 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* the auditor should test the operating effectiveness of a specified control by determining whether the specified control operated as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively. In determining the nature, timing, and extent of tests of controls, the auditor should apply paragraphs 50-54 of Auditing Standard No. 5.

x. Paragraph 33 is replaced with –

The auditor should perform tests of the specified controls over a period of time that is adequate to determine whether, as of the date specified in management's assertion, the controls necessary for achieving the stated control objective are operating effectively. The timing of the auditor's tests should vary with the risk associated with the control being tested. For example, a transaction-based, daily reconciliation generally would permit the auditor to obtain sufficient evidence as to its operating effectiveness in a shorter period of time than a pervasive, entity-level control, such as any of those described in paragraphs 22-24 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Additionally, the auditor typically will be able to obtain sufficient evidence as to the operating effectiveness of controls over the company's period-end financial reporting process only by testing those controls in connection with a period-end.

y. Within paragraph 35, the reference to paragraphs B1 through B13 of Appendix B of Auditing Standard No. 2 is replaced with a reference to paragraphs B10-B16 of Appendix B, *Special Topics,* of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

z. Within paragraph 36, the reference to paragraphs 109 through 115 and 117 through 125 of Auditing Standard No. 2 is replaced with a reference to paragraphs 16-19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

aa. The second sentence of paragraph 37 is replaced with –

Therefore, if the auditor has been engaged to report on more than one material weakness or on more than one stated control objective, the auditor must evaluate whether he or she has obtained sufficient evidence that the control objectives related to each of the material weaknesses identified in management's assertion are achieved.

bb. The first two sentences of paragraph 38 are replaced with –

Paragraphs 18-19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* should be applied in the context of the engagement to report on whether a previously reported material weakness continues to exist.

cc. The note to paragraph 38 is deleted.

dd. The note to paragraph 39 is deleted.

ee. Paragraph 42 is replaced with –

Management may conclude that a previously reported material weakness no longer exists because its severity has been sufficiently reduced such that it is no longer a material weakness.

ff. Subparagraph f. of paragraph 44 is replaced with –

Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a misstatement in the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting and that has occurred or come to management's attention since the date of management's most recent annual assessment of internal control over financial reporting.

gg. Within the note to subparagraph b. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

hh. Within the note to subparagraph l. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

ii. Within the note to the second bullet point of subparagraph o. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

jj. Within paragraph 52, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

kk. Within paragraph 63, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29-32 of AU sec. 722, *Interim Financial Information*.

ll. Within paragraph 64, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29-32 of AU sec. 722, *Interim Financial Information*.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
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[Date]

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rule on Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, and Related Independence Rule and Conforming Amendments

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on May 25, 2007, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission" or "SEC") the proposed rules described in Items I, II, and III below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules.

I. Board's Statement of the Terms of Substance of the Proposed Rule

On May 24, 2007, the Board adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* ("Auditing Standard No. 5"); Rule 3525, *Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting*, and conforming amendments to its auditing standards. The proposed rule text is set out below.

Auditing Standard No. 5 –
An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

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APPENDICES

Introduction

1. This standard establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of **management's assessment**[1/] of the effectiveness of **internal control over financial reporting** ("the audit of internal control over financial reporting") that is integrated with an audit of the financial statements.[2/]

2. Effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.[3/] If one or more **material weakness**es exist, the company's internal control over financial reporting cannot be considered effective.[4/]

3. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting. Because a company's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance[5/] about whether material weaknesses exist as of the date specified in management's assessment. A material weakness in internal control over financial reporting may exist even when financial statements are not materially misstated.

4. The general standards[6/] are applicable to an audit of internal control over financial reporting. Those standards require technical training and proficiency as an auditor, independence, and the exercise of due professional care, including professional

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[1/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[2/] This auditing standard supersedes Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements,* and is the standard on attestation engagements referred to in Section 404(b) of the Act. It also is the standard referred to in Section 103(a)(2)(A)(iii) of the Act.

[3/] See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f); Paragraph A5.

[4/] See Item 308 of Regulation S-K, 17 C.F.R. § 229.308.

[5/] See AU sec. 230, *Due Professional Care in the Performance of Work*, for further discussion of the concept of reasonable assurance in an audit.

[6/] See AU sec. 150, *Generally Accepted Auditing Standards.*

skepticism. This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

5. The auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting.[7/]

Integrating the Audits

6. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.

7. In an integrated audit of internal control over financial reporting and the financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously –

- To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end, and

- To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

8. Obtaining sufficient evidence to support control risk assessments of low for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements. (See Appendix B for additional direction on integration.)

> Note: In some circumstances, particularly in some audits of smaller and less complex companies, the auditor might choose not to assess control risk as low for purposes of the audit of the financial statements. In such circumstances, the auditor's tests of the operating effectiveness of controls would be performed principally for the purpose of supporting his or her opinion on whether the

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[7/] See Securities Exchange Act Rules 13a-15(c) and 15d-15(c), 17 C.F.R. §§ 240.13a-15(c) and 240.15d-15(c). SEC rules require management to base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework (also known as control criteria) established by a body or group that followed due-process procedures, including the broad distribution of the framework for public comment. For example, the report of the Committee of Sponsoring Organizations of the Treadway Commission (known as the COSO report) provides such a framework, as does the report published by the Financial Reporting Council, Internal Control Revised Guidance for Directors on the Combined Code, October 2005 (known as the Turnbull Report).

company's internal control over financial reporting is effective as of year-end. The results of the auditor's financial statement auditing procedures also should inform his or her risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Planning the Audit

9. The auditor should properly plan the audit of internal control over financial reporting and properly supervise any assistants. When planning an integrated audit, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures –

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee[8/] or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;

[8/] If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;

- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and

- The relative complexity of the company's operations.

  Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Role of Risk Assessment

10. Risk assessment underlies the entire audit process described by this standard, including the determination of **significant accounts and disclosures** and **relevant assertion**s, the selection of controls to test, and the determination of the evidence necessary for a given control.

11. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

12. The complexity of the organization, business unit, or process, will play an important role in the auditor's risk assessment and the determination of the necessary procedures.

Scaling the Audit

13. The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its **control objective**s. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks. Scaling is most

effective as a natural extension of the risk-based approach and applicable to the audits of all companies. Accordingly, a smaller, less complex company, or even a larger, less complex company might achieve its control objectives differently than a more complex company.[9/]

Addressing the Risk of Fraud

14. When planning and performing the audit of internal control over financial reporting, the auditor should take into account the results of his or her fraud risk assessment.[10/] As part of identifying and testing entity-level controls, as discussed beginning at paragraph 22, and selecting other controls to test, as discussed beginning at paragraph 39, the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include –

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

15. If the auditor identifies deficiencies in controls designed to prevent or detect fraud during the audit of internal control over financial reporting, the auditor should take into account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit, as provided in AU sec. 316.44 and .45.

9/ The SEC Advisory Committee on Smaller Public Companies considered a company's size with respect to compliance with the internal control reporting provisions of the Act. See Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, Final Report, at p. 5 (April 23, 2006).

10/ See paragraphs .19 through .42 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* regarding identifying risks that may result in material misstatement due to fraud.

Using the Work of Others

16. The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* applies in an integrated audit of the financial statements and internal control over financial reporting.

17. For purposes of the audit of internal control, however, the auditor may use the work performed by, or receive direct assistance from, internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of internal control over financial reporting. In an integrated audit of internal control over financial reporting and the financial statements, the auditor also may use this work to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of the financial statements.

18. The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work. The auditor should apply paragraphs .09 through .11 of AU sec. 322 to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use.

> Note: For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding and knowledge that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the person's qualifications and ability to perform the work the auditor plans to use. To assess objectivity, the auditor should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the auditor plans to use.

> Note: The auditor should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the auditor.

19. The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk

associated with a control increases, the need for the auditor to perform his or her own work on the control increases.

Materiality

20. In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements.[11/]

Using a Top-Down Approach

21. The auditor should use a top-down approach to the audit of internal control over financial reporting to select the controls to test. A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the **financial statements and related disclosures**. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

> Note: The top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the auditing procedures.

Identifying Entity-Level Controls

22. The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

23. Entity-level controls vary in nature and precision –

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

[11/] See AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, which provides additional explanation of materiality.

- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.

- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

24. Entity-level controls include –

- Controls related to the control environment;

- Controls over management override;

  Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

- The company's risk assessment process;

- Centralized processing and controls, including shared service environments;

- Controls to monitor results of operations;

- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;

- Controls over the period-end financial reporting process; and

- Policies that address significant business control and risk management practices.

25. *Control Environment.* Because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company. As part of evaluating the control environment, the auditor should assess –

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the Board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

26. *Period-end Financial Reporting Process*. Because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following –

- Procedures used to enter transaction totals into the general ledger;
- Procedures related to the selection and application of accounting policies;
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements; and
- Procedures for preparing annual and quarterly financial statements and related disclosures.

  Note: Because the annual period-end financial reporting process normally occurs after the "as-of" date of management's assessment, those controls usually cannot be tested until after the as-of date.

27. As part of evaluating the period-end financial reporting process, the auditor should assess –

- Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;
- The extent of information technology ("IT") involvement in the period-end financial reporting process;
- Who participates from management;

- The locations involved in the period-end financial reporting process;
- The types of adjusting and consolidating entries; and
- The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.

  Note: The auditor should obtain sufficient evidence of the effectiveness of those quarterly controls that are important to determining whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion as of the date of management's assessment. However, the auditor is not required to obtain sufficient evidence for each quarter individually.

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

28. The auditor should identify significant accounts and disclosures and their relevant assertions. Relevant assertions are those financial statement assertions that have a reasonable possibility of containing a misstatement that would cause the financial statements to be materially misstated. The financial statement assertions include[12/] –

- Existence or occurrence
- Completeness
- Valuation or allocation
- Rights and obligations
- Presentation and disclosure

Note: The auditor may base his or her work on assertions that differ from those in this standard if the auditor has selected and tested controls over the pertinent risks in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.

29. To identify significant accounts and disclosures and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include –

[12/] See AU sec. 326, *Evidential Matter*, which provides additional information on financial statement assertions.

- Size and composition of the account;
- Susceptibility to misstatement due to errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;
- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- Existence of related party transactions in the account; and
- Changes from the prior period in account or disclosure characteristics.

30. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

31. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

> Note: In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts, disclosures and assertions that are not determined to be significant accounts and disclosures and relevant assertions.[13/]

[13/] This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (see AU sec. 312.39 for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed

32. The components of a potential significant account or disclosure might be subject to significantly differing risks. If so, different controls might be necessary to adequately address those risks.

33. When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements. Having made those determinations, the auditor should then apply the direction in Appendix B for multiple locations scoping decisions.

Understanding Likely Sources of Misstatement

34. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives –

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;

- Verify that the auditor has identified the points within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material;

- Identify the controls that management has implemented to address these potential misstatements; and

- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.

35. Because of the degree of judgment required, the auditor should either perform the procedures that achieve the objectives in paragraph 34 himself or herself or supervise the work of others who provide direct assistance to the auditor, as described in AU sec. 322.

36. The auditor also should understand how IT affects the company's flow of transactions. The auditor should apply paragraphs .16 through .20, .30 through .32, and .77 through .79, of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, which discuss the effect of information technology on internal control over financial reporting and the risks to assess.

(see paragraph 61 and AU sec. 316.50 for further discussion about predictability of auditing procedures).

Note: The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify significant accounts and disclosures and their relevant assertions, and the controls to test, as well as to assess risk and allocate audit effort as described by this standard.

37. *Performing Walkthroughs.* Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 34. In performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

38. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

Selecting Controls to Test

39. The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

40. There might be more than one control that addresses the assessed risk of misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

41. The decision as to whether a control should be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement to a given relevant assertion rather than on how the control is labeled (e.g., entity-level control, transaction-level control, control activity, monitoring control, **preventive control**, **detective control**).

Testing Controls

Testing Design Effectiveness

42. The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

> Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, 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. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

43. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

44. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

> Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.

45. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Relationship of Risk to the Evidence to be Obtained

46. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be

effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

> Note: Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

47. Factors that affect the risk associated with a control include –

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls, especially controls that monitor other controls;
- The nature of the control and the frequency with which it operates;
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and

  Note: A less complex company or business unit with simple business processes and centralized accounting operations might have 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 might 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.

- The complexity of the control and the significance of the judgments that must be made in connection with its operation.

  Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

48. When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.

49. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing may provide sufficient evidence in relation to the risk associated with the control.

Note: Walkthroughs usually consist of a combination of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control and might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough and the results of those procedures.

50. *Nature of Tests of Controls*. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

51. The nature of the tests of effectiveness that will provide competent evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

> Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls, might provide sufficient evidence about whether the control is effective.

52. *Timing of Tests of Controls*. Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the date of management's assessment provides more evidence than testing performed earlier in the year. The auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness.

53. Prior to the date specified in management's assessment, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment, the auditor should test the design and operating effectiveness of those superseded controls, as appropriate. (See additional direction on integration beginning at paragraph B1.)

54. *Extent of Tests of Controls*. The more extensively a control is tested, the greater the evidence obtained from that test.

55. *Roll-Forward Procedures.* When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

56. The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors –

- The specific control tested prior to the as-of date, including the risks associated with the control and the nature of the control, and the results of those tests;
- The sufficiency of the evidence of effectiveness obtained at an interim date;
- The length of the remaining period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.

Special Considerations for Subsequent Years' Audits

57. In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary. This decision-making process is described in paragraphs 46 through 56.

58. Factors that affect the risk associated with a control in subsequent years' audits include those in paragraph 47 and the following –

- The nature, timing, and extent of procedures performed in previous audits,
- The results of the previous years' testing of the control, and
- Whether there have been changes in the control or the process in which it operates since the previous audit.

59. After taking into account the risk factors identified in paragraphs 47 and 58, the additional information available in subsequent years' audits might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.

60. The auditor may also use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28.

61. In addition, the auditor should vary the nature, timing, and extent of testing of controls from year to year to introduce unpredictability into the testing and respond to changes in circumstances. For this reason, each year the auditor might test controls at

a different interim period, increase or reduce the number and types of tests performed, or change the combination of procedures used.

Evaluating Identified Deficiencies

62. The auditor must evaluate the severity of each control **deficiency** that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.

63. The severity of a deficiency depends on –

- Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and
- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

64. The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.

65. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following –

- The nature of the financial statement accounts, disclosures, and assertions involved;
- The susceptibility of the related asset or liability to loss or fraud;
- The subjectivity, complexity, or extent of judgment required to determine the amount involved;
- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;
- The interaction of the deficiencies; and
- The possible future consequences of the deficiency.

Note: The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

Note: Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.

66. Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in controls include, but are not limited to, the following –

- The financial statement amounts or total of transactions exposed to the deficiency; and

- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

67. In evaluating the magnitude of the potential misstatement, the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

68. The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.

Indicators of Material Weaknesses

69. Indicators of material weaknesses in internal control over financial reporting include –

- Identification of fraud, whether or not material, on the part of senior management;[14/]

- Restatement of previously issued financial statements to reflect the correction of a material misstatement;[15/]

[14/] For the purpose of this indicator, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of the Act as well as any other members of senior management who play a significant role in the company's financial reporting process.

- Identification by the auditor of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting; and

- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

70. When evaluating the severity of a deficiency, or combination of deficiencies, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that a deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then the auditor should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

Wrapping-Up

Forming an Opinion

71. The auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies.

> Note: As part of this evaluation, the auditor should review reports issued during the year by internal audit (or similar functions) that address controls related to internal control over financial reporting and evaluate control deficiencies identified in those reports.

72. After forming an opinion on the effectiveness of the company's internal control over financial reporting, the auditor should evaluate the presentation of the elements that management is required, under the SEC's rules, to present in its annual report on internal control over financial reporting.[16/]

[15/] See Financial Accounting Standards Board Statement No. 154, *Accounting Changes and Error Corrections*, regarding the correction of a misstatement.

[16/] See Item 308(a) of Regulations S-B and S-K, 17 C.F.R. §§ 228.308(a) and 229.308(a).

73. If the auditor determines that any required elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should follow the direction in paragraph C2.

74. The auditor may form an opinion on the effectiveness of internal control over financial reporting only when there have been no restrictions on the scope of the auditor's work. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement (see paragraphs C3 through C7).

Obtaining Written Representations

75. In an audit of internal control over financial reporting, the auditor should obtain written representations from management –

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;

b. Stating that management has performed an evaluation and made an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;

c. Stating that management did not use the auditor's procedures performed during the audits of internal control over financial reporting or the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting;

d. Stating management's conclusion, as set forth in its assessment, about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;

e. Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's evaluation, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;

f. Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;

g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraphs 77 and 79 have been resolved, and specifically identifying any that have not; and

h. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

76. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit. As discussed further in paragraph C3, when the scope of the audit is limited, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including those obtained in the audit of the company's financial statements.

77. AU sec. 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter.

Communicating Certain Matters

78. The auditor must communicate, in writing, to management and the audit committee all material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting.

79. If the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors.

80. The auditor also should consider whether there are any deficiencies, or combinations of deficiencies, that have been identified during the audit that are **significant deficiencies** and must communicate such deficiencies, in writing, to the audit committee.

81. The auditor also should communicate to management, in writing, all deficiencies in internal control over financial reporting (i.e., those deficiencies in internal control over financial reporting that are of a lesser magnitude than material weaknesses) identified during the audit and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that has been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization.

82. The auditor is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the auditor communicates deficiencies in internal control over financial reporting of which he or she is aware.

83. Because the audit of internal control over financial reporting does not provide the auditor with assurance that he or she has identified all deficiencies less severe than a material weakness, the auditor should not issue a report stating that no such deficiencies were noted during the audit.

84. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. In such circumstances, the auditor must determine his or her responsibilities under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[17/]

Reporting on Internal Control

85. The auditor's report on the audit of internal control over financial reporting must include the following elements[18/] –

a. A title that includes the word *independent*;

b. A statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;

c. An identification of management's report on internal control;

d. A statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on his or her audit;

e. A definition of internal control over financial reporting as stated in paragraph A5;

f. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

17/ See 15 U.S.C. § 78j-1.

18/ See Appendix C, which provides direction on modifications to the auditor's report that are required in certain circumstances.

g. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

h. A statement that an audit includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;

i. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;

j. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;

k. The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria;

l. The manual or printed signature of the auditor's firm;

m. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

n. The date of the audit report.

Separate or Combined Reports

86. The auditor may choose to issue a combined report (i.e., one report containing both an opinion on the financial statements and an opinion on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting.

87. The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8. We also have audited W Company's internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

[*Scope paragraph*]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

88. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph to the auditor's report on the financial statements –

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), W Company's internal control over financial reporting as of December 31, 20X8, based on [*identify control criteria*]

> and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

The auditor also should add the following paragraph to the report on internal control over financial reporting –

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

Report Date

89. The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Because the auditor cannot audit internal control over financial reporting without also auditing the financial statements, the reports should be dated the same.

Material Weaknesses

90. Paragraphs 62 through 70 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement.[19/]

91. When expressing an adverse opinion on internal control over financial reporting because of a material weakness, the auditor's report must include –

- The definition of a material weakness, as provided in paragraph A7.
- A statement that a material weakness has been identified and an identification of the material weakness described in management's assessment.

  Note: If the material weakness has not been included in management's assessment, the report should be modified to state that a material weakness has been identified but not included in management's assessment. Additionally, the auditor's report should include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness

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[19/] See paragraph C3 for direction when the scope of the engagement has been limited.

and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. In this case, the auditor also should communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's assessment. If the material weakness has been included in management's assessment but the auditor concludes that the disclosure of the material weakness is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe the material weakness.

92. The auditor should determine the effect his or her adverse opinion on internal control has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements was affected by the adverse opinion on internal control over financial reporting.

Note: If the auditor issues a separate report on internal control over financial reporting in this circumstance, the disclosure required by this paragraph may be combined with the report language described in paragraphs 88 and 91. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.

Subsequent Events

93. Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors and obtain written representations from management relating to such matters, as described in paragraph 75h.

94. To obtain additional information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following –

- Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period,

- Independent auditor reports (if other than the auditor's) of deficiencies in internal control,

- Regulatory agency reports on the company's internal control over financial reporting, and

- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

95. The auditor might inquire about and examine other documents for the subsequent period. Paragraphs .01 through .09 of AU sec. 560, *Subsequent Events*, provide direction on subsequent events for a financial statement audit that also may be helpful to the auditor performing an audit of internal control over financial reporting.

96. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment, the auditor should issue an adverse opinion on internal control over financial reporting (and follow the direction in paragraph C2 if management's assessment states that internal control over financial reporting is effective). If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim an opinion. As described in paragraph C13, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

97. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date and before issuance of the auditor's report. If a subsequent event of this type has a material effect on the company's internal control over financial reporting, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report.

98. After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

APPENDIX A *– Definitions*

A1. For purposes of this standard, the terms listed below are defined as follows –

A2. A **control objective** provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant assertion and states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented or detected by controls on a timely basis.

A3. A **deficiency** in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

A4. **Financial statements and related disclosures** refers to a company's financial statements and notes to the financial statements as presented in accordance with generally accepted accounting principles ("GAAP"). References to financial statements and related disclosures do not extend to the preparation of management's discussion and analysis or other similar financial information presented outside a company's GAAP-basis financial statements and notes.

A5. **Internal control over financial reporting** is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that –

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with

generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.[1/]

Note: The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal control over financial reporting.

Note: Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

A6. **Management's assessment** is the assessment described in Item 308(a)(3) of Regulations S-B and S-K that is included in management's annual report on internal control over financial reporting.[2/]

A7. A **material weakness** is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Note: There is a **reasonable possibility** of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS 5").[3/]

[1/] See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f).

[2/] See 17 C.F.R. §§ 228.308(a)(3) and 229.308(a)(3).

[3/] See FAS 5, paragraph 3.

A8. Controls over financial reporting may be **preventive controls** or **detective controls**. Effective internal control over financial reporting often includes a combination of preventive and detective controls.

- Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring.

- Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements.

A9. A **relevant assertion** is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

A10. An account or disclosure is a **significant account or disclosure** if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

A11. A **significant deficiency** is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

APPENDIX B – *Special Topics*

Integration of Audits

B1. *Tests of Controls in an Audit of Internal Control.* The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole*.

B2. To express an opinion on internal control over financial reporting as of a point in time, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

B3. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on internal control over financial reporting, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

B4. *Tests of Controls in an Audit of Financial Statements.* To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

B5. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the company's internal control over financial reporting, as discussed in paragraph B2. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

B6. *Effect of Tests of Controls on Substantive Procedures.* If, during the audit of internal control over financial reporting, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

B7. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

B8. *Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls.* In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum –

- The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.

- Findings with respect to illegal acts and related party transactions.

- Indications of management bias in making accounting estimates and in selecting accounting principles.

- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

B9. To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Multiple Locations Scoping Decisions

B10. In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk.

> Note: The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the company's consolidated financial statements.

B11. In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements. In lower-risk locations or business units, the auditor first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient evidence.

B12. In determining the locations or business units at which to perform tests of controls, the auditor may take into account work performed by others on behalf of management. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of locations or business units at which the auditor would otherwise need to perform auditing procedures.

B13. The direction in paragraph 61 regarding special considerations for subsequent years' audits means that the auditor should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.

B14. *Special Situations.* The scope of the audit should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The direction in this multiple-locations discussion describes how to determine whether it is necessary to test controls at these entities or operations.

B15. For equity method investments, the scope of the audit should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The audit ordinarily would not extend to controls at the equity method investee.

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not

be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AU sec. 722, *Interim Financial Information*. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

Use of Service Organizations

B17. AU sec. 324, *Service Organizations*, applies to the audit of financial statements of a company that obtains services from another organization that are part of the company's information system. The auditor may apply the relevant concepts described in AU sec. 324 to the audit of internal control over financial reporting.

B18. AU sec. 324.03 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, the auditor should include the activities of the service organization when determining the evidence required to support his or her opinion.

B19. AU sec. 324.07 through .16 describe the procedures that the auditor should perform with respect to the activities performed by the service organization. The procedures include –

a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and

b. Obtaining evidence that the controls that are relevant to the auditor's opinion are operating effectively.

B20. Evidence that the controls that are relevant to the auditor's opinion are operating effectively may be obtained by following the procedures described in AU sec. 324.12. These procedures include –

a. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in AU sec. 324.24b). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in AU sec. 324.24a) does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU sec. 324, the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

b. Performing tests of the user organization's controls over the activities of the service organization (e.g., testing the user organization's independent re-performance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).

c. Performing tests of controls at the service organization.

B21. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient evidence to support his or her opinion. In evaluating whether such a service auditor's report provides sufficient evidence, the auditor should assess the following factors –

- The time period covered by the tests of controls and its relation to the as-of date of management's assessment,

- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls, and

- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements, as described in AU sec. 324.16.

B22. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures.

B23. In determining whether the service auditor's report provides sufficient evidence to support the auditor's opinion, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10a of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

B24. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.

B25. The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors. As risk increases, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment,

- The significance of the activities of the service organization,

- Whether there are errors that have been identified in the service organization's processing, and

- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

B26. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures might include –

- Evaluating procedures performed by management and the results of those procedures.

- Contacting the service organization, through the user organization, to obtain specific information.

- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.

- Visiting the service organization and performing such procedures.

B27. The auditor should not refer to the service auditor's report when expressing an opinion on internal control over financial reporting.

Benchmarking of Automated Controls

B28. Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.

B29. If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.

B30. The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

B31. To determine whether to use a benchmarking strategy, the auditor should assess the following risk factors. As these factors indicate lower risk, the control being evaluated might be well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated is less suited for benchmarking. These factors are –

- The extent to which the application control can be matched to a defined program within an application.

- The extent to which the application is stable (i.e., there are few changes from period to period).

- The availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed.)

B32. Benchmarking automated application controls can be especially effective for companies using purchased software when the possibility of program changes is remote – e.g., when the vendor does not allow access or modification to the source code.

B33. After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be reestablished. To determine when to reestablish a baseline, the auditor should evaluate the following factors –

- The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations.

- The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls.

- The nature and timing of other related tests.

- The consequences of errors associated with the application control that was benchmarked.

- Whether the control is sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

<u>APPENDIX C</u> – Special Reporting Situations

Report Modifications

C1. The auditor should modify his or her report if any of the following conditions exist.

a. Elements of management's annual report on internal control are incomplete or improperly presented,

b. There is a restriction on the scope of the engagement,

c. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report,

d. There is other information contained in management's annual report on internal control over financial reporting, or

e. Management's annual certification pursuant to Section 302 of the Sarbanes-Oxley Act is misstated.

C2. *Elements of Management's Annual Report on Internal Control Over Financial Reporting Are Incomplete or Improperly Presented.* If the auditor determines that elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should modify his or her report to include an explanatory paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about a material weakness is not fairly presented in all material respects, the auditor should follow the direction in paragraph 91.

C3. *Scope Limitations*. The auditor can express an opinion on the company's internal control over financial reporting only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion states that the auditor does not express an opinion on the effectiveness of internal control over financial reporting.

C4. When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal control over financial reporting (paragraph 85 g, h, and i); to do so might overshadow the disclaimer.

C5. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report also should include –

- The definition of a material weakness, as provided in paragraph A7.

- A description of any material weaknesses identified in the company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraph 91.

C6. The auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

> Note: In this case, in following the direction in paragraph 89 regarding dating the auditor's report, the report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

C7. If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the audit, the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

C8. *Opinions Based, in Part, on the Report of Another Auditor*. When another auditor has audited the financial statements and internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion. AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements must participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

C9. When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by the other auditor. In these circumstances, the auditor's decision is based on factors analogous to those of the auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AU sec. 543.

C10. The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because management's assessment of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.[1/]

C11. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion on the company's internal control over financial reporting, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinion.

C12. *Management's Annual Report on Internal Control Over Financial Reporting Containing Additional Information*. Management's annual report on internal control over financial reporting may contain information in addition to the elements described in paragraph 72 that are subject to the auditor's evaluation.

C13. If management's annual report on internal control over financial reporting could reasonably be viewed by users of the report as including such additional information, the auditor should disclaim an opinion on the information.

C14. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. AU sec. 317, *Illegal Acts by Clients* and Section 10A of the Securities Exchange Act of 1934 may also require the auditor to take additional action.[2/]

> Note: If management makes the types of disclosures described in paragraph C12 outside its annual report on internal control over financial reporting and includes them elsewhere within its annual report on the company's financial statements,

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[1/] See paragraph B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

[2/] See 15 U.S.C. § 78j-1.

the auditor would not need to disclaim an opinion. However, in that situation, the auditor's responsibilities are the same as those described in this paragraph if the auditor believes that the additional information contains a material misstatement of fact.

C15. *Management's Annual Certification Pursuant to Section 302 of the Sarbanes-Oxley Act is Misstated.* If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[3/] the auditor should follow the communication responsibilities as described in AU sec. 722 *Interim Financial Information*, for any interim period. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in AU sec. 722, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Filings Under Federal Securities Statutes

C16. AU sec. 711, *Filings Under Federal Securities Statutes*, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should apply AU sec. 711 with respect to the auditor's report on internal control over financial reporting included in such filings. In addition, the auditor should extend the direction in AU sec. 711.10 to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements to matters that could have a material effect on internal control over financial reporting.

C17. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on internal control over financial reporting in the securities filing, the auditor's consent should clearly indicate that both the audit report on financial statements and the audit report on internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

[3/] See 17 C.F.R. §§ 240.13a-14(a) and 240.15d-14(a).

<u>Rule 3525</u>: Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting

In connection with seeking audit committee pre-approval to perform for an audit client any permissible non-audit service related to internal control over financial reporting, a registered public accounting firm shall –

(a) describe, in writing, to the audit committee of the issuer the scope of the service;

(b) discuss with the audit committee of the issuer the potential effects of the service on the independence of the firm; and

> Note: Independence requirements provide that an auditor is not independent of his or her audit client if the auditor is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Several principles guide the application of this general standard, including whether the auditor assumes a management role or audits his or her own work. Therefore, an auditor would not be independent if, for example, management had delegated its responsibility for internal control over financial reporting to the auditor or if the auditor had designed or implemented the audit client's internal control over financial reporting.

(c) document the substance of its discussion with the audit committee of the issuer.

Conforming Amendments to PCAOB Auditing Standards

AU sec. 230, "Due Professional Care in the Performance of Work"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures," section 230, "Due Professional Care in the Performance of Work" (AU sec. 230, "Due Professional Care in the Performance of Work"), as amended, is amended as follows –

a. Paragraph .10 is replaced with –

The exercise of due professional care allows the auditor to obtain *reasonable assurance* about whether the financial statements are free of material misstatement, whether caused by error or fraud, or whether any material weaknesses exist as of the date of management's assessment. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Although not absolute assurance, reasonable assurance is a high level of assurance. Therefore, an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) may not detect a material weakness in internal control over financial reporting or a material misstatement to the financial statements.

b. The term "financial statements" within the first sentence of paragraph .13 is replaced with the term "financial statements or internal control over financial reporting."

c. The second sentence of paragraph .13 is replaced with –

Therefore, the subsequent discovery that either a material misstatement, whether from error or fraud, exists in the financial statements or a material weakness in internal control over financial reporting exists does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with the standards of the Public Company Accounting Oversight Board (United States).

AU sec. 310, "Appointment of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, is amended as follows –

a. The third bullet point of paragraph .06 is replaced with –

Management is responsible for establishing and maintaining effective internal control over financial reporting. If, in an integrated audit of financial statements and internal control over financial reporting, the auditor concludes that he or she cannot express an opinion on internal control over financial reporting because there has been a limitation on the scope of the audit, he or she should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

b. The eighth bullet point of paragraph .06 is amended as follows –

Under Integrated audit of financial statements and internal control over financial reporting, the last sub-bullet point is replaced with the following –

To the board of directors – any conclusion that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.

Under Audit of financial statements, the last sub-bullet is replaced with the following –

To the board of directors – if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the audit committee is ineffective, that conclusion.

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision" (AU sec. 311, "Planning and Supervision"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to paragraph 39 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 9 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), as amended, is amended as follows –

a. Within the note to paragraph 3, the reference to paragraphs 22-23 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 20 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. Within the note to paragraph 7, the reference to paragraphs 24-26 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 14-15 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

c. The note to paragraph 12 is replaced with –

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 9 and 20 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* regarding planning considerations and materiality, respectively.

d. Within the note to paragraph 18, the reference to Appendix B, *Additional Performance Requirements and Directions; Extent-of-Testing Examples* of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B10-B16 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

e. Within the note to paragraph 30, the reference to paragraphs 147-149 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 6-8 and paragraphs B1-B5 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards – 1983" (AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), is amended as follows –

Within the note to paragraph 1, the reference to paragraphs 98-103 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 52-53 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows –

The last sentence of paragraph 16 is replaced with –

Furthermore, the predecessor auditor is not a specialist as defined in AU sec. 336, *Using the Work of a Specialist,* nor does the predecessor auditor's work constitute the work of others as described in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* or paragraphs 16-19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), is amended as follows –

Within the note to paragraph 1, the reference to paragraphs 24-26 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 14-15 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), as amended, is amended as follows –

a. The note to paragraph 2 is replaced with –

   Note: Refer to paragraph A9 of Appendix A, *Definitions,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* for the definition of a relevant assertion and paragraphs 28-33 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* for discussion of identifying relevant assertions.

b. Within the note to paragraph 9, the reference to Appendix B, *Additional Performance Requirements and Directions; Extent of Testing Examples,* of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B10-B16 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

c. The last sentence of paragraph 33 is deleted.

d. The note to paragraph 65 is deleted.

e. The note to paragraph 83 is deleted.

f. Within the note to paragraph 97, the reference to paragraphs 104-105 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph

54 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

g. The appendix at paragraph 110 is deleted.

AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"

SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), is amended as follows –

a. Within the note to paragraph 1, the reference to paragraphs 108-126 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 16-19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The note to paragraph 20 is deleted.

c. Within the note to paragraph 22, the reference to paragraph 122 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 18-19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations" (AU sec. 324, "Service Organizations"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to Appendix B, *Additional Performance Requirements and Directions; Extent-of-Testing Examples,* of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B17-B27 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements"[1/]

AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements" is amended as follows –

a. The first bullet point before paragraph 1 is amended as follows –

The reference to paragraphs 207-214 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 78-84 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The first bullet point in paragraph 1 is replaced with –

A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

c. Paragraph 2 is replaced with –

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

d. The notes to paragraph 2 are deleted.

e. Paragraph 3 is replaced with –

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

[1/] When the Board adopted Auditing Standard No. 2, it superseded SAS No. 60 in the context of an integrated audit of financial statements and internal control over financial reporting by paragraphs 207-214 of Auditing Standard No. 2. See PCAOB Release No. 2004-008, *Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements"* (Sept. 15, 2004). As a result of superseding Auditing Standard No. 2, paragraphs 78-84 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* now supersede SAS No. 60 in the context of an integrated audit.

Note: There is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in paragraph 3 of Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*.

Note: In evaluating whether a deficiency exists and whether deficiencies, either individually or in combination with other deficiencies, are material weaknesses, the auditor should follow the direction in paragraphs 62-70 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

f. Paragraph 5 is replaced with –

If oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that circumstance should be regarded as an indicator that a material weakness in internal control over financial reporting exists. Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight in an audit of only the financial statements, if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that information in writing to the board of directors.

g. The last sentence of paragraph 9 is replaced with –

In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph 2 of this standard.

<u>AU sec. 9325, "Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325"</u>

AU sec. 9325, "Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325" is amended as follows –

The note prior to paragraph 1 is replaced with –

Note: In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph 2 of this standard. Within the example report within paragraph 4 of the interpretation, the third sentence is replaced with the definition of a material weakness in paragraph A7 of Appendix A, *Definitions,* of PCAOB

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), is amended as follows –

The first sentence of paragraph 41 is replaced with –

Events and transactions that occur after the balance-sheet date but before the date of the auditor's report (for example, a sale of an investment shortly after the balance-sheet date), may provide audit evidence regarding management's fair value measurements as of the balance-sheet date [7/]

[7/] The auditor's consideration of a subsequent event or transaction, as contemplated in this paragraph, is a substantive test and thus differs from the review of subsequent events performed pursuant to section 560, *Subsequent Events*.

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), is amended as follows –

The note to paragraph 11 is replaced with –

Note: When performing an integrated audit of financial statements and internal control over financial reporting, paragraph 39 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* states "[t]he auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if there are relevant assertions related to the company's investment in derivatives and securities, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and service organizations whose services are part of the entity's information system.

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows –

a. Within the note to paragraph 5, the reference to paragraphs 142-144 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 75-77 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The second sentence of paragraph 9 is replaced with –

Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the representations should be made as of the date of the auditor's report.

<u>AU sec. 9337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337"</u>

AU sec. 9337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337" is amended as follows –

a. The last sentence of paragraph 4 is replaced with –

What is the relationship between the effective date of the lawyer's response and the date of the auditor's report?

b. Paragraph 5 is replaced with –

Interpretation – Section 560.10 through .12 indicates that the auditor is concerned with events, which may require adjustment to, or disclosure in, the financial statements, occurring through the date of his or her report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the date of the auditor's report as is practicable in the circumstances. Consequently, specifying the effective date of the lawyer's response to reasonably approximate the expected date of the auditor's report will in most instances obviate the need for an updated response from the lawyer.

<u>AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"</u>

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows –

The second sentence of paragraph 2 is replaced with –

The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), is amended as follows –

a. Subparagraph c. of paragraph 10 is replaced with –

c. Review subsequent events or transactions occurring prior to the date of the auditor's report.

b. Paragraph 13 is replaced with –

Review subsequent events or transactions. Events or transactions sometimes occur subsequent to the date of the balance sheet, but prior to the date of the auditor's report, that are important in identifying and evaluating the reasonableness of accounting estimates or key factors or assumptions used in the preparation of the estimate. In such circumstances, an evaluation of the estimate or of a key factor or assumption may be minimized or unnecessary as the event or transaction can be used by the auditor in evaluating their reasonableness.

AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees"), as amended, is amended as follows –

Within footnote 1 to paragraph 1, the reference to PCAOB Auditing Standard No. 2 is replaced with a reference to PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508, "Reports on Audited Financial Statements"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to paragraphs 162-199 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 85-98 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* and Appendix C, *Special Reporting Situations,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. The sentence that reads "In addition, see Appendix A, *Illustrative Reports on Internal Control Over Financial Reporting,* of PCAOB

Auditing Standard No. 2, which includes an illustrative combined audit report and examples of separate reports," is replaced with, "In addition, see paragraphs 86-88 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* which includes an illustrative combined audit report."

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 530, "Dating of the Independent Auditor's Report" (AU sec. 530, "Dating of the Independent Auditor's Report"), as amended, is amended as follows –

a. Paragraph .01 is replaced with –

The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Paragraph .05 describes the procedure to be followed when a subsequent event occurring after the report date is disclosed in the financial statements.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same date.

Note: If the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion on the financial statements, then the auditor's report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

b. Paragraph .05 is replaced with –

The independent auditor has two methods for dating the report when a subsequent event disclosed in the financial statements occurs after the auditor has obtained sufficient competent evidence on which to base his or her opinion, but before the issuance of the related financial statements. The auditor may use "dual dating," for example, "February 16, 20__, except for Note __, as to which the date is March 1, 20__," or may date the report as of the later date. In the former instance, the responsibility for events occurring subsequent to the original report date is limited to the specific event referred to in the note (or otherwise disclosed). In the latter instance, the independent auditor's responsibility for subsequent events extends to the later report date and, accordingly, the procedures outlined in section 560.12 generally should be extended to that date.

c. Within the heading before paragraph .03, the reference to "completion of field work" is replaced with "the date of the independent auditor's report."

AU sec. 543, "Part of Audit Performed by Other Independent Auditors"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 543, "Part of Audit Performed by Other Independent Auditors" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), as amended, is amended as follows –

Within the note to paragraph .01, the reference to paragraphs 182-185 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs C8-C11 of Appendix C, *Special Reporting Situations,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 560, "Subsequent Events"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 560, "Subsequent Events" (AU sec. 560, "Subsequent Events"), as amended, is amended as follows –

a. Within the note to paragraph .01, the reference to paragraphs 186-189 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 93-97 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The second sentence of paragraph .12 is replaced with –

   These procedures should be performed at or near the date of the auditor's report.

AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report" (AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"), as amended, is amended as follows –

Within the note to paragraph .01, the reference to paragraph 197 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 98 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 711, "Filings Under Federal Securities Statutes"

SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), is amended as follows –

a. Within the note to paragraph 2, the reference to paragraphs 198-199 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs C16-C17 of Appendix C, *Special Reporting Situations,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The third sentence of paragraph 10 is replaced with –

The likelihood that the auditor will discover subsequent events necessarily decreases following the date of the auditor's report, and, as a practical matter, after that time the independent auditor may rely, for the most part, on inquiries of responsible officials and employees.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), is amended as follows –

a. The following is inserted after the first sentence of paragraph 3 –

The SEC also requires management, with the participation of the principal executive and financial officers (the certifying officers) to make certain quarterly and annual certifications with respect to the company's internal control over financial reporting.[2/]

[2/] See Section 302 of the Sarbanes-Oxley Act of 2002, and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), (17 C.F.R. § 240.13a-14a or 17 C.F.R. § 240.15d-14a), whichever applies.

b. The note to paragraph 3 is deleted.

c. The following is added to the end of paragraph 7 –

Likewise, the auditor's responsibility as it relates to management's quarterly certifications on internal control over financial reporting is different from the auditor's responsibility as it relates to management's annual assessment of internal control over financial reporting. The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

> Note: The auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting take effect beginning with the first quarter after the company's first annual assessment of internal control over financial reporting as described in Item 308(a)(3) of Regulations S-B and S-K.

d. The following lettered section is added to the end of paragraph 18 –

g. Evaluating management's quarterly certifications about internal control over financial reporting by performing the following procedures –

- Inquiring of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information;

- Evaluating the implications of misstatements identified by the auditor as part of the auditor's other interim review procedures as they relate to effective internal control over financial reporting; and

- Determining, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

e. Paragraph 29 is replaced with –

As a result of conducting a review of interim financial information, the accountant may become aware of matters that cause him or her to believe that –

a. material modification should be made to the interim financial information for it to conform with generally accepted accounting principles;

b. modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies; and

c. the entity filed the Form 10-Q or Form 10-QSB before the completion of the review.

In such circumstances, the accountant should communicate the matter(s) to the appropriate level of management as soon as practicable.

f. Paragraph 32 is replaced with –

If the auditor becomes aware of information indicating that fraud or an illegal act has or may have occurred, the auditor must also determine his or her responsibilities under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[1/]

[1/] See 15 U.S.C. § 78j-1

g. Within paragraph 33, the third sentence is replaced with –

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

Auditing Standard No. 3, *Audit Documentation*

Auditing Standard No. 3, *Audit Documentation* is amended as follows –

Within footnote 2 to paragraph 6, the reference to paragraphs 68-70 of Auditing Standard No. 2 is replaced with a reference to paragraphs 28-33 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* is amended as follows –

a. Within note 1 to paragraph 1, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal*

Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

b. Within paragraph 2, the two references to Auditing Standard No. 2 are replaced with references to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

c. Within the note to paragraph 2, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

d. Within paragraph 4, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

e. Paragraph 9 is replaced with –

The terms *internal control over financial reporting*, *deficiency*, *significant deficiency*, and *material weakness* have the same meanings as the definitions of those terms in Appendix A, *Definitions,* of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

f. The first sentence of paragraph 10 is replaced with –

Paragraph 5 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* states "[t]he auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting."

g. Within the note to paragraph 10, the reference to Auditing Standard No. 2 in the first sentence is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and the last sentence is amended as follows –

More information about the COSO framework is included within the COSO report.

h. Paragraph 11 is replaced with –

The terms *relevant assertion* and *control objective* have the same meaning as the definitions of those terms in Appendix A, *Definitions,* of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

i. Paragraph 13 is replaced with –

In an audit of internal control over financial reporting, the auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.[2/]

[2/] See paragraph 42 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

j. Within the note to paragraph 17, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

k. Within note 2 to paragraph 18, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

l. Within paragraph 21, the last sentence is deleted.

m. Within paragraph 23, the reference to paragraphs 22 and 23 of Auditing Standard No. 2 is replaced with a reference to paragraph 20 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Additionally, the second sentence is deleted.

n. Within paragraph 24, the reference to paragraph 39 of Auditing Standard No. 2 is replaced with a reference to paragraph 9 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

o. Within paragraph 25, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

p. Within the note to paragraph 25, the two references to Auditing Standard No. 2 are replaced with references to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

q. Within subparagraph a. of paragraph 26, the reference to paragraphs 47 through 51 of Auditing Standard No. 2 is replaced with a reference to paragraphs 22-27 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

r. Subparagraph b. of paragraph 26 is replaced with –

Perform the procedures described in paragraphs 34-38 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* for those transactions that are directly affected by controls specifically identified by management as addressing the material weakness.

s. The note to subparagraph b. of paragraph 26 is deleted.

t. Within paragraph 27, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

u. The note to paragraph 28 is deleted.

v. Within paragraph 31, the reference to paragraphs 88 through 91 of Auditing Standard No. 2 is replaced with a reference to paragraphs 42-43 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

w. Paragraph 32 is replaced with –

Consistent with the direction in paragraphs 44-45 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* the auditor should test the operating effectiveness of a specified control by determining whether the specified control operated as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively. In determining the nature, timing, and extent of tests of controls, the auditor should apply paragraphs 50-54 of Auditing Standard No. 5.

x. Paragraph 33 is replaced with –

The auditor should perform tests of the specified controls over a period of time that is adequate to determine whether, as of the date specified in management's assertion, the controls necessary for achieving the stated control objective are operating effectively. The timing of the auditor's tests should vary with the risk associated with the control being tested. For example, a transaction-based, daily reconciliation generally would permit the auditor to obtain sufficient evidence as to its operating effectiveness in a shorter period of time than a pervasive, entity-level control, such as any of those described in paragraphs 22-24 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Additionally, the auditor typically will be able to obtain sufficient evidence as to the operating effectiveness of controls over the company's period-end financial reporting process only by testing those controls in connection with a period-end.

y. Within paragraph 35, the reference to paragraphs B1 through B13 of Appendix B of Auditing Standard No. 2 is replaced with a reference to paragraphs B10-B16 of Appendix B, *Special Topics,* of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

z. Within paragraph 36, the reference to paragraphs 109 through 115 and 117 through 125 of Auditing Standard No. 2 is replaced with a reference to paragraphs 16-19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

aa. The second sentence of paragraph 37 is replaced with –

Therefore, if the auditor has been engaged to report on more than one material weakness or on more than one stated control objective, the auditor must evaluate whether he or she has obtained sufficient evidence that the control objectives related to each of the material weaknesses identified in management's assertion are achieved.

bb. The first two sentences of paragraph 38 are replaced with –

Paragraphs 18-19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* should be applied in the context of the engagement to report on whether a previously reported material weakness continues to exist.

cc. The note to paragraph 38 is deleted.

dd. The note to paragraph 39 is deleted.

ee. Paragraph 42 is replaced with –

Management may conclude that a previously reported material weakness no longer exists because its severity has been sufficiently reduced such that it is no longer a material weakness.

ff. Subparagraph f. of paragraph 44 is replaced with –

Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a misstatement in the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting and that has occurred or come to management's attention since the date of management's most recent annual assessment of internal control over financial reporting.

gg. Within the note to subparagraph b. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

hh. Within the note to subparagraph l. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

ii. Within the note to the second bullet point of subparagraph o. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

jj. Within paragraph 52, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

kk. Within paragraph 63, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29-32 of AU sec. 722, *Interim Financial Information*.

ll. Within paragraph 64, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29-32 of AU sec. 722, *Interim Financial Information*.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Board's Statement of the Purpose Of, and Statutory Basis for, the Proposed Rule

(a) Purpose

In 2002, Congress passed the Act, which, among other things, established new provisions related to internal control over financial reporting. Section 404 of the Act requires company management to assess and report on the effectiveness of the company's internal control. It also requires a company's independent auditor, registered with the Board, to attest to management's disclosures regarding the effectiveness of its internal control. As directed by Sections 103 and 404 of the Act, the Board established a standard to govern the newly required audit by adopting Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("Auditing Standard No. 2"). The SEC approved Auditing Standard No. 2 on June 17, 2004.

Since Auditing Standard No. 2 became effective, the Board has closely monitored the progress registered firms have made in implementing its requirements. The PCAOB's monitoring has included gathering information during inspections of registered public accounting firms; participating, along with the SEC, in two roundtable discussions with representatives of issuers, auditors, investor groups, and others; meeting with its Standing Advisory Group; receiving feedback from participants in the Board's Forums on Auditing in the Small Business Environment; and reviewing academic, government, and other reports and studies.

As a result of this monitoring, two basic propositions emerged. First, the audit of internal control over financial reporting has produced significant benefits, including an enhanced focus on corporate governance and controls and higher quality financial reporting. Second, these benefits have come at a significant cost. Costs have been greater than expected and, at times, the related effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.

As part of a four-point plan to improve implementation of the internal control requirements, the Board determined to amend Auditing Standard No. 2. On December 19, 2006, the Board proposed for comment a new standard on auditing internal control, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would replace Auditing Standard No. 2. After careful consideration of the comments it received and the input from the SEC, the Board has refined its proposals to provide additional clarity and further help auditors to focus on the most important matters.

The Board adopted the revised standard on auditing internal control as Auditing Standard No. 5, to supersede Auditing Standard No. 2.

Under Section 10A(i) of the Exchange Act, as amended by Section 202 of the Act, all non-audit services that the auditor proposes to perform for an issuer client "shall be pre-approved by the audit committee of the issuer." Rule 3525 would further implement the Act's pre-approval requirement by requiring auditors to take certain steps as part of seeking audit committee pre-approval of internal control related non-audit services. These steps are intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect independence. Rule 3525 requires a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related non-audit services that are not otherwise prohibited by the Act or the rules of the SEC or the Board to: describe, in writing, to the audit committee the scope of the proposed service; discuss with the audit committee the potential effects of the proposed service on the firm's independence; and document the substance of the firm's discussion with the audit committee.

The conforming amendments update the Board’s other auditing standards in light of Auditing Standard No. 5, move information contained in Auditing Standard No. 2 to the Board’s interim standards, and change the existing requirement that "generally, the date of completion of the field work should be used as the date of the independent auditor's report" to "the auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion." This change is consistent with a recent change adopted by both the International Auditing and Assurance Standards Board and the AICPA Auditing Standards Board.

(b) Statutory Basis

The statutory basis for the proposed rule is Titles I and II and Section 404 of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rule will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rules would apply equally to all registered public accounting firms and their associated persons. Moreover, Auditing Standard No. 5 explains how to tailor internal control audits to fit the size and complexity of the company being audited.

C. Board's Statement on Comments on the Proposed Rule Received from Members, Participants or Others

The Board released the proposed rules for public comment in Release No. 2006-007 (December 19, 2006). A copy of Release No. 2006-007 and the comment letters received in response to the PCAOB's request for comment are available on the PCAOB's Web site at www.pcaobus.org. The Board received 175 written comments. The Board also discussed the proposals with its Standing Advisory Group on February 22, 2007.[1/] The Board has clarified and modified

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[1/] A transcript of the portion of the meeting that related to the proposals and an archived web cast of the entire meeting are available on the Board's Web site at certain aspects of the proposed rules in response to the comments it received, as discussed below.

The Board issued these proposals with the primary objectives of focusing auditors on the most important matters in the audit of internal control over financial reporting and eliminating procedures that the Board believes are unnecessary to an effective audit of internal control. The proposals were designed to both increase the likelihood that material weaknesses in companies' internal control will be found before they cause material misstatement of the financial statements and steer the auditor away from procedures that are not necessary to achieve the intended benefits. The Board also sought to make the internal control audit more clearly scalable for smaller and less complex public companies and to make the text of the standard easier to understand. In formulating these proposals, the Board re-evaluated every significant aspect of Auditing Standard No. 2.

A large majority of commenters were generally supportive of the Board's proposals, particularly the top-down, risk-based approach and focus on the most important matters. Based on the comments received, the Board believes that the proposal achieves, in large part, the objectives the Board set out when deciding to amend Auditing Standard No. 2. Many commenters also offered suggestions to improve the final standard, which the Board has carefully analyzed.

In considering the comments received and formulating a final standard, the Board closely coordinated its work with the SEC, which proposed guidance

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http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2007/02-22/SAG_Transcript.pdf.

for management on evaluating internal control at the same time that the Board issued its proposals.[2/] In addition to its role in implementing Section 404(a) of the Act, the SEC must approve new PCAOB auditing standards before they can become effective.[3/] On April 4, 2007, the Commission held a public meeting to discuss the Board's proposals and the coordination of those proposals with the Commission's proposed management guidance. At the meeting, the SEC staff provided the Commission its analysis of the public comments on the PCAOB's proposal and the proposed management guidance. The Commission endorsed the recommendations of its staff and directed its staff to focus its remaining work in four areas:

- "Aligning the PCAOB's new auditing standard … with the SEC's proposed new management guidance under Section 404, particularly with regard to prescriptive requirements, definitions, and terms";

- "Scaling the 404 audit to account for the particular facts and circumstances of companies, particularly smaller companies";

- "Encouraging auditors to use professional judgment in the 404 process, particularly in using risk-assessment"; and

- "Following a principles-based approach to determining when and to what extent the auditor can use the work of others."[4/]

After careful consideration of the comments it received and the input from the SEC, the Board has refined its proposals to provide additional clarity and

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[2/] See Securities Exchange Act Release No. 54976 (Dec. 20, 2006).

[3/] See Section 107 of the Act.

[4/] See SEC Press Release, "SEC Commissioners Endorse Improved Sarbanes-Oxley Implementation To Ease Smaller Company Burdens, Focusing Effort On 'What Truly Matters'" (Apr. 4, 2007).

further help auditors to focus on the most important matters. The Board has decided to adopt the revised standard on auditing internal control as Auditing Standard No. 5, to supersede Auditing Standard No. 2. The Board has also decided to adopt the independence rule and conforming amendments to the auditing standards.[5/]

Notable Areas of Change in the Final Standard

The Board believes that the changes made to the proposal reflect refinements, rather than significant shifts in approach. This section describes the areas of change to the proposals that are most notable. Additional discussion of comments received on the proposals and the Board's response is included below.

Alignment with management guidance

On December 20, 2006, the SEC issued proposed guidance to help management evaluate internal control for purposes of its annual assessment. In formulating a new standard on auditing internal control, the Board sought to describe an audit process that would be coordinated with management's evaluation process. Many commenters suggested, however, that the SEC's management guidance and the Board's standard should be more closely aligned.

After considering the comments in this area, the Board has decided to make changes that will improve the coordination between the SEC's management guidance and the Board's standard. In doing so, the Board has been mindful of the inherent differences in the roles of management and the

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[5/] As discussed below, the Board has determined not to adopt the proposed auditing standard on considering and using the work of others.

auditor. Management's daily involvement with its internal control system provides it with knowledge and information that may influence its judgments about how best to evaluate internal control and the sufficiency of the evidence it needs for its annual assessment. Management also should be able to rely on self-assessment and, more generally, the monitoring component of internal control, provided the monitoring component is properly designed and operates effectively.

The auditor is required to provide an independent opinion on the effectiveness of the company's internal control over financial reporting. The auditor does not have the familiarity with the company's controls that management has and does not interact with or observe these controls with the same frequency as management. Therefore, the auditor cannot obtain sufficient evidence to support an opinion on the effectiveness of internal control based solely on observation of or interaction with the company's controls. Rather, the auditor needs to perform procedures such as inquiry, observation, and inspection of documents, or walkthroughs, which consist of a combination of those procedures, in order to fully understand and identify the likely sources of potential misstatements, while management might be aware of those risk areas on an on-going basis.

The Board believes, however, that the general concepts necessary to an understanding of internal control should be described in the same way in the Board's standard and in the SEC's guidance. Accordingly, the Board has decided to use the same definition of material weakness in its standard that the SEC uses in its final management guidance and related rules. In addition, the Board is adopting the definition of significant deficiencies that the SEC has proposed. The final standard and final management guidance also describe the same indicators of a material weakness. In addition, as described more fully below, the final standard on auditing internal control uses the term "entity-level controls" instead of "company-level controls," which was used in the proposed standard, in order to use the same term as the SEC uses in its final management guidance.[6/] Auditing Standard No. 5's discussion of the effect of these controls is also consistent with the discussion of the same topic in the SEC's final guidance.

The top-down approach

The proposed standard on auditing internal control was structured around the top-down approach to identifying the most important controls to test. This approach follows the same principles that apply to the financial statement audit – the auditor determines the areas of focus through the identification of significant accounts and disclosures and relevant assertions. Under the proposed standard, the auditor would specifically identify major classes of transactions and significant processes before identifying the controls to test.

In response to comments about the level of detail in the requirements of the proposed standard, the Board has reconsidered whether the final standard should include the identification of major classes of transactions and significant

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[6/] These terms were used interchangeably in the proposed standard and SEC's proposed management guidance and, for these purposes, they mean the same thing. See Securities Exchange Act Release No. 54976 (Dec. 20, 2006), at 12 fn. 29.

processes as a specifically required step in the top-down approach. As a practical matter, the auditor will generally need to understand the company's processes to appropriately identify the correct controls to test. The Board believes, however, that specific requirements directing the auditor how to obtain that understanding are unnecessary and could contribute to a "checklist approach" to compliance, particularly for auditors who have a long-standing familiarity with the company. Accordingly, the Board has removed the requirements to identify major classes of transactions and significant processes from the final standard. While this should allow auditors to apply more professional judgment as they work through the top-down approach, the end point is the same as in the proposed standard – the requirement to test those controls that address the assessed risk of misstatement to each relevant assertion.[7/]

Emphasis on fraud controls

The proposed standard on auditing internal control discussed fraud controls and the auditor's procedures related to these controls among the testing concepts included near the end of the standard. Commenters suggested that the placement of the discussion, or the lack of specificity regarding the controls that should be deemed fraud controls, failed to properly emphasize these controls or provide auditors with sufficient direction on how to test fraud controls. In response, the Board has made several changes in the final standard.

[7/] See paragraph 21.

First, the discussion of fraud risk and anti-fraud controls has been moved closer to the beginning of the standard to emphasize to auditors the relative importance of these matters in assessing risk throughout the top-down approach.[8/] Incorporating the auditor's fraud risk assessment – required in the financial statement audit – into the auditor's planning process for the audit of internal control should promote audit quality as well as better integration. While internal control cannot provide absolute assurance that fraud will be prevented or detected, these controls should help to reduce instances of fraud, and, therefore, a concerted focus on fraud controls in the internal control audit should enhance investor protection. Second, management fraud has also been identified in the final standard as an area of higher risk; accordingly, the auditor should focus more of his or her attention on this area.[9/] Finally, the standard, as adopted, provides additional guidance on the types of controls that might address fraud risk.[10/]

Entity-level controls

The proposed standard on auditing internal control emphasized entity-level controls because of their importance both to the auditor's ability to appropriately tailor the audit through a top-down approach – specifically by identifying and testing the most important controls – and to effective internal control. Additionally, the proposed standard emphasized that these controls

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[8/] See paragraphs 14 and 15.

[9/] See paragraph 11.

[10/] See paragraph 14.

might, depending on the circumstances, allow the auditor to reduce the testing of controls at the process level. Commenters suggested that the proposed standard did not provide enough direction on how entity-level controls can significantly reduce testing, and some suggested that controls that operate at the level of precision necessary to do so are uncommon. Many commenters suggested incorporating in the final standard the discussion of direct versus indirect entity-level controls that was included in the SEC's proposed management guidance.

The Board continues to believe that entity-level controls, depending on how they are designed and operate, can reduce the testing of other controls related to a relevant assertion. This is either because the entity-level control sufficiently addresses the risk related to the relevant assertion, or because the entity-level controls provide some assurance so that the testing of other controls related to that assertion can be reduced. In response to comments and in order to clarify these concepts, the Board included in the final standard a discussion of three broad categories of entity-level controls, which vary in nature and precision, along with an explanation of how each category might have a different effect on the performance of tests of other controls.[11/]

The final standard explains that some controls, such as certain control environment controls, have an important, but indirect effect, on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls

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[11/] See paragraph 23. The Board believes that expertise of auditors and companies in the area of entity-level controls will continue to evolve. For example, the Committee of Sponsoring Organizations of the Treadway Commission has begun a project on the monitoring component of internal control that may provide some guidance in this area.

might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

The final standard explains that other entity-level controls may not operate at the level of precision necessary to eliminate the need for testing of other controls, but can reduce the required level of testing of other controls, sometimes substantially. This is because the auditor obtains some of the supporting evidence related to a control from an entity-level control and the remaining necessary evidence from the testing of the control at the process level. Controls that monitor the operation of other controls are the best example of these types of controls. These monitoring controls help provide assurance that the controls that address a particular risk are effective and, therefore, they can provide some evidence about the effectiveness of those lower-level controls, reducing the testing of those controls that otherwise would be necessary.

Lastly, the final standard explains that some entity-level controls might operate at a level of precision that, without the need for other controls, sufficiently addresses the risk of misstatement to a relevant assertion. If a control sufficiently addresses the risk in this manner, the auditor does not need to test other controls related to that risk.

Walkthroughs

The proposed standard on auditing internal control would have required auditors to perform a walkthrough of each significant process each year. This proposed requirement represented a change from Auditing Standard No. 2, which required a walkthrough of each major class of transactions within a significant process. Commenters were split on the question of whether the re-calibration from major class of transactions to significant process in the proposed standard would result in a reduction of effort. Some issuers and auditors suggested that walkthroughs are already being performed on significant processes, while other issuers and auditors commented that this proposed requirement would make a difference. A few commenters suggested that a walkthrough of each significant process was insufficient and would negatively affect audit quality, but many others stated that walkthroughs should not be required at all.

In evaluating these comments, the Board focused principally on the objectives it believes are achieved through a properly performed walkthrough. The Board firmly believes that those objectives should be met for the auditor to verify that he or she has a sufficient understanding of the points within the processes where misstatements could occur and to properly identify the controls to test.[12/] Procedures that fulfill those objectives also play an important role in the evaluation of the effectiveness of the design of the controls. The Board believes that, in some instances, the requirement to perform a walkthrough may have overshadowed the objectives it was meant to achieve. This may have resulted in some walkthroughs being performed to meet the requirement but failing to achieve the intended purpose.

The final standard, therefore, focuses specifically on achieving certain important objectives, and the performance requirement is based on fulfilling

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[12/] See paragraph 34, which describes these objectives.

those objectives as they relate to the understanding of likely sources of misstatement and the selection of controls to test.[13/] While a walkthrough will frequently be the best way of attaining these goals, the auditor's focus should be on the objectives, not on the mechanics of the walkthrough. In some cases, other procedures may be equally or more effective means of achieving them.

Evaluation and communication of deficiencies

The proposed standard on auditing internal control required the auditor to evaluate the severity of identified control deficiencies to determine whether they are significant deficiencies or material weaknesses. It then required the auditor to communicate, in writing, to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The proposed standard defined "significant deficiency" as "a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected." The term "significant misstatement" was defined, in turn, to mean "a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

Commenters generally supported the proposed definition of the term "significant misstatement," though some were concerned that it was too subjective. Other commenters questioned whether the standard should include a definition of significant deficiency and a requirement to communicate significant

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[13/] See paragraph 34.

deficiencies to the audit committee. At least one commenter suggested that the term be removed from the standard.

After considering these comments, the Board has determined to make changes to the definition of significant deficiency and related requirements.[14/] The Board continues to believe that the standard should require auditors to provide relevant information about important control deficiencies – even those less severe than a material weakness – to management and to the audit committee. The final standard, therefore, requires the auditor to consider and communicate any identified significant deficiencies to the audit committee. In order to emphasize that the auditor need not scope the audit to identify all significant deficiencies, however, the Board placed these provisions in the section of the final standard that describes communications requirements.[15/]

[14/] The Board also made minor changes to the definition of material weakness in order to use the same definition in the SEC's management guidance and related rule. In the final standard, material weakness is defined as "a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

[15/] See paragraph 80. The final standard also includes the proposed requirement for the auditor to communicate, in writing, to management, all deficiencies in internal control identified during the audit and inform the audit committee when such a communication has been made, and the proposed requirement to inform, when applicable, the board of directors of the auditor's conclusion that the audit committee's oversight is ineffective. See paragraphs 79 and 81. Some commenters believed that the requirement to communicate all identified deficiencies to management would result in an unnecessary administrative exercise. The Board continues to believe, however, that auditors should provide information about identified control deficiencies to management.

The relatively minor changes that the Board made to the definition of significant deficiency are also intended to focus the auditor on the communication requirement and away from scoping issues. The final definition is based on the proposed definition of "significant misstatement," which commenters generally supported, and is aligned with the SEC's proposed definition of the same term. Under the final standard, a significant deficiency is "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

Scaling the audit

The proposed standard on auditing internal control indicated that a company's size and complexity are important considerations and that the procedures an auditor should perform depend upon where along the size and complexity continuum a company falls. The proposed standard included a section on scaling the audit for smaller, less complex companies and would have required auditors to evaluate and document the effect of the company's size and complexity on the audit. This documentation requirement applied to audits of companies of all sizes. The proposed standard also included a list of the attributes of smaller, less complex companies and a description of how the auditor might tailor his or her procedures when these attributes are present. In general, commenters were supportive of the proposed standard's general approach to scalability, but had several recommendations for change.

Some commenters suggested that scalability should not be covered as a stand-alone discussion applicable only to smaller companies and that other companies, regardless of size, might have areas that are less complex. The Board agrees that the direction on scaling will be most effective if it is a natural extension of the risk-based approach and applicable to all companies. Consequently, the Board shortened the separate section on "scaling the audit," and incorporated a discussion of scaling concepts, similar to what was proposed, throughout the final standard. Specifically, notes to relevant paragraphs describe how to tailor the audit to the particular circumstances of a smaller, less complex company or unit. The Board also retained the list of attributes of smaller, less complex companies and acknowledged that, even within larger companies, some business units or processes may be less complex than others. Discussion of these attributes has been incorporated in the section on the auditor's planning procedures in the final standard.[16/] As described in the proposing release, the provisions on scalability in the final standard will form the basis for guidance on auditing internal control in smaller companies to be issued this year.

Several commenters, mostly auditors, suggested that the performance requirements that applied to all companies, including large, complex companies, would lead to unnecessary and costly documentation requirements. These commenters were particularly concerned about the requirement to document the effects of size and complexity on all aspects of the audit, even if a particular engagement could not be tailored as a result of these factors. After considering

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[16/] See paragraph 9.

these comments, the Board agreed that this documentation requirement is not necessary to promote audit quality and, therefore, has not included it in the final standard.

Use of the work of others in an integrated audit

At the time the Board proposed Auditing Standard No. 5 for public comment, the Board also proposed an auditing standard entitled *Considering and Using the Work of Others in an Audit* that would have superseded the Board's interim standard AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("AU sec. 322"), and replaced the direction on using the work of others in an audit of internal control in Auditing Standard No. 2. As discussed in the proposing release, the Board had several objectives in proposing this standard. The first was to better integrate the financial statement audit and the audit of internal control by having only one framework for using the work of others in both audits. Additionally, the Board wanted to encourage auditors to use the work of others to a greater extent when the work is performed by sufficiently competent and objective persons. Among other things, under the proposed standard, auditors would have been able to use the work of sufficiently competent and objective company personnel – not just internal auditors – and third parties working under the direction of management or the audit committee for purposes of the financial statement audit as well as the audit of internal control.

The Board received numerous comments on the proposed standard on using the work of others. Commenters generally indicated support for a single framework regarding the auditor's use of the work of others in an integrated audit. Some, however, suggested retaining existing AU sec. 322 as the basis for that single framework. They expressed the view that the objective of removing barriers to integration and using the work of others to the fullest extent appropriate could be achieved by retaining AU sec. 322 and going forward with the proposed removal of the "principal evidence" provision. At the same time, some other commenters suggested that the proposed standard did not go far enough in encouraging auditors to use the work of others.

After considering these comments, the Board continues to believe that a single framework for the auditor's use of the work of others is preferable to separate frameworks for the audit of internal control and the audit of financial statements. The factors used to determine whether and to what extent it is appropriate to use the work of others should be the same for both audits. At the same time, the Board agreed with those commenters who suggested that better integration of the audits could be achieved without replacing the existing auditing standard. The Board therefore has decided to retain AU sec. 322 for both audits and incorporate language into Auditing Standard No. 5 that establishes these integration concepts rather than adopt the proposed standard on considering and using the work of others.

Consistent with the proposal, however, Auditing Standard No. 5 allows the auditor to use the work of others to obtain evidence about the design and operating effectiveness of controls and eliminates the principal evidence provision. Recognizing that issuers might employ personnel other than internal auditors to perform activities relevant to management's assessment of internal control over financial reporting, the final standard allows the auditor to use the work of company personnel other than internal auditors, as well as third parties working under the direction of management or the audit committee.[17/]

In line with the overall risk-based approach to the audit of internal control over financial reporting, the extent to which the auditor may use the work of others depends, in part, on the risk associated with the control being tested. As the risk decreases, so does the need for the auditor to perform the work him or herself. The impact of the work of others on the auditor's work also depends on the relationship between the risk and the competence and objectivity of those who performed the work. As the risk decreases, the necessary level of competence and objectivity decreases as well.[18/] Likewise, in higher risk areas (for example, controls that address specific fraud risks), use of the work of others would be limited, if it could be used at all.

Finally, the Board understands that some of the work performed by others for the purposes of management's assessment of internal controls can be relevant to the audit of financial statements. Therefore, in an integrated audit, the final standard allows the auditor to use the work of these sufficiently competent and objective others – not just internal auditors – to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of financial

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[17/] See paragraph 17.

[18/] See paragraph 18.

statements.[19] The Board believes that this provision will promote better integration of the audit of internal control with the audit of financial statements.

Rule 3525 – Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting

The Board also proposed a new rule related to the auditor's responsibilities when seeking audit committee pre-approval of internal control related non-audit services. As proposed, the rule required a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related non-audit services that are not otherwise prohibited by the Act or the rules of the SEC or the Board to: describe, in writing, to the audit committee the scope of the proposed service; discuss with the audit committee the potential effects of the proposed service on the firm's independence; and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee pre-approval to perform tax services for an audit client under PCAOB Rule 3524. Most commenters were supportive of the rule as proposed, though some offered suggestions about what should be included in the required communication. After considering the comments on the proposed rule, the Board has adopted it without change.

Conforming Amendments

As part of the proposal issued for public comment, the Board proposed amendments to certain of the Board's other auditing standards. Only one

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[19] See paragraph 17.

comment letter specifically addressed the proposed amendments. That letter expressed support for the amendments and suggested a few additional amendments that might be necessary. The Board has considered this comment and added these additional amendments, as well as others, as necessary based on the final standard.

Effective Date

The proposing release solicited commenters' feedback on how the Board could structure the effective date of the final requirements so as to best minimize disruption to ongoing audits, but make greater flexibility available to auditors as early as possible. Most commenters on this topic suggested making the final standard on auditing internal control effective as soon as possible in order to be available for 2007 audits.

The Board agrees that the improvements in Auditing Standard No. 5 should be available as soon as possible. Accordingly, the Board has determined that Auditing Standard No. 5, Rule 3525, and the conforming amendments will be effective, subject to approval by the SEC, for audits of fiscal years ending on or after November 15, 2007. Earlier adoption is permitted, however, at any point after SEC approval. Auditors who elect to comply with Auditing Standard No. 5 after SEC approval but before its effective date must also comply, at the same time, with Rule 3525 and other PCAOB standards as amended by this release.

Auditing Standard No. 2 will be superseded when Auditing Standard No. 5 becomes effective. Auditors who do not elect to comply with Auditing Standard No. 5 before that date (but after SEC approval) must continue to comply with

Auditing Standard No. 2 until it is superseded. Such auditors should, however, apply the definition of "material weakness" contained in Auditing Standard No. 5, rather than the one contained in Auditing Standard No. 2. The SEC has adopted a rule to define the term "material weakness," and the definition in Auditing Standard No. 5 parallels the new SEC definition.

Additional Discussion of Comments and the Board's Response

Alignment of Board's Internal Control Auditing Standard and the SEC's Guidance to Management

Many commenters suggested that the SEC's guidance to management and the Board's auditing standard should be more closely aligned. The commenters appeared to hold different opinions, however, about what alignment should mean in this context. Some commenters suggested that the most important issue was the need to use the same definitions of important terms in both documents. Some focused on perceived differences in scope, testing, and documentation requirements, while others suggested that the tone of the two documents was different and that the Board's proposals were more prescriptive. A few commenters suggested that the standard on auditing internal control should merely refer to the SEC management guidance without providing additional direction to the auditor.

As discussed above, in formulating a new standard on auditing internal control, the Board intended to describe an audit process that would be coordinated with management's evaluation process. After considering the comments in this area, the Board made several changes, described above, that improve coordination while recognizing the inherent differences in the roles of management and the independent auditor under Section 404. The Board also adopted, as proposed, the final standard without a requirement for the auditor to perform an evaluation of management's assessment process. Commenters generally supported this aspect of the proposal, which was intended to respond to concerns that the requirements of Auditing Standard No. 2 had become *de facto* guidance for management's process. The absence of this requirement in the final standard should also allow for improved coordination between management and the auditor.

Level of Prescriptive Detail

Some commenters suggested that there remained too many instances of the use of the terms "should" and "must" in the proposed standard and that this might drive excessive documentation and possibly unnecessary work. The Board's Rule 3101 describes the level of responsibility that these imperatives impose on auditors when used in PCAOB standards, and the Board uses these terms in its standards to clearly convey its expectations. In response to these comments, the Board analyzed each requirement in the proposed standard to determine whether more reliance could be placed on general principles rather than detailed requirements. Where appropriate, the Board made modifications to make the final standard more principles-based. As discussed more fully above, areas in which changes were made include the focus on fulfilling the objectives of a walkthrough and in the description of the top-down approach. Some of these changes also contributed to better coordination with the SEC's guidance for management.

In addition, several commenters expressed concern over the creation of presumptively mandatory responsibilities related to efficiency concepts. The example cited most often was the note to paragraph 3 of the proposed standard on auditing internal control, which stated –

> Note: The auditor should select for testing only those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to a given relevant assertion that could result in a material misstatement to the company's financial statements.

Commenters suggested that because of this requirement for the auditor to select "only those controls that are important" for testing, an auditor would have violated the Board's standards if he or she tested even one control that was later shown to be not important. Commenters believed that this would undermine audit effectiveness and recommended removal of such statements.

One of the objectives of the revised standard is to encourage auditors to focus on those areas that present the greatest risk of allowing a material misstatement in the financial statements. However, the Board agrees that its standards should not define a ceiling or maximum amount of work which the auditor may not exceed. While this statement (and others like it) in the proposed standard was not intended to imply that the Board would, with hindsight, suggest that an auditor violated the standard through testing of a control that was later determined to be not important to the audit, the Board has removed the note to paragraph 3 in response to these comments. Similar statements throughout the standard have also either been removed or modified.

Walkthroughs

The proposed standard required that the auditor perform a walkthrough of each significant process each year and allowed the auditor to use others, such as management personnel and internal auditors, to directly assist the auditor in this work. The proposed standard also indicated that the walkthrough provides audit evidence but did not prescribe further requirements regarding the circumstances in which a walkthrough might provide the auditor with sufficient evidence of operating effectiveness for a particular control. The proposing release, however, noted that a walkthrough could be sufficient for some low-risk controls in subsequent years.

As discussed above, the Board received a significant number of comments on this topic. While several commenters expressed support for the importance of the walkthrough to audit quality, many commenters suggested that the proposed provisions in this area were more prescriptive than necessary, and suggested risk concepts as a way to add flexibility. While these commenters acknowledged the value of a walkthrough and its importance to the evaluation of design effectiveness, many stated that the requirement to perform a walkthrough in an area that is either low-risk, not complex, or unchanged appears inconsistent with the other areas in the proposed standard that rely upon auditor judgment to a much greater extent.

Use of others in achieving the objectives of a walkthrough

Commenters supported allowing the auditor to use others to provide the auditor with direct assistance, particularly in low-risk areas, with only a few commenters believing that this change could jeopardize the quality of the audit. In addition, many commenters believed that the standard should allow full use of the work of others in performing walkthroughs, although some commenters strongly disagreed with this point.

As discussed above, the final standard focuses the auditor on achieving four objectives related to the identification of where within the company's processes misstatements could arise, rather than specifically on performing walkthroughs. Due to the importance of achieving these objectives to the auditor's conclusion about internal control, the Board believes that allowing the use of the work of others to a greater extent than what was proposed would not provide the auditor with an adequate understanding of the relevant risks and the related controls. Therefore, similar to the proposed standard, Auditing Standard No. 5 allows the auditor to use the work of others in achieving the objectives of a walkthrough, but only as direct assistance. That is, the auditor will be required to supervise, review, evaluate, and test the work performed by others.[20/]

Using walkthroughs to test operating effectiveness

On the subject of using walkthroughs to test operating effectiveness, commenters suggested that walkthroughs can provide sufficient evidence of operating effectiveness, but held different views about situations in which this would be the case. Some commenters supported the use of walkthroughs in low-risk areas, while others focused on whether the control itself should be low-risk. Several commenters suggested that a walkthrough could provide sufficient

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[20/] See paragraph 27 of AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.*

evidence of operating effectiveness for lower-risk controls but only when entity-level controls are strong. Almost all commenters agreed that the proposed standard focused on the appropriate conditions for using such an approach – specifically, when risk is low, when past audits indicate effective design and operation of the control, and when no changes have been made to the control or process in which the control resides.

After considering these comments, the Board has decided that the risk-based approach that is described in the final standard is the appropriate framework for determining the evidence necessary to support the auditor's opinion. Therefore, Auditing Standard No. 5 articulates the principle that performance of a walkthrough might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthroughs and the results of the procedures performed.[21/] The Board believes that establishing more detailed requirements in this area is not necessary, because application of the general principle in the standard will depend on the particular facts and circumstances presented.

Assessing Risk

The Board's May 16, 2005 guidance emphasized the importance of risk assessment in the audit of internal control, and that element of the guidance was incorporated and enhanced in the proposed standard. The proposed standard required risk assessment at each of the decision points in a top-down approach,

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[21/] See paragraph 49.

including the auditor's identification of significant accounts and disclosures and their relevant assertions. The proposed standard also required an assessment of risk at the individual control level, and required that the auditor determine the evidence necessary for a given control based on this risk assessment.

The Board received many comments on the risk assessment provisions in the proposed standard. Comments on the proposed risk assessment approach were generally supportive, with some commenters suggesting ways for improving the risk assessment emphasis in the standard. Many commenters discussed the requirement in the proposed standard for the auditor to assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result for each control the auditor selected for testing. Commenters suggested that this requirement conflicted with both current practice and the requirements within the interim standards for the financial statement audit, which involve risk assessment at the financial statement assertion level. These commenters believed that this requirement would result in risk assessments at both the assertion level and the individual control level and suggested that assessing (and documenting) risk at the relevant assertion level is sufficiently precise to drive appropriate audits. Furthermore, they believed that a specific requirement to assess risk at the individual control level and its associated documentation requirement would be unnecessary.

After considering these comments, the Board continues to believe that the auditor may vary the nature, timing, and extent of testing based on the assessed risk related to a control. Making this assessment a presumptively mandatory requirement, as it was in the proposed standard, however, does not appear necessary to achieve the intended benefits of varied testing based on the risk associated with a control. Auditing Standard No. 5, therefore, requires the auditor to assess the risk related to the relevant assertion, but not the risk at the individual control level. The standard permits the auditor to consider the risk at the control level, however, and alter the nature, timing, and extent of testing accordingly.

Several commenters expressed concern about the advisability of taking a risk-based approach and the adequacy of the Board's interim standards regarding risk assessment. These commenters suggested that auditors have frequently been unsuccessful at applying a risk-based approach to the financial statement audit in the past.

The Board has found the arguments for a more principles-based approach to internal control auditing convincing, and the principle that the auditor should vary the testing to respond to the risk is one of the most important in the standard. Early implementation of Auditing Standard No. 2 demonstrated that, when internal control is audited without adequate consideration of risk, the areas that pose the greatest danger of material misstatement may be obscured or lost. The emphasis on risk, therefore, drives an audit that is more effective and focused. While the Board believes that auditors can appropriately assess risk based on the interim auditing standards, it has committed to examining the existing standards in this area to see where improvements can be made. This is currently one of the Board's standard setting priorities.

Evaluation of Deficiencies

The Board received a substantial number of comments on the topic of evaluating deficiencies, including comments on the proposed definitions of material weakness and significant deficiency, the "strong indicators" of a material weakness, and the requirement to evaluate all identified deficiencies. While a number of commenters stated that auditors do identify material weaknesses in the absence of an actual material misstatement, some noted that, in many cases, material weaknesses are identified only when material misstatements are discovered. Several commenters suggested that the proposed standard, with its focus on using a top-down approach and scoping to identify material weaknesses, would allow auditors to do a more thorough review of the most important controls with less effort expended on reviewing lower risk controls. These commenters often stated that this approach should increase the likelihood of the auditor detecting material weaknesses before a material misstatement occurs.

Definition of a material weakness

The proposed standard retained the basic framework in Auditing Standard No. 2 that described material weaknesses by reference to the likelihood and magnitude of a potential misstatement. While the Board believed that framework to be sound, it made an effort to clarify the definition in the proposed standard by replacing the reference to "more than remote likelihood" with "reasonable possibility." Financial Accounting Standards Board ("FASB") Statement No. 5 describes the likelihood of a future event occurring as "probable," "reasonably possible," or "remote." The definition in Auditing Standard No. 2 referred to a "more than remote" likelihood of a misstatement occurring. In accordance with FASB Statement No. 5, the likelihood of an event is "more than remote" when it is either "reasonably possible" or "probable."

As the Board noted in the proposing release, however, some auditors and issuers have misunderstood the term "more than remote" to mean something significantly less likely than a reasonable possibility. This, in turn, could have caused these issuers and auditors to evaluate the likelihood of a misstatement at a much lower threshold than the Board intended. Because the term "more than remote" could have resulted in auditors and issuers evaluating likelihood at a more stringent level than originally intended, the Board proposed changing the definition to refer to a "reasonable possibility."

Commenters on this change were split between those that felt the change would reduce unnecessary effort spent on identifying and analyzing deficiencies, and those who believed it would not. Several commenters noted that the replacement of the term "more than remote likelihood" with the term "reasonable possibility" does not raise the auditor's threshold for classifying deficiencies. According to those commenters, the change simply attempts to align the description of the threshold for identifying deficiencies with previous guidance issued by the PCAOB. The Board continues to believe that the proposed definition – as well as Auditing Standard No. 2 – established an appropriate threshold for the likelihood part of the definition of material weakness. While the Board agrees that, as a definitional matter, "reasonable possibility" and "more than remote" describe the same threshold, it believes that "reasonable possibility" describes that threshold more appropriately and clearly, and will therefore avoid the misunderstanding of the threshold created by the way it was described in Auditing Standard No. 2. As a result, it retained that term in the final definition in the standard.

In addition, some commenters noted that the definitions of material weakness and significant deficiency in the proposed standard, like the definitions in Auditing Standard No. 2, referred to the likelihood of a material misstatement in both the interim and annual financial statements. Most of these commenters suggested that the Board remove the term "interim" from the definitions of material weakness and significant deficiency because, according to the commenters, it causes confusion when scoping the audit of internal control and unnecessarily complicates the evaluation of deficiencies, particularly in the absence of guidance from the SEC and FASB regarding interim materiality. Some commenters, however, said that the Board should not remove the term "interim" from the definitions because the evaluation of deficiencies should be performed to consider the effectiveness of internal control for both the interim and annual financial statements. After carefully considering these comments, and in order to use the same definition that the SEC uses in its guidance to management, the Board determined to retain the reference to interim financial statements in the final definition of material weakness.[22/]

[22/] The provisions in the final standard relating to significant deficiencies are discussed above. As discussed above, the Board also made

Indicators of a material weakness

The proposed standard described circumstances that should be regarded as strong indicators of a material weakness in internal control. The proposing release noted that the identification of one of these strong indicators should bias the auditor toward a conclusion that a material weakness exists but does not require the auditor to reach that conclusion. Under the proposal, the auditor could determine that these circumstances do not rise to the level of a material weakness, and in some cases, are not deficiencies at all.

Many commenters supported the proposed changes from Auditing Standard No. 2 relating to strong indicators, agreeing that, by allowing greater use of professional judgment in this area, practice will improve. A few commenters stated that these changes may lead to some inconsistency in practice, but consistent with other commenters, they still supported the use of greater professional judgment in the evaluation of deficiencies. At least one commenter suggested that several of the strong indicators were not indicators of a material weakness but should be, under all circumstances, a material weakness. A few commenters also suggested that the list of strong indicators in Auditing Standard No. 2 actually stifles the auditor's judgment to the point that auditors fail to identify material weaknesses that exist because the deficiency is not on the list of strong indicators. These commenters suggested that removing the list of strong indicators entirely would be best.

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minor wording changes to the definition of material weakness in order to use the same definition as the SEC in its guidance to management and related rules.

The Board believes that auditor judgment is imperative in determining whether a deficiency is a material weakness and that the standard should encourage auditors to use that judgment. At the same time, the Board continues to believe that highlighting certain circumstances that are indicative of a material weakness provides practical information about the application of the standard. As a result, the Board has included this information in the final standard but has taken a more principles-based approach. Additionally, the Board has coordinated with the SEC so that the indicators in the auditing standard parallel those in the SEC's management guidance.

Rather than referring to "strong indicators," the final standard refers simply to "indicators" of material weakness.[23/] The standard also makes clear that the list of indicators is not exhaustive and should not be used as a checklist. Specifically, under the final standard, the presence of one of the indicators does not mandate a conclusion that a material weakness exists. At the same time, a deficiency that is not a listed indicator may be a material weakness.

The Board did not adopt as indicators in the final standard certain proposed strong indicators. The Board believes, as at least one commenter

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[23/] The Board included as an indicator the proposed standard's requirement to determine the level of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. In the proposal, if the auditor determined that a deficiency would prevent prudent officials from concluding that they have such reasonable assurance, the auditor was required to deem the deficiency to be at least a significant deficiency. Under the final standard, if the auditor determines that a deficiency might prevent prudent officials from concluding that they have such reasonable assurance, this circumstance is an indicator of material weakness.

suggested, that some of these proposed strong indicators are better characterized as material weaknesses rather than as indicators of a material weakness.[24/] Including them in the list of indicators, as adopted, would therefore be inconsistent with the degree of judgment required to evaluate whether an indicator of a material weakness is, under particular facts and circumstances, a material weakness.

Requirement to evaluate all identified deficiencies

The proposed standard required the auditor to evaluate the severity of each control deficiency that comes to his or her attention. The same provision in the proposed standard made clear, however, that the auditor need not scope the audit to find control deficiencies that are less severe than material weaknesses. A few commenters believed that this requirement is not necessary and suggested that an acceptable alternative would be for the auditor to verify that management has evaluated all deficiencies.

The Board continues to believe that the auditor needs to evaluate all deficiencies that come to his or her attention. Without such an evaluation, there would not be a sufficient basis for the auditor's opinion.

[24/] One such proposed strong indicator was an ineffective control environment. Under the proposal, indicators of an ineffective control environment included identification of fraud on the part of senior management and significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after some reasonable period of time. The final standard includes the identification of fraud on the part of senior management as an indicator of a material weakness. In order to simplify the list and make it more principles-based, as well as to align it with the SEC management guidance, however, the Board did not include significant deficiencies that remain uncorrected as an indicator in the final standard.

Additional Scoping and Materiality Issues

The proposed standard clarified that the auditor should plan and perform the audit of internal control using the same materiality measures used to plan and perform the audit of the annual financial statements. This direction was intended to address concerns that auditors have interpreted Auditing Standard No. 2 as directing them to search for potential defects in internal control at a lower materiality level than that used in the audit of the annual financial statements.

The Board received many comments on materiality and scoping, and a large portion of the commenters expressed support for the proposed standard's approach. Some commenters, however, recommended providing clear quantitative guidelines for calculating materiality. Other commenters expressed concern about such an approach, fearing that material areas would be inappropriately excluded from the audit scope. Finally, some commenters suggested that the Board should provide additional guidance on scoping and extent of control testing decisions, such as guidance on sample sizes related to testing of high-risk controls versus low-risk controls or more specific guidance on the scope of the internal control audit for entities with multiple locations.[25/]

[25/] The proposed standard focused on the auditor's assessment of risk of material misstatement and how the auditor could carry that assessment process into the scoping of a multi-location audit. Commenters were very supportive of the Board's approach in this area and, consequently, the Board has determined to adopt these provisions as proposed.

After considering these comments, the Board has determined to adopt its discussion of materiality in the internal control audit as proposed. The Board believes that the auditing standard on internal control is an inappropriate place to redefine or refine the meaning of materiality, which is a long-established concept in the federal securities laws. With respect to requests for more specific guidance on scoping or extent of testing issues, the Board has, as discussed above, endeavored to adopt a standard that relies more on general principles than detailed requirements. Accordingly, the Board believes that auditors should make specific determinations of how to comply with the general scoping and testing requirements in the standard using professional judgment in the particular circumstances presented.

Scaling the Audit for Smaller Companies

As discussed above, the Board received many comments on the proposed section on scaling the audit from commenters with a variety of perspectives. The comments covered a wide range of issues. In addition to the matters discussed above, commenters suggested:

- That the proposed section on scalability should be focused more closely on how complexity relates to a risk-based audit;
- That the proposed standard did not provide sufficient flexibility for smaller companies and that the standard should provide for more "credit" for control testing based on work done as part of the financial statement audit;
- That the resulting costs of these proposed changes would need to be studied for several years to determine if they are appropriate;
- That the attributes of smaller, less complex companies that were included in the proposed standard were appropriate and that the tailoring directions for auditors were adequate;

- That some of the attributes of smaller, less complex companies that might allow the auditor to tailor the audit might be, instead, risk factors that require more testing;
- That the emphasis on entity-level controls might not be appropriate; and
- That the Board's project to develop guidance on auditing internal control in smaller public companies is necessary.

As discussed above, the Board made several changes in response to comments in the final standard. The new standard provides direction on how to tailor internal control audits to fit the size and complexity of the company being audited. It does so by including notes throughout the standard on how to apply the principles in the standard to smaller, less complex companies, and by including a discussion of the relevant attributes of smaller, less complex companies as well as less complex units of larger companies. The Board believes that the final standard appropriately considers the circumstances of smaller and less complex public companies (and other companies with less complex business units) while requiring a high-quality audit regardless of company size or complexity. The planned guidance on this topic will provide additional practical information for auditors of smaller companies.

Information Technology Principles

In gaining an understanding of the effect of information technology ("IT") on internal control over financial reporting and the risks the auditor should assess, the proposed standard directed the auditor to apply guidance in AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*. Additionally, the proposed standard included a discussion of IT operations at smaller and less complex companies. A number of commenters discussed the importance of IT risks to determining the scope of the audit and recommended that the final standard include additional guidance on how the risk assessment related to IT is incorporated in the audit of internal control.

In response to these comments, the Board included in Auditing Standard No. 5 a note to paragraph 36 that clarifies that the identification of risks and controls within IT should not be a separate evaluation but, rather, an integral part of the auditor's top-down risk assessment, including identification of significant accounts and disclosures and their relevant assertions, as well as the controls to test.

Roll-forward Procedures

The proposed standard discussed the procedures the auditor should perform to obtain additional evidence concerning the operation of the control when the auditor reports on the effectiveness of the control "as of" a specific date, but has tested the effectiveness of the control at an interim date. The Board received a few comments on this topic, mainly from auditors. The comments were consistent in their view that the proposed standard improperly implies, by using the expression "if any" in relation to additional evidence the auditor is required to obtain, that the auditor may not need to do any roll-forward work. Commenters suggested that such an approach would be inconsistent with paragraph .99 of AU sec. 319 and suggested that the words "if any" be removed from the final standard. The Board believes that its standard should be consistent with AU sec. 319.99 in that the auditor should perform some level of roll-forward procedures. Consequently, the Board removed the words "if any" from the relevant paragraphs of Auditing Standard No. 5 to correct the inconsistency. The Board also noted that, in some circumstances, inquiry alone might be a sufficient roll-forward procedure.

Cumulative Knowledge and Rotation

The proposed standard on auditing internal control allowed the auditor to incorporate knowledge from previous years' audits into his or her decision making process for determining the nature, timing, and extent of testing necessary. The section in the proposed standard on special considerations for subsequent years' audits built upon the risk-based framework in the proposed standard for determining the nature, timing, and extent of testing by describing certain additional factors for the auditor to evaluate in subsequent years. These factors included the results of prior years' testing and any change that may have taken place in the controls or the business since that testing was performed. This section retained the requirement in Auditing Standard No. 2 that each control deemed important to the auditor's conclusion be tested every year, but allowed for a reduction in testing when the additional risk factors indicated that the risk was lower than in the past.

Many commenters strongly supported these provisions as proposed. Many investors, in particular, stated that while they supported the proposed approach, they would not be supportive of rotation of control testing over a multiple-year period. These commenters were generally concerned that rotation of control testing would negatively affect audit quality. Among supporters of the approach in the proposed standard, several requested further clarification in the standard or additional guidance on how this approach should affect the level of testing.

Many issuers suggested that the standard should allow for full rotation – which exempts some important controls from testing each year – of at least controls in low-risk areas. Other commenters recommended that all controls should be tested on a multi-year rotating basis. These comments often focused on the fact that while the proposed standard required the auditor to evaluate whether there had been any relevant changes since the control was tested, it still required testing at some level even when there had been no change. These commenters considered this requirement to be unnecessary.

The Board shares the concern that multi-year rotation of control testing would not provide sufficient evidence for the auditor's opinion on internal control effectiveness, which is required by the Act to be issued each year. In the financial statement audit, control testing plays a supporting role – to the extent that controls have been tested and are effective, the auditor can reduce the level of (but not eliminate) the necessary substantive testing. In contrast, in the internal control audit, control testing does not play a supporting role but is the sole basis for the auditor's opinion. Additionally, even if the design of the control and its related process does not change from the prior year, it is not possible to assess the control's operating effectiveness without performing some level of testing. For these reasons, rotation is not a viable option in the audit of internal control. Instead, the approach described in the proposed standard has been clarified in the final standard and continues to focus the auditor on relevant changes since a particular control was last tested, as many commenters suggested. Under this approach, the auditor would consider, in addition to the risk factors described in the standard that are always relevant to determining the nature, timing, and extent of testing, whether there has been a change in the controls or in the business that might necessitate a change in controls; the nature, timing, and extent of procedures performed in previous audits; and the results of the previous years' testing of the control.[26/] After taking into account these additional factors, the additional information in subsequent years' audits might permit the auditor to assess risk as lower than in the initial year and, thus, might permit the auditor to reduce testing.

This treatment of cumulative knowledge is analogous to the roll-forward provisions in the final standard. In the case of subsequent years, the auditor, in essence, rolls forward the prior years' testing when the control was found to be effective in the past and no change has occurred (or would have been expected to occur due to changes in the environment or process that contains the control). Because the auditor might be able to assess the risk lower in the subsequent years, a walkthrough, or equivalent procedures, might be sufficient for low-risk controls. This approach appropriately factors in the effect of cumulative knowledge, while maintaining audit quality and providing a sufficient basis for the auditor's opinion.

[26/] See paragraph 55.

Reporting the Results of the Audit

In the proposed standard, the Board attempted to address concerns that the separate opinion on management's assessment required by Auditing Standard No. 2 contributed to the complexity of the standard and caused confusion regarding the scope of the auditor's work.[27/] Accordingly, to emphasize the proper scope of the audit and to simplify the reporting, the proposed standard required that the auditor express only one opinion on internal control – a statement of the auditor's opinion on the effectiveness of the company's internal control over financial reporting. The proposal eliminated the separate opinion on management's assessment because it was redundant of the opinion on internal control itself and because the opinion on the effectiveness of controls more clearly conveys the same information – specifically, whether the company's internal control is effective.

Many commenters agreed with the Board that eliminating the separate opinion on management's assessment would reduce confusion and clarify the reporting. Some commenters, however, suggested that the Board should instead require only an opinion on management's assessment. These commenters expressed their belief that the Act requires only that the auditor review management's assessment process and not the company's internal control. Additionally, a few commenters expressed confusion about why the proposed

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[27/] Although Auditing Standard No. 2 requires the auditor to evaluate management's process, the auditor's opinion on management's assessment is not an opinion on management's internal control evaluation process. Rather, it is the auditor's opinion on whether management's statements about the effectiveness of the company's internal controls are fairly stated.

standard continued to reference an audit of management's assessment in paragraph 1 of the proposed standard and the auditor's report.

The Board has determined, after considering these comments, to adopt the provision requiring only an opinion on internal control.[28/] The Board continues to believe that the overall scope of the audit that was described by Auditing Standard No. 2 and the proposed standard is correct; that is, to attest to and report on management's assessment, as required by Section 404(b) of the Act, the auditor must test controls directly to determine whether they are effective.[29/] Accordingly, paragraphs 1 and 2 of the proposed standard provided that the auditor audits management's assessment – the statement in management's annual report about whether internal control is effective – by auditing whether that statement is correct – that is, whether internal control is, in fact, effective. The final standard similarly makes this clear. In response to commenters, however, the Board has clarified the auditor's report so that it will consistently refer to the required audit as the audit of internal control.

[28/] The SEC has adopted changes to its rules that require the auditor to express an opinion directly on internal control.

[29/] In addition, Section 103 of the Act requires the Board's standard on auditing internal control to include "testing of the internal control structure and procedures of the issuer …." Under Section 103, the Board's standard also must require the auditor to present in the audit report, among other things, "an evaluation of whether such internal control structure and procedures … provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles …."

Implementation

Some commenters urged the Board to focus on implementation issues after it adopts a final standard, and noted that effective implementation by the Board is crucial to the internal control reporting process. Some of these commenters focused on the inspections process, which they suggested is key to promoting audit efficiency. Some stated that auditors would be unlikely to change their audit approach until they are confident that the inspections will be similarly focused. The Board is committed to effective monitoring of firms' compliance with the new standard and will continue to promote proper implementation through other means, including the Board's Forums on Auditing in the Small Business Environment and guidance for auditors of smaller companies.

III. Date of Effectiveness of the Proposed Rule and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents the Commission will:

(a) by order approve such proposed rule; or

(b) institute proceedings to determine whether the proposed rules should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule is consistent with the requirements of Title I of the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All submissions should refer to File No. PCAOB-2007-02 and should be submitted within [ ] days.

By the Commission.

Secretary

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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 December 19, 2006 PCAOB Rulemaking Docket Matter No. 021

Summary: The Public Company Accounting Oversight Board (the "Board" or "PCAOB") is proposing an auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would supersede its Auditing Standard No. 2. The PCAOB is also proposing a related auditing standard, *Considering and Using the Work of Others in an Audit*, an independence rule relating to the auditor's provision of internal control-related non-audit services, and certain amendments to its interim standards.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 021 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on February 26, 2007.

Board Contacts: Laura Phillips, Deputy Chief Auditor (202/207-9111; phillipsl@pcaobus.org), Sharon Virag, Associate Chief Auditor (202/207-9164; virags@pcaobus.org).

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I. Introduction

In June 2003, the Securities and Exchange Commission ("SEC") implemented Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") by adopting rules requiring issuers to include in their annual reports an assessment of the company's internal control over financial reporting as well as an auditor's report on that assessment.[1/] Soon after, as required by Sections 404(b) and 103 of the Act, the Board adopted Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS No. 2"), to apply to the newly required audits. The SEC approved AS No. 2 on June 17, 2004.

Two annual financial reporting cycles have been completed since public company auditors began applying AS No. 2 to audits of accelerated filers.[2/] During this time, the PCAOB has closely monitored implementation of the standard and the progress auditors have made in complying with its requirements. The PCAOB's monitoring has included gathering information during inspections of registered public accounting firms; participating, along with the SEC, in two roundtable discussions with representatives of issuers, auditors, investor groups, and others; meeting with its Standing Advisory Group; receiving feedback from participants in the Board's Forums on Auditing in the Small Business Environment; and reviewing academic, government, and other reports and studies.

From all of these sources of information, two basic propositions have emerged. First, the audit of internal control over financial reporting has produced significant benefits. Issuers and auditors have described a focus on corporate governance that had not existed in the past and improvements in the quality and efficiency of important corporate processes and controls.[3/] Corporate board members have noted an

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[1/] See Item 308 of Regulation S-K, 17 C.F.R. § 229.308.

[2/] Companies considered accelerated filers by the SEC (generally, U.S. companies with public float of $75 million or more) have been required to comply with Section 404 of the Act since fiscal years ended on or after November 15, 2004.

[3/] See, e.g., comments of Phillip D. Ameen, General Electric Company, and Samuel A. DiPiazza, PricewaterhouseCoopers International, at *Roundtable Discussion on Second-Year Experiences with Internal Control Reporting and Auditing Provisions* (May 10, 2006) ("May 10 Roundtable), transcript available at

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improvement in audit committee oversight, while investors have found public company financial reporting to be of higher quality and enhanced transparency.[4/] At the same time, research shows that effective internal control is positively correlated with accurate financial reporting.[5/]

Second, these benefits have come with significant cost. Over the last two years, the Board has heard a consistent message that compliance with the internal control provisions of the Act has required greater effort and resulted in higher costs than expected. The Board agrees that auditors should perform internal control audits as efficiently as possible for companies that are required by the SEC's rules to obtain an audit report on internal control.[6/] With this in mind, the Board has evaluated every significant aspect of the audit of internal control to determine whether the existing standard encourages auditors to perform procedures that are not necessary in order to achieve the intended benefits. As a result of that evaluation, the Board is proposing a new auditing standard on internal control over financial reporting that would supersede AS No. 2. The Board also is proposing a new auditing standard on using the work of

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http://www.pcaobus.org/Standards/Standards_and_Related_Rules/AS2/2006/05-10/Unedited_Transcript.pdf.

[4/] See, e.g., comments of Barbara Hackman Franklin, board member, various companies and Michael J. McConnell, Managing Director, Shamrock Capital Advisors, May 10 Roundtable.

[5/] See Doyle, Jeffrey T., Ge, Weili and McVay, Sarah E., "Accruals Quality and Internal Control over Financial Reporting," American Accounting Association 2006 Financial Accounting and Reporting Section Meeting Paper (December 4, 2006), available at SSRN: http://ssrn.com/abstract=789985.

[6/] See PCAOB, *"Statement Regarding the Public Company Accounting Oversight Board's Approach to Inspections of Internal Control Audits in the 2006 Inspection Cycle"* (May 1, 2006); *"Report on the Initial Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements"* (Nov. 30, 2005); *"Policy Statement Regarding Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements"* (May 16, 2005) (May 16, 2005 Policy Statement).

others, a new independence rule on non-audit services related to internal control, and certain related amendments to the Board's interim auditing standards.

As described below, the proposals are designed primarily to –

- **Focus the audit on the matters most important to internal control** by, among other things, directing the auditor's testing to the most important controls; emphasizing the importance of risk assessment; revising the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness; and clarifying the role of materiality, including interim materiality, in the audit;

- **Eliminate unnecessary procedures** by, among other things, removing the requirement to evaluate management's process; permitting consideration of knowledge obtained during previous audits; refocusing the multi-location testing requirements on risk rather than coverage; removing barriers to using the work of others; and recalibrating the walkthrough requirement;

- **Scale the audit for smaller companies** by, among other things, directing the auditor to tailor the audit to reflect the attributes of smaller, less complex companies; and

- **Simplify the requirements** by, among other things, reducing detail and specificity; better reflecting the sequential flow of an audit of internal control; and improving readability.

The Board requests comment on all aspects of the proposals. In addition to the specific questions below, the Board is particularly interested in whether the proposed changes will preserve the intended benefits of the audit of internal control. The Board is also particularly interested in whether the proposed changes will reduce audit hours and, if so, by how much.

II. Significant Changes to the Standard

The Board is proposing a new standard on auditing internal control rather than revisions to the existing standard. The following section describes the significant changes the Board proposes to make in order to effect its four primary objectives and specifically seeks comment on these significant changes.

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A. Focusing the Audit on the Matters Most Important to Internal Control

Many commentators have expressed concern that the internal control audit is overly focused on the more detailed, process-level aspects of internal control.[7/] Additionally, some commentators have expressed concern that internal control audits are failing to identify the material weaknesses that are most important—those that are early indicators of problems, rather than those that already have resulted in a material misstatement.[8/] The Board's proposals are designed to bolster the audit's ability to detect the most important problems by requiring auditors to use a top-down approach, stressing the importance of risk assessment, and clarifying certain definitions and terms.

1. Directing the Auditor's Attention Towards the Most Important Controls

The proposed standard on auditing internal control incorporates the top-down approach to the audit emphasized in the Board's May 16, 2005 guidance on applying AS No. 2.[9/] 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, and, finally, to the significant processes where other important controls reside. Following the top-down approach helps the auditor focus the testing on the right controls—those controls that are important to the auditor's conclusion—while avoiding those that are outside the scope of the audit of internal control.

7/ See, e.g., letter from David C. Chavern, Vice President Capital Markets Programs, Chamber of Commerce of the United States of America to Office of the Secretary, PCAOB (May 3, 2006) ("Greater focus needs to be given to the review and testing of significant entity-level controls, as opposed to individual transaction-based controls.").

8/ See, e.g., Gregory J. Jonas, Managing Director of Accounting Specialists Group, Moody's Investor Service, remarks at Roundtable (May 10, 2006) ("I really think we need to turn up the volume on controls that prevent and detect fraudulent financial reporting. I think our disclosures about material weaknesses have become, maybe inadvertently, backward looking rather than forward looking.").

9/ See May 16, 2005 Policy Statement.

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In a top-down approach, if company-level controls are strong and link directly to the process-level controls, or if they are sufficiently precise to prevent or detect material misstatements to relevant assertions, the auditor will likely be able to reduce the testing of controls at the process level.[10/] The proposed standard therefore emphasizes the importance of obtaining an understanding of the audit client's company-level controls at the beginning of the audit process. Because of the positive effect a top-down approach can have on the efficiency of the audit, the proposed standard would require auditors to take this approach to the audit, including testing important company-level controls.

The Board also wants to encourage an appropriate focus on controls important to the prevention and detection of fraud. Accordingly, the proposed standard specifically would require the auditor to evaluate the control environment and controls over the period-end financial statement close process and test, among other things, controls to address the risk of management override.

Questions

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

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

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

[10/] The proposed standard omits the statement in paragraph 54 of AS No. 2 that "[t]esting company level controls alone is not sufficient for the purposes of expressing an opinion on the effectiveness of a company's internal control over financial reporting." This statement has been interpreted to prohibit reliance on company level controls related to individual relevant assertions. The proposed standard would allow the auditor to determine that company-level controls are sufficient to address the risk of misstatement to a particular relevant assertion.

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2. Emphasizing the Importance of Risk Assessment

The Board's May 16, 2005 guidance emphasized the importance of risk assessment in the audit of internal control and that element of the guidance also has been incorporated and enhanced in the proposals. The auditor's assessment of risk should have a pervasive effect on an audit of internal control. From the auditor's initial evaluation of the risk of material weakness at the company overall, to the analysis of risk at the individual account, assertion, or control level, the auditor should continuously adjust his or her procedures to reflect information that the auditor has learned, including experiences from both the audit of internal control and the audit of the financial statements. Focusing the auditor's attention on the areas of greatest risk is likely to produce a more effective audit and substantially decrease the opportunity for a material weakness to go undetected. Appropriate use of risk assessment also enhances audit efficiency because the auditor does not spend time testing controls that, even if deficient, would not present a reasonable possibility of material misstatements in the financial statements.

The proposed standard on auditing internal control, therefore, requires risk assessment at each of the decision points in a top-down approach. The auditor's identification of significant accounts and relevant assertions requires an understanding of the related risks and how those risks should affect the auditor's decision making. Additionally, the proposed standard would require a risk-based approach to multi-location testing and includes an expanded discussion of the relationship of risk to the evidence necessary for the auditor to conclude that a given control is effective.

Importantly, the proposed standard makes clear that the evidence necessary to persuade the auditor that a control is effective depends on the risk associated with the control. The proposed standard describes risk factors that the auditor should assess in making this determination. Further, under the proposed standard, different combinations of the nature, timing, and extent of the auditor's testing can provide sufficient evidence in relation to the risk associated with a given control.

To appropriately emphasize the role of risk assessment in the auditor's work, the proposed standard also includes a change to the direction on integrating the audits. AS No. 2 states that "the absence of misstatements detected by substantive procedures [performed in the financial statement audit] does not provide evidence that controls related to the assertion being tested are effective."[11] In contrast, the proposed standard directs the auditor to consider the results of substantive audit procedures performed in the financial statement audit when determining the overall risk related to a control. This additional risk factor should be used by the auditor, along with others described in the proposed standard, in determining the evidence necessary for that control. At the same time, however, the proposed standard states that to obtain evidence about whether a control is effective, the control must be directly tested. In other words, effectiveness cannot be inferred solely from the absence of financial statement misstatements detected by the auditor.

Questions

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?

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

3. Revising the Definitions of Significant Deficiency and Material Weakness

The evaluation of deficiencies is, inherently, one of the most difficult aspects of an audit of internal control. Given the individual characteristics of each company and each deficiency, any method for evaluating deficiencies will demand a high degree of professional judgment. Commentators have suggested that the definitions of both significant deficiency and material weakness in AS No. 2 are confusing and are contributing to the difficulty of assessing the severity of the deficiencies.[12]

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[11] See AS No. 2, paragraph 158.

[12] See, e.g., Written Statement of Robert C. Pozen, Chairman, MFS Investment Management, May 10 Roundtable ("the use of phrases like "remote likelihood" or "more than remote" could easily lead to auditor concerns about internal control based on hypothetical situations that have not occurred and are not very likely to occur"); and Written Statement of Joseph A. Grundfest, Professor, Stanford Law School, May 10 Roundtable ("The inescapable implication of these definitions is that, in order to determine whether a company's controls suffer from significant deficiencies, auditors must search for controls at the margin between those that (a) raise a more than

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The Board believes that the existing framework in AS No. 2, which describes significant deficiencies and material weaknesses by reference to the likelihood and magnitude of a potential misstatement, is fundamentally sound. At the same time, however, the Board agrees that specific improvements to these definitions would simplify and clarify the standard. As a result, the proposed standard on auditing internal control includes three changes to these definitions –

a. <u>Replacement of the term "more than remote likelihood" with the term "reasonable possibility"</u>

In defining the terms "significant deficiency" and "material weakness" in AS No. 2, the Board used terms defined in Financial Accounting Standards Board's Statement No. 5, *Accounting for Contingencies* ("FASB Statement No. 5") to describe the threshold for likelihood of occurrence. The Board chose to use these terms because it believed that auditors and financial statement preparers were already familiar with how to apply them, and the Board expected that their use would promote consistency in the evaluation of deficiencies. FASB Statement No. 5 describes the likelihood of a future event occurring as "probable" "reasonably possible" or "remote" The definitions in AS No. 2 refer to a "more than remote" likelihood of a misstatement occurring. In accordance with FASB Statement No. 5, the likelihood of an event is "more than remote" when it is either "reasonably possible" or "probable."

The Board's monitoring of the implementation of AS No. 2 has shown, however, that some auditors and issuers have misunderstood the term "more than remote" to mean something significantly less likely than a reasonable possibility. This, in turn, may have caused these issuers and auditors to evaluate the likelihood of a misstatement at a much lower threshold than the Board intended. To encourage correct application of the definitions, the proposed standard replaces the reference to "more than remote likelihood" with "reasonable possibility" within the definitions of both material weakness and significant deficiency. To the extent that the term "more than remote" has resulted in auditors and issuers evaluating likelihood at a more stringent level than originally intended, this change should significantly improve the evaluation of deficiencies such that material weaknesses, when they are identified, are indeed the deficiencies that are most important.

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remote likelihood of an immaterial but more than inconsequential misstatement of the company's financial statements, and (b) those that raise a less than remote likelihood of an inconsequential misstatement.").

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b. Re-articulation of the definition of material weakness to exclude significant deficiency

AS No. 2 defines a material weakness as "a significant deficiency, or combination of significant deficiencies, that result in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected."[13/] Reference within this definition to significant deficiency has raised concern that auditors may be performing their audits at a level of detail necessary to ensure that their procedures identify all significant deficiencies, rather than only all material weaknesses. The objective of an audit of internal control is to obtain reasonable assurance as to whether material weaknesses exist. The audit of internal control does not require auditors to search for deficiencies that, individually or in combination, are less severe than material weaknesses. To better explain the objective of the audit and minimize confusion, the Board's proposed standard uses the term "a control deficiency, or combination of control deficiencies," in place of the reference to significant deficiencies in the definition of material weakness.

c. Replacement of the term "more than inconsequential" with the term "significant"

AS No. 2 defines a significant deficiency as a control deficiency, or combination of control deficiencies, that has a more than remote likelihood of resulting in a misstatement that is more than inconsequential. Several commentators expressed concern that the term "more than inconsequential" has caused companies and auditors to spend excess time identifying, discussing and fixing deficiencies that are not sufficiently important to the company's overall system of internal control. The Board is, therefore, proposing to re-articulate the definition of significant deficiency to better establish the threshold of what the Board believes is important enough to be identified as a significant deficiency. The proposed standard, therefore, replaces the term "more than inconsequential" with the term "significant" and defines "significant" as "less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

[13/] See AS No. 2, paragraph 10.

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Questions

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?

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?

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?

4. Revising the Strong Indicators of a Material Weakness

In addition to clarifying the definitions, the proposed standard on auditing internal control is intended to better describe their application in particular contexts. AS No. 2 describes circumstances that should be regarded as at least significant deficiencies and as strong indicators of a material weakness in internal control.[14/] Examples of such circumstances include the restatement of previously issued financial statements and an ineffective control environment. The identification of one of these strong indicators should bias the auditor toward a conclusion that a material weakness exists but does not require the auditor to reach that conclusion. Instead, the auditor may determine that these circumstances do not rise to the level of a material weakness and that only a significant deficiency exists. In practice, however, auditors sometimes have determined that, in fact, no deficiency existed at all.

To ensure that the requirement does not force the auditor to conclude that a deficiency exists when one does not, and to reaffirm the degree of judgment required to make these evaluations, the Board is proposing to modify this provision by removing the requirement to consider the described circumstances as at least significant deficiencies.

[14/] See AS No. 2, paragraph 140.

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Under the proposed standard on auditing internal control, these circumstances would continue to be strong indicators of material weaknesses but would, at the same time, accommodate an auditor's appropriate conclusion that no deficiency exists.

The proposed standard also would clarify how the auditor should evaluate whether uncorrected significant deficiencies reflect a material weakness in the company's internal controls. Under AS No. 2, significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after a reasonable period of time are a strong indicator of a material weakness. The proposed standard revises this provision to emphasize its relationship to the auditor's evaluation of the company's control environment. Specifically, significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after a reasonable period of time could indicate that the company's control environment may be ineffective. The auditor would need to evaluate whether the company's control environment is, in fact, ineffective. If so, the ineffective control environment—not the uncorrected significant deficiencies—would be a strong indicator of a material weakness.

This proposed modification would clarify that uncorrected significant deficiencies are an indicator of a material weakness because, in some circumstances, they suggest that the company is not sufficiently committed to or capable of correcting problems in its internal control. Sometimes, however, the auditor may find that the company evaluated the significant deficiencies and reasonably determined under the circumstances not to correct them. When that is the case, the proposed standard would allow the auditor to conclude that the control environment is effective and that no material weakness exists. This proposed modification would highlight the importance of the auditor's evaluation of the control environment by focusing the auditor on the reasons why the company left significant deficiencies uncorrected.

<u>Question</u>

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?

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5. Clarifying the Role of Materiality in the Audit

As in the financial statement audit, the concept of materiality is key to the audit of internal control. Although AS No. 2 relies on the existing concept of materiality contained in the federal securities laws,[15/] commentators have expressed concern about several aspects of AS No. 2 relating to materiality, including the concern that auditors have interpreted the standard as directing them to search for all potential defects in internal control, regardless of the effect on financial reporting.[16/] While such an interpretation is contrary to the Board's intentions regarding the scope of the audit of internal control as well as the provisions of AS No. 2 itself, the proposed standard on auditing internal control addresses these concerns by further clarifying that the auditor should plan and perform the audit of internal control using the same materiality measures used to plan and perform the audit of the annual financial statements.

For example, the proposed standard makes clear that the auditor should use the same consideration of account-level materiality in determining the nature, timing, and extent of his or her procedures in the audit of internal control as used in the financial statement audit. Similarly, inherent risk also is the same for both audits and, therefore, the proposed standard clarifies that significant accounts identified in the audit of internal control should be the same as the significant accounts identified in the financial statement audit.

6. Clarifying the Role of Interim Materiality in the Audit

The definitions of material weakness and significant deficiency in AS No. 2 and the proposed standard on auditing internal control refer to both the interim and annual financial statements when describing the likelihood and magnitude of potential misstatements. Some commentators have expressed concern that this reference to interim materiality has caused some auditors to scope their audit procedures at too fine

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[15/] See AS No. 2, paragraphs 22 and 23.

[16/] See, e.g., Letter from Ross Guyer, AAP, Chairman, Government Relations Committee, Association for Financial Professionals, to Nancy M. Morris, Secretary, SEC (May 1, 2006) ("we have yet to see significant improvement 'in the field' in the determination of what is material and what is not material when auditors perform their audit and SOX testing and reporting.").

a level. The reference to interim financial statements only relates to the evaluation of deficiencies, not to the scope of the auditor's testing. The auditor should plan the audit of internal control using the same materiality considerations he or she would use to plan the audit of the company's annual financial statements. To emphasize this point, the Board added additional description of the role of scoping and evaluation to the proposed standard.

Questions

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

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?

B. Eliminating Unnecessary Procedures

The proposals eliminate procedures that the Board believes, based on its monitoring, are unnecessary to an effective audit of internal control. Specifically, the proposals would eliminate the requirement to evaluate the process management used to evaluate its internal control, allow the auditor to reduce procedures or the evidence he or she needs to obtain in certain areas of lower risk, refocus the multi-location testing requirements, remove barriers to using the work of others, and recalibrate the walkthrough requirement.

1. Removing the Requirement to Evaluate Management's Process

SEC rules implementing Section 404 of the Act require the management of each issuer to evaluate, as of the end of each fiscal year, the effectiveness of the issuer's internal controls. These rules require management to base this evaluation on a suitable, recognized control framework.[17/] To complete an audit of internal control under AS No. 2, the auditor is required to evaluate management's annual evaluation process.[18/] If the

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[17/] See Securities Exchange Act Rules 13a-15(c) and 15d-15(c), 17 C.F.R. §§ 240.13a-15(c) and 240.15d-15(c).

[18/] See AS No. 2, paragraphs 40-46.

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auditor determines that management's evaluation process did not provide a sufficient basis for management's conclusion, the auditor is required to disclaim an opinion on the company's internal controls.[19/]

Many commentators have expressed concern over these requirements. Some believe that, under AS No. 2, the auditor performs work unnecessary to achieve the intended benefits by both directly testing controls and evaluating management's evaluation process. Some have expressed concern that auditors were performing detailed testing, such as re-testing items tested by management, solely to conclude on management's evaluation process. Others believe that, as a result of these provisions of AS No. 2, auditors are inappropriately dictating how management should perform its evaluation, which in some cases may result in unnecessary cost and effort by management.[20/] In response to these concerns, some commentators have suggested that the auditor only should evaluate the quality of management's process, without any independent testing of controls, while others have recommended that the auditor's involvement in management's process be removed or substantially reduced.[21/]

In considering this issue, the Board has reevaluated what is necessary to complete an effective audit of internal control. The Board continues to believe that the overall scope of the audit described by AS No. 2 is correct, i.e., to attest to and report

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[19/] See AS No. 2, paragraphs 21, 175 and 178.

[20/] In addition, these provisions may have led some to misunderstand the first of the two auditor's opinions required by AS No. 2—the opinion on management's assessment. Although AS No. 2 requires the auditor to evaluate management's process, the auditor's opinion on management's assessment is not an opinion on management's internal controls evaluation process. Rather, it is the auditor's opinion on whether management's statements about the effectiveness of the company's internal controls are fairly stated. See Thomas Ray, PCAOB Chief Auditor, Remarks at the 25th Annual SEC and Financial Reporting Institute, Pasadena, Cal. (June 8, 2006).

[21/] See, e.g., Letter from Thomas A. Fanning, Executive Vice President and Chief Financial Officer, Southern Company, to Bill Gradison, Acting Chairman, PCAOB, (April 27, 2006) ("Eliminate the requirement for the independent auditor to opine on both management's assessment and operating effectiveness of controls. Instead require the independent auditor to opine only on the effectiveness of the registrant's controls.").

on management's assessment, the auditor must test controls directly to determine whether they are effective.[22/] For that reason, the Board also believes that the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process.

As a result, the proposed standard on auditing internal control eliminates the requirements in paragraphs 40 through 46 of AS No. 2 to evaluate management's annual evaluation process. Under the proposed standard, an auditor still would need to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which he or she will use the work of others. The extent of work necessary for these purposes, however, should be limited.

Although the removal of the evaluation requirement should eliminate unnecessary work, the quality of management's process is inherently linked to the amount of work the auditor will need to do. For example, the extent of the auditor's ability to use the work of others will depend on the quality of the company's annual evaluation process and its on-going monitoring activities, as well as on the competence and objectivity of those performing the work. For this reason, it will continue to be necessary for the auditor and management to coordinate their respective efforts.

Additionally, some commentators have suggested that the separate opinion on management's assessment has contributed to the complexity of the standard and confusion regarding the scope of the auditor's work.[23/] To emphasize the proper scope

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[22/] In addition, Section 103 of the Act requires the Board's standard on auditing internal control to include "testing of the internal control structure and procedures of the issuer." Under Section 103, the Board's standard also must require the auditor to present in the audit report, among other things, "an evaluation of whether such internal control structure and procedures provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles."

[23/] See, e.g., Letter from Michael E. Keane, Vice President and Chief Financial Officer, Computer Sciences Corporation, to Nancy M. Morris, Secretary, SEC (April 28, 2006) ("We recommend the auditor be required to form only two opinions, one on the financial statements and the other on the effectiveness of internal control over financial reporting. The auditors' opinion on management's assertion is redundant and of the audit and simplify the reporting, the proposed standard would require that the auditor express only one opinion on internal control—a statement of the auditor's opinion on the effectiveness of the company's internal control over financial reporting.[24/] The proposal eliminates the separate opinion on management's assessment because it is redundant of the opinion on internal control itself and because the latter opinion more clearly conveys the same information—specifically, whether the company's internal control is effective.

The proposed standard would further simplify the reporting by providing that the auditor's report expressing an adverse opinion on internal control would refer to the description of the material weakness in management's report rather than including a separate, detailed description of the same material weakness. If management's description does not fairly present the material weakness, the auditor's report would include an explanatory paragraph with the information necessary to fairly describe it.

Questions

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

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does not provide further assurance for the investor. The opinion on the effectiveness of internal control over financial reporting provides the most conclusive assurance and is similar to the manner in which the auditor expresses his attestation on fair presentation of the registrant's financial statements.").

[24/] SEC rules implementing Section 404 require the auditor to express an opinion on "whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects." Rule 2-02 of Regulation S-X, 17 C.F.R.§ 210.2-02; see also Rule 1-02 of Regulation S-X, 17 C.F.R. § 210.1-02 (defining the required auditor's report as one in which the auditor "expresses an opinion concerning management's assessment of the effectiveness of the registrant's internal control over financial reporting."). On December 13, 2006, the SEC voted to propose revisions to these rules which, among other things, would require the auditor to express an opinion on internal control itself. These revisions, if they are adopted, would allow the Board to make the changes it is proposing to the form of the auditor's report. The Board and the SEC have planned their respective comment periods to overlap and will ensure that their final rules are consistent.

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

2. Permitting Consideration of Knowledge Obtained During Previous Audits

Many commentators have suggested that, after the first-year's audit of internal control, the auditor should be allowed to reduce the nature, timing, and extent of testing based on his or her cumulative knowledge related to individual controls. The degree to which commentators believed that testing should be decreased has varied, with some suggesting that certain lower risk controls be tested less in subsequent years and others suggesting that the auditor should be allowed to rotate[25/] his or her tests of controls.[26/]

[25/] Rotation is commonly understood as an approach to testing that allows the auditor to rely on the procedures that were performed in prior years for large sections of internal control, refreshing the testing every few years to ensure that nothing has changed and that controls continue to be effective. Under a rotation approach, the auditor might test one-half to one-third of all controls each year, selecting those areas that have not been tested in the past several years.

[26/] See, e.g., Letter from James W. DeLoach, Jr., Managing Director, Protiviti Inc. to Nancy M. Morris, Secretary, SEC (April 28, 2006) ("Reconsider the 'each year stands on its own' premise of Auditing Standard No. 2"), Letter from Bruce Renihan, Executive Vice-President & Controller, CIBC to Nancy M. Morris, Secretary, SEC (April 26, 2006) ("CIBC believes that some relief in assessing operating effectiveness should be provided by introducing rotational testing in the areas of low and medium risk, as identified through risk assessment"); Letter from Arnold C. Hanish, Executive Director, Finance, and Chief Accounting Officer, Eli Lilly and Company, to Nancy M. Morris, Secretary, SEC (September 14, 2006) ("Processes that have not changed could be eligible for periodic rotational testing. Rotational testing could also be permitted for material, but low risk areas even where changes have occurred assuming appropriate change control procedures have been followed.").

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The Board recognizes that the knowledge gained from the prior years' audits has significant value in subsequent years. Although the Board is not proposing to permit rotation, as that term is commonly understood, the proposed standard on auditing internal control would provide the auditor with the flexibility to decide to reduce testing in some areas based on that knowledge and its affect on the auditor's assessment of risk. As one step to facilitating this change, the proposed standard deliberately omits the statement that "each year's audit must stand on its own," which is included in AS No. 2.[27/] The proposed standard also includes direction to the auditor describing how to appropriately consider prior years' knowledge to reduce the evidence necessary for a given control in subsequent audits.

The approach outlined in the proposed standard directs the auditor to assess, in addition to the risk factors considered in the initial year, three factors when determining the risk related to a given control in subsequent years' audits: the nature, timing, and extent of procedures performed in prior years' audits; the results of that testing; and any changes in the control or its related process since the last audit. Based on the auditor's overall risk assessment (including the considerations for subsequent years), the auditor should then determine the evidence to be obtained based on the risk associated with the control.

For example, after considering the risk factors described in the proposed standard and determining that a control presents low risk overall (because, for example, there is low inherent risk and a low degree of complexity, there were no changes to the controls or processes since the previous audit, and the previous years' testing revealed no deficiencies), the auditor may determine that sufficient evidence of operating effectiveness could be obtained by performing a walkthrough. For controls that present higher risk, a walkthrough likely would not provide sufficient evidence; however, under the proposed standard the auditor could adjust the nature, timing, and extent of testing in subsequent years commensurate with the risk indicated. Under the approach described by the proposed standard, some controls would be so important to the overall effectiveness of internal control over financial reporting or otherwise present such a high degree of risk that, even in subsequent years, the necessary evidence would not be reduced.

[27/] See AS No. 2, paragraph E120.

Question

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

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?

3. Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage

Companies with multiple locations or business units ("multi-locations") present the auditor with additional decision points when planning and performing the audit. AS No. 2 describes an approach to multi-location scoping that identifies three categories of locations: locations that are individually significant or involve specific risk; locations that are significant only when aggregated with others; and locations that are insignificant individually and in the aggregate. AS No. 2 describes how the auditor should determine the appropriate level of testing for each of these categories. Additionally, AS No. 2 directs the auditor to evaluate whether his or her testing strategy results in the auditor performing tests of controls over a "large portion" of the company. If the auditor's testing strategy for the three categories does not result in coverage of a large portion, the auditor should select additional locations to test until attaining such coverage.

Many commentators have suggested that the approach outlined in AS No. 2 results in excessive and unnecessary work. Generally, these commentators are concerned that this approach may lead the auditor to be overly focused on meeting a certain coverage ratio without adequate consideration of risk at the various locations.[28/]

Based on its monitoring over the past two years, the Board agrees that the approach described in AS No. 2 may not allow the flexibility necessary to efficiently address the specific risks of a particular company. In the proposed standard on auditing internal control, therefore, the Board has omitted the provision requiring testing of

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[28/] See, e.g., Letter from Loretta V. Cangialosi, Vice President and Controller, Pfizer Inc., to Nancy M. Morris, Secretary, SEC (May 1, 2006) ("Our auditors' interpretation of the requirement to obtain sufficient evidence in a multi-location environment includes obtaining at least 50% coverage of each significant account.").

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controls over a large portion of the company and, instead, directs the auditor to use a risk based approach to determining the proper strategy for auditing multiple locations. The flexibility provided by this approach should allow auditors to exercise the necessary judgment in the particular circumstances and result in more efficient multi-location audits.

Question

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?

4. Removing Barriers to Using the Work of Others

The auditor's ability to use the work of others has a direct effect on the procedures that the auditor must perform himself or herself. When the auditor duplicates high-quality, relevant work that already has been performed by competent and objective individuals, he or she risks increasing effort without enhancing quality. AS No. 2 incorporates a flexible approach to using the work of others, and the Board has seen improvement in auditors' willingness, where appropriate, to leverage that work. Nevertheless, commentators have suggested that the Board examine this area of the standard to determine whether there are barriers that prevent auditors from making the best use of this resource, and the Board has done so.[29/]

As a result of that evaluation, the Board believes that certain provisions in AS No. 2 that may have impeded the auditor's ability to use the work of others in the audit of internal control—most notably, the "principal evidence" provision—can be eliminated. In order to effect these changes, and others, the Board is proposing a new auditing standard, *Considering and Using the Work of Others in an Audit.* This standard would provide direction to the auditor for using the work of others in both the audit of internal control over financial reporting and the audit of the financial statements. Accordingly, it

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[29/] See, e.g., Letter from David K. Owens, Executive Vice President, Edison Electric Institute, to Nancy M. Morris, Secretary, SEC (September 15, 2006) ("provide explicit guidance that allows and encourages external auditors to rely on the work performed by others, including company management and staff and not just internal auditors, provided the auditors are comfortable that the work has been done competently and objectively.").

would supersede the Board's interim standard AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("AU sec. 322"), and replace the direction on using the work of others in an audit of internal control that is currently included in AS No. 2. This change would, therefore, affect both integrated audits of internal control and the financial statements and audits of only the financial statements.

A single, unified framework for the auditor's use of the work of others would remove possible barriers to integration of the audit of internal control and the audit of the financial statements. At present, the auditor may use the work of internal auditors, other company personnel, and third parties working under the direction of management or the audit committee for purposes of testing controls in the audit of internal control. The auditor may only use the work of internal auditors, however, for purposes of testing controls in the audit of the financial statements. This has resulted in some of the work performed by others being used by the auditor to test the effectiveness of controls in the audit of internal control, but not as support for the auditor's assessment of control risk in the financial statement audit.[30/] The proposed standard would establish a single framework, based on the nature of the subject matter being tested and the competence and objectivity of the personnel performing the testing, for the auditor's decisions about using the work of others (including, but not limited to, internal auditors) as audit evidence—whether testing controls for purposes of the audit of internal control or testing controls and account balances and disclosures for purposes of the audit of the financial statements.

The Board considers a single, unified framework to be appropriate because the factors used to determine when it is appropriate to use the work of others should be the same for both the audit of the financial statements and the integrated audit. These factors include the nature of the subject matter being tested, and the competence and objectivity of the persons performing the testing. If the auditor appropriately evaluates these factors, he or she should make decisions that are sound in any audit engagement.

[30/] As another example, AS No. 2 is silent regarding the auditor's ability to use others as direct assistance, whereas AU sec. 322 allows the auditor only to use internal audit personnel as direct assistance. The proposed standard allows the auditor to use any sufficiently competent and objective others as direct assistance in both audits. Providing this type of consistent, additional flexibility should facilitate auditors' full integration of their audits of internal control and the financial statements.

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The proposed standard on using the work of others first directs the auditor to obtain an understanding of work performed by others to identify the activities relevant to the audit. Relevant activities are defined as those that provide evidence about design and operating effectiveness of internal control over financial reporting or that provide evidence about potential misstatements of the company's financial statements. This definition is similar to the description of relevant activities in AU sec. 322.

The proposed standard would require the auditor to obtain an understanding of relevant activities undertaken by others to determine how that work might alter the nature, timing, and extent of the work the auditor otherwise would have performed. This should encourage auditors to leverage the available work of others to the greatest extent possible in their audits. Equally important, the definition of relevant activities is meant to guard against the auditor expending effort to obtain an understanding of work performed by others that is not relevant to the audit.

The proposed standard also would direct the auditor to determine whether the results of relevant activities undertaken by others identified control deficiencies, fraud, or financial statement misstatements. This requirement would apply regardless of the auditor's decision about whether and how to use the work of others. When others working on behalf of the company have surfaced problems with the company's internal controls or financial statements, the auditor should confront those known problems as part of the audit.

The proposed standard would omit two provisions currently contained in AS No. 2. First, as discussed above, the proposed standard would eliminate the "principal evidence" provision. AS No. 2 requires the auditor's own work to provide the principal evidence for the auditor's opinion. Many commentators have expressed concern that the principal evidence provision in AS No. 2 inappropriately limits the auditors' use of the work of others, particularly in lower-risk areas.[31/] The Board believes that the

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[31/] See Letter from Lawrence J. Salva, Chair, Committee on Corporate Reporting, Financial Executives International, to Nancy M. Morris, Secretary, SEC (May 1, 2006) ("This has caused the auditor to place limited reliance on management and/or internal audit testing, resulting in significant duplicative testing by the auditor—even in low risk areas"); Letter from James G. Campbell, Vice President and Corporate Controller, Intel Corporation, to Nancy Morris, SEC (September 8, 2006,) ("AS2 requires the auditor to rely on their own work as 'principal evidence' for their attestation conclusion. However the requirement creates a conservative posture that does not proposed standard would guard against inappropriate use of the work of others while encouraging auditors to exercise professional judgment, assess risk, and tailor their work to the facts and circumstances of a particular audit. Accordingly, the Board's proposed standard on using the work of others does not include the principal evidence provision.[32/] Instead, under the proposed standard, auditors would determine how much of the work of others could be used by evaluating the nature of the subject matter tested by others, and the competence and objectivity of those who performed the work. In addition, the proposed standard would remind the auditor that the responsibility to report on the financial statements or management's assessment of internal controls rests solely with the auditor and that the auditor must obtain sufficient competent evidence to support his or her opinion.

Because the proposed standard places significant emphasis on the auditor's evaluation of the degree of objectivity and competence of the persons performing testing, it includes several factors for the auditor to consider in making this evaluation. Factors related to competence include such things as the education and experience level of the individual performing the testing, as well as the quality of his or her work. Factors related to objectivity include the company's policies to address the objectivity of the individuals performing the testing, the organizational status of the persons responsible for the work of others, and the company's policies designed to assure that compensation arrangements for individuals performing the work do not adversely affect objectivity. None of these factors individually determines the competence and objectivity of the personnel. Instead, each of them contributes to the auditor's overall evaluation of the competence and objectivity of the persons performing testing.

Second, the proposed standard would omit the specific restriction in AS No. 2 on using the work of others for testing controls in the control environment. Application of the general principles in the proposed standard would allow the auditor to use the work of others for testing certain aspects of the control environment when the competence and objectivity of the persons performing the work are sufficiently high. In such circumstances, for example, the auditor could use the work of others for determining that a written code of conduct exists and that employees have received and confirmed

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maximize reliance on the work of others, resulting in duplicative testing efforts and unnecessary operational burden.").

[32/] AU sec. 322 does not include a principal evidence provision.

their understanding of it. On the other hand, evaluating whether the company's code of conduct is actually being followed requires more judgment. Applying the principles in the proposed standard on using the work of others, the auditor should appropriately determine that he or she would need to perform more of the testing himself or herself, regardless of the objectivity or competence of others, due to the high-risk nature of the control being tested.

Questions

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?

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?

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

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

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?

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

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?

5. Recalibrating the Walkthrough Requirements

In an audit of internal control, performing a walkthrough is an effective way for the auditor to gain an understanding of the company and its controls, determine what has changed within the company and its internal control from year to year, and evaluate the design of internal control in a disciplined manner. In performing a walkthrough, the auditor follows a transaction from its origination through the company's information systems until it is reflected in the company's financial reports. Walkthroughs require the auditor to "get out of the audit room" and interact with those responsible for internal control from day to day. They also provide the auditor with the opportunity to learn about the everyday activities of the company, which may not be reflected in any document that the auditor reviews.

Under AS No. 2, the auditor must complete walkthroughs of all major classes of transactions. Many commentators have expressed concern over the amount of time and effort required to do so, and have suggested that these walkthroughs should be voluntary or that the number or frequency of required walkthroughs should be reduced.[33/]

Based on the experience of the past two years, the Board believes that walkthroughs are essential to every audit of internal control but that the number of required walkthroughs can be reduced without negatively affecting audit quality. The proposed standard on auditing internal control would, therefore, require a walkthrough only for each significant process rather than for each major class of transactions within each significant process. In the case of an issuer that generates revenue through retail sales, for example, it would be necessary to perform a walkthrough of at least one retail sales transaction. If the issuer generates revenue from both store and internet sales, it

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[33/] See, e.g., Letter from David Fannin, General Counsel, Office Depot, Inc, Chairman, Coordinating Committee, Corporate Governance Task Force Business Roundtable, to Nancy M. Morris, Secretary, SEC (May 5, 2006) ("Propose that the independent auditor may use its professional judgment to conduct walkthroughs for only a random sampling, rather than all, of the major classes of transactions in any given audit year"); and, Letter from Stacey K. Greer, PCAOB Subcommittee Chairperson, Society of Corporate Secretaries & Governance Professionals, to PCAOB members (February 15, 2006) ("We would like to see modifications to AS-2 that limit the frequency of testing and walkthroughs in some circumstances.").

would not, however, be necessary to walk through both types of retail sales as long as both types of transactions were handled by the same significant process and did not have significantly different risks.

As the auditor walks a transaction through the process, he or she should consider whether different risks are present for varying transaction types and determine how the company's internal control addresses those risks. The proposed standard's emphasis on the role of probing inquiries is meant to clarify that the auditor is not required to follow a separate transaction through each minor variance in the process. These proposed changes should make the walkthroughs more efficient.

The proposed standard also would allow the auditor to utilize the direct assistance of others when performing the required walkthroughs.[34/] AS No. 2 requires the walkthroughs to be performed by the auditor himself or herself. In light of the importance of the walkthrough to the audit, the Board continues to believe that the objectives of the walkthrough only can be achieved when the auditor is significantly and personally involved. The difference, however, between an audit staff member and another sufficiently competent and objective individual providing direct assistance should be minimal and should not affect audit quality, provided either is properly supervised. Permitting direct assistance in walkthroughs should, however, afford opportunities to reduce cost and increase efficiency.

Questions

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

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?

[34/] See Appendix 4 – *Proposed Auditing Standard* – Considering and Using the Work of Others in an Audit, for additional information on direct assistance.

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C. Scaling the Audit for Smaller Companies

Complying with Section 404 has posed challenges for smaller public companies. Some commentators have noted that although smaller companies may have fairly simple internal control structures, they may not be able to achieve efficiencies of scale, which can make the costs of their own work to design, maintain, and evaluate their internal control, as well as their audit costs, disproportionately higher than those of larger companies. In considering how to minimize the costs of the audit of internal control while preserving its benefits, the Board recognized that such companies often present different financial reporting risks than larger and more complex ones and that their internal control systems often appropriately address those risks in different ways. The proposed standard therefore recognizes that a company's size and complexity are important and that the procedures an auditor should perform depend upon where along the size and complexity continuum a company falls.

The Board expects that the broad changes in the proposals that are designed to eliminate unnecessary audit work for all companies will particularly affect smaller company audits. In general, the proposals' reliance on principles rather than detailed instruction would require auditors to consider each company's unique facts and circumstances before determining how to apply the standard. Specific changes, which include focusing the auditor on the most important controls and using risk to determine the necessary evidence (and, accordingly, the auditor's effort) should together make the audit more scalable for any company. Under the proposed standard, the auditor can use strong company level controls and financial statement audit procedures to reduce the level of testing for smaller companies.

The Board also has included a section within the proposed standard that would require the auditor to evaluate the size and complexity of a company in planning and performing the audit. Consistent with the SEC's recently proposed guidance to management on evaluating internal control, the proposed standard includes a provision that identifies smaller companies in light of the SEC's Advisory Committee on Smaller Public Companies' final report and the SEC's definition of "large accelerated filer."[35/]

[35/] The Advisory Committee report described "Smaller Public Companies" as those with under $787.1 million in market capitalization and "Microcap Companies" as those Smaller Public Companies with market capitalization under $128.2 million. See Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, Final Report, at 5 (April 23, 2006); see also Securities

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Under the proposed standard, the auditor should scale the audit so that it is appropriate for the company's size and complexity.

The section on scalability in the proposed standard includes a description of some of the attributes of smaller, less-complex companies that typically make them different from larger and more complex companies. For example, senior management of smaller, less-complex companies may be extensively involved in the day-to-day business activities. Understanding whether these attributes are present in a particular company is important in order for the auditor to determine the type and extent of controls that might be appropriate and how the auditor should correspondingly tailor his or her procedures.

To help auditors make these determinations, the section on scaling the audit in the proposed standard also includes discussion of six areas of the audit that are often affected by the attributes of smaller, less-complex companies. For each of these areas, the proposed standard describes the principles the auditor should apply in order to obtain sufficient competent evidence in a manner that is practical and reasonable. This part of the standard would provide the foundation for planned guidance on auditing internal control in smaller companies to be issued next year. That guidance, which is currently being developed with assistance from a task force of small company auditors and input from smaller companies, will expand on the principles in the standard and provide practical advice about the audit of internal control. The section of the proposed standard on scaling the audit, particularly when coupled with the forthcoming guidance, should help auditors tailor the audit of internal control appropriately for the size and complexity of the company.

Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2 (defining "large accelerated filer" as a public company with "an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $700 million or more," among other things)."

Questions

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?

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

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?

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

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?

D. Simplifying the Requirements

Taken as a whole, the proposals are intended to simplify the requirements and make them easier to apply while retaining the core principles necessary for an effective audit of internal control. The drafting is intended to reflect three improvements from AS No. 2. First, the level of detail and specificity has been reduced, which should encourage auditors to apply professional judgment under the facts and circumstances, rather than taking a one-size-fits-all approach. Second, the presentation has been reorganized to better reflect the sequential flow of an audit of internal control. Third, the requirements have been articulated in a more readable manner that should be understandable to audit clients as well as auditors.

In reducing the level of detail and specificity in AS No. 2, the Board evaluated the standard to determine what direction is fundamental to a quality audit. Based on this analysis, the Board removed provisions that were more detailed than necessary and that may have inadvertently encouraged a checklist approach to compliance. The proposals thus place more reliance on general principles than on detailed instruction.

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This should allow auditors more flexibility to use professional judgment to determine the specific procedures required in particular circumstances. The Board's approach to interpretation of the proposed standard would be to look to the particular facts and circumstances and consider how to apply the general principles in the standard to those facts and circumstances.

The Board also reorganized the requirements to better reflect the flow of an audit of internal control. This approach should help auditors focus their work on identifying the most important controls to test and make the process more efficient. In addition, to simplify organization, where appropriate, some requirements have been moved to the Board's existing interim standards. Finally, the proposals attempt to articulate the requirements in a manner that is more readable, including for non-auditors, and incorporate the significant concepts from the guidance on AS No. 2 issued by the Board and staff, including those focused on efficiencies.[36/] These changes should give auditors from firms of all sizes a clearer understanding of their responsibilities and make the audit of internal control more scalable to any company, regardless of its size or the associated risk.

III. Proposed Rule 3525 – Audit Committee Pre-approval of Services Related to Internal control

The Board also is proposing a new rule related to the auditor's responsibilities when seeking audit committee pre-approval of internal control-related non-audit services. Under Section 10A(i) of the Exchange Act, as amended by Section 202 of the Sarbanes-Oxley Act, all non-audit services that the auditor proposes to perform for an issuer client "shall be pre-approved by the audit committee of the issuer." The proposed rule would further implement the Act's pre-approval requirement by requiring auditors to take certain steps as part of seeking audit committee pre-approval of internal control-related non-audit services. These steps are intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect independence.

Specifically, the proposed rule would require a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal

[36/] See May 16, 2005 Policy Statement; *Staff Questions and Answers, Auditing Internal Control Over Financial Reporting* (May 16, 2005).

control-related non-audit services that are not otherwise prohibited by the Act or the rules of the SEC or the Board to –

- Describe, in writing, to the audit committee the scope of the proposed service;

- Discuss with the audit committee the potential effects of the proposed service on the firm's independence; and

- Document the substance of the firm's discussion with the audit committee.

These requirements parallel the auditor's responsibility in seeking audit committee pre-approval to perform tax services for an audit client under PCAOB Rule 3524 and would be codified, like that rule, as part of the Board's rules on ethics and independence.

The proposed rule would replace existing provisions of AS No. 2 related to auditor independence. In addition to some general discussion, AS No. 2 includes a requirement for the auditor to obtain specific pre-approval from the audit committee to perform an engagement to provide internal control-related services.[37/] The Board has reevaluated this requirement, based in part on its adoption, subsequent to AS No. 2, of the parallel rule on audit committee pre-approval of tax services. Consistent with the Board's tax service pre-approval rule, the proposed rule does not specify that the pre-approval must be specific. Instead, the proposed rule is neutral as to whether an audit committee pre-approves a non-audit service on an ad hoc basis or on the basis of policies and procedures.[38/] Many issuers have adopted policies that provide for pre-approval in annual audit committee meetings, and the Board understands that such an annual planning process can include as robust a presentation to the audit committee as a case-by-case pre-approval process. Therefore, the Board proposes that its rule on audit committee pre-approval of internal control-related services be flexible enough to

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37/ AS No. 2, paragraph 33.

38/ The SEC's 2003 independence rules implemented the Act's pre-approval requirement by adopting a provision on audit committee administration of the engagement. See 17 C.F.R. § 210.2-01(c)(7).

accommodate either system and to encourage auditors and audit committees to develop systems tailored to the needs and attributes of the issuer.

AS No. 2 also includes discussion of the application of principles of independence to internal control-related services and specifically notes that designing or implementing an issuer's controls would place the auditor in a management role and result in the auditor auditing his or her own work.[39/] The Board proposes to not repeat this independence guidance in the auditing standard or in a separate independence rule. As noted above, however, the proposed audit committee pre-approval rule would require auditors, among other things, to discuss with the audit committee the potential effect of the internal control-related service on their independence. The Board proposes to add a Note to this portion of the pre-approval rule that would explain the general standard of independence,[40/] and that application of this general standard is guided by several principles, including whether the auditor assumes a management role or audits his or her own work.[41/] The Note would further specify, as an example of the application of this general standard, that an auditor would not be independent if management had delegated its responsibility for internal control to the auditor or if the auditor had designed or implemented the audit client's internal control.

Question

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?

IV. Amendments to the Board's Interim Standards

The Board also is proposing amendments to several of its existing interim standards. In some cases, these proposed amendments are administrative, such as updating the interim standards' references to the proposed new standards' paragraph

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[39/] AS No. 2, paragraph 32.

[40/] Reg. S-X, Rule 2-01(b), 17 C.F.R. 210.2-01(b); see also paragagrah .03 of AU sec. 220, *Independence*.

[41/] Reg. S-X, Rule 2-01 (Preliminary Note), 17 C.F.R. 210.2-01 (Preliminary Note).

numbers and definitions. In other cases, the amendments have been proposed to move information currently contained in AS No. 2 to the existing standards. For example, AU sec. 722, *Interim Financial Information*, would be amended to include the direction in AS No. 2 on the auditor's responsibility as it relates to management's quarterly certifications on internal control. This change would not only simplify the proposed standard on auditing internal control but also would make it easier for auditors to identify all of the relevant information on the auditor's responsibility related to interim periods in one standard.

In the case of the amendment to AU sec. 530, *Dating of the Independent Auditor's Report*, however, the Board is proposing a substantive change that would affect both integrated audits and audits of only financial statements. The proposals would change the existing requirement that "generally, the date of completion of the field work should be used as the date of the independent auditor's report" to "the auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion." This proposed change is consistent with a recent change adopted by both the International Auditing and Assurance Standards Board and the AICPA Auditing Standards Board and more accurately states the date at which the auditor's responsibility for events affecting the financial statements should reasonably end.[42/] Furthermore, the change in the report date requirement should not have a significant effect on the auditor's current procedures, as many auditors have already begun interpreting the last day of fieldwork as the date the auditor has obtained sufficient competent evidence to support the audit opinion.

VI. Effective Date

The proposals are meant to improve and refine the implementation of the Act's internal control requirements. The Board intends to set an effective date at the time they

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[42/] See International Standards on Auditing (ISA) 700 (Revised) *"The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements"* Paragraph 52 and Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures,* "Subsequent Events," paragraph 12, as amended by paragraph 12 of SAS 113 Omnibus Statement on Auditing Standards are adopted that reflects the Board's commitment to minimizing disruption to on-going audits.

Question

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?

VII. Opportunity for Public Comment

The Board will seek comment for a 70-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 021 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on February 26, 2007

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The Board will carefully consider all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the Securities and Exchange Commission for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are rules of the Board under the Act.

On the 19th day of December, in the year 2006, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Secretary

December 19, 2006

APPENDIX 1 – *Proposed Auditing Standard* – An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of the Financial Statements

APPENDIX 2 – *Proposed Auditing Standard* – Considering and Using the Work of Others in an Audit

APPENDIX 3 – *Proposed Rule 3525* – Audit Committee Pre-approval of Non-Audit Services Related to Internal Control Over Financial Reporting

APPENDIX 4 – *Proposed Amendments to the Interim Standards*

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Appendix 1 – Auditing Standard

December 19, 2006
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

This proposed auditing standard will supersede Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements" if it is adopted by the Board and approved by the Securities and Exchange Commission.

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APPENDICES

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Introduction

1. This standard establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of **management's assessment** [1/] of the effectiveness of **internal control over financial reporting** ("the audit of internal control over financial reporting") that is integrated with an audit of the financial statements.

2. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the company's internal control over financial reporting. To form a basis for expressing such an opinion, the auditor must plan and perform the audit to obtain reasonable assurance about whether **material weakness**es exist as of the date specified in management's assessment. A material weakness in internal control over financial reporting may exist even when financial statements are not materially misstated.

3. To obtain reasonable assurance about whether material weaknesses exist as of a specified date, the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all **relevant assertion**s.[2/] The auditor may obtain this evidence by performing tests of controls himself or herself or by using the work of others.[3/]

> Note: The auditor should select for testing only those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to a given relevant assertion that could result in a material misstatement to the company's financial statements.

[1/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[2/] See AU sec. 230, *Due Professional Care in the Performance of Work*, for further discussion of the concept of reasonable assurance.

[3/] See paragraph 13 for additional direction on using the work of others.

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4. The general standards[4/] are applicable to an audit of internal control over financial reporting. Those standards require technical training and proficiency as an auditor, independence, and the exercise of due professional care, including professional skepticism. This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

5. The auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting.[5/]

Planning the Audit

6. The audit of internal control over financial reporting should be properly planned and assistants, if any, should be properly supervised. When planning the audit, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures –

- Knowledge of the company's internal control over financial reporting obtained during other engagements;

[4/] See AU sec. 150, *Generally Accepted Auditing Standards.*

[5/] See Securities Exchange Act Rules 13a-15(c) and 15d-15(c), 17 C.F.R. §§ 240.13a-15(c) and 240.15d-15(c). SEC rules require management to base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework (also known as *control criteria*) established by a body or group that followed due-process procedures, including the broad distribution of the framework for public comment. For example, the report of the Committee of Sponsoring Organizations of the Treadway Commission (known as the COSO report) provides such a framework, as does the report published by the Institute of Chartered Accountants in England & Wales, *Internal Control: Guidance for Directors on the Combined Code* (known as the Turnbull Report.)

- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;

- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;

- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;

- The auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses;

- Control deficiencies previously communicated to the audit committee or management;

- Legal or regulatory matters of which the company is aware;

- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting; and

- Preliminary judgments about the effectiveness of internal control over financial reporting.

Integration with Financial Statement Audit

7. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits. (See Appendix B for additional direction on integration.)

Role of Risk Assessment

8. Risk assessment underlies the entire audit process described by this standard. Therefore, the auditor's risk assessment should have a pervasive effect on an audit of internal control. A direct relationship exists between the degree of risk that a material

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weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention the auditor should devote to that area. Accordingly, the auditor should focus the majority of his or her attention on the areas of greatest risk to substantially decrease the opportunity for a material weakness to go undetected. The lower the risk that a material weakness could exist in a particular area, the less audit attention the auditor would need to devote to the area. Additionally, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

Scaling the Audit for Smaller Companies

9. The auditor should evaluate the size and complexity of the company when planning and performing the audit of internal control. Because the size and complexity of the company affect the risks of misstatement and the controls necessary to address those risks, the auditor's evaluation of both size and complexity should have a pervasive effect on the audit. The auditor should document how the size and complexity of the company affected the audit. In evaluating the size and complexity of the company, the auditor should take into account the company's individual facts and circumstances.

> Note: The final report of the SEC Advisory Committee on Smaller Public Companies indicates that market capitalization and annual revenue are useful indicators of a company's size. In light of the Advisory Committee's report, as well as the SEC's definition of "large accelerated filer," companies with a market capitalization of approximately $700 million or less, with reported annual revenues of approximately $250 million or less, should be considered smaller companies.[6/]

[6/] The Advisory Committee report described "Smaller Public Companies" as those with under $787.1 million in market capitalization and "Microcap Companies" as those Smaller Public Companies with market capitalization under $128.2 million. See Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, Final Report, at 5 (April 23, 2006); see also Securities Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2 (defining "large accelerated filer" as a public company with "an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $700 million or more," among other things)."

10. As part of evaluating the size and complexity of the company, the auditor should determine to what extent attributes common to a smaller and less-complex company, which affect the risks of misstatement and the controls necessary to address those risks, are present. These attributes include –

- Few business lines,
- Less complex business processes and financial reporting systems,
- Centralized accounting functions,
- Extensive involvement by senior management in the day-to-day activities of the business, and
- Few levels of management, each with a wide span of control.

11. Because of these attributes, the auditor should recognize that a smaller and less-complex company often achieves many of its **control objective**s through the daily interaction of senior management with company personnel rather than through formal policies and procedures. Routine checks and supervisory activities are often used instead of multiple layers of controls involving numerous personnel performing independent functions.

12. The auditor should evaluate how the audit of internal control is affected by the attributes of a smaller and less-complex company. These attributes should affect many aspects of the audit. The audit of a smaller and less-complex company might vary from the audit of a larger and more-complex company in, among others, the following respects –

- *Obtaining sufficient competent audit evidence with limited company documentation.* The 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. The 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.

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

- *Evaluating the risk of management override and mitigating actions.* Because of the extensive involvement of senior management in performing controls and the period-end financial reporting process, controls to prevent management override are particularly important in a smaller and less-complex company. 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. 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.

- *Evaluating controls implemented in lieu of segregation of duties.* A smaller and less-complex company might have few employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor's selection of controls to test should focus on those alternative controls and whether they achieve the control objectives.

- *Evaluating financial reporting competencies.* When assessing the competence of the personnel responsible for the company's financial reporting and associated controls, 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.

- *Evaluating information technology ("IT") controls.* 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.

Using the Work of Others

13. The auditor should evaluate the extent to which he or she will use the work of others, including management's internal control evaluation. Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*, establishes direction for obtaining an understanding of the nature, timing, and extent of the work performed by others, and determining its effect on the audit. That standard states that to use the work of others to reduce the nature, timing, and extent of the work the auditor would have otherwise performed, the auditor should evaluate the nature of the subject matter tested by others, evaluate the competence and objectivity of the individuals who perform the work, and test some of the work performed by others to evaluate the quality and effectiveness of their work.

Materiality

14. In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements.[7/]

[7/] AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, provides additional explanation of materiality.

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15. To evaluate whether a **control deficiency** or combination of control deficiencies identified during the audit is a **significant deficiency** or material weakness, the auditor must consider the possibility of misstatement to both annual and interim financial statements.

Using a Top-Down Approach

16. The auditor should use a top-down approach to the audit of internal control over financial reporting to select the controls to test. A top-down approach begins at the financial statement level and company-level controls, and then works down to **significant account**s and disclosures, relevant assertions, and **significant process**es. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the **financial statements and related disclosures**. Finally, the auditor selects for testing controls that sufficiently address the assessed risk of misstatement to each relevant assertion. The top-down approach thereby leads to the auditor testing only those controls necessary to obtain reasonable assurance about whether material weaknesses exist.

Identifying Company-Level Controls

17. The auditor must test those company-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. Because the results of that work should affect the way the auditor evaluates the other aspects of internal control over financial reporting, the auditor should test those controls early in the audit process. The auditor's evaluation of company-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on controls at the process, transaction, or application levels.

18. Company-level controls include –

- Controls related to the control environment;
- Controls over management override;
- The company's risk assessment process;

- Centralized processing and controls, including shared service environments;
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

19. *Control Environment.* Because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company.

20. As part of evaluating the control environment, the auditor should assess –

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether management and employees are assigned appropriate authority and responsibility to facilitate effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood;
- Whether the Board or audit committee understands and exercises oversight responsibility over financial reporting and internal control; and
- Whether the company takes actions to reduce or mitigate the incentives and pressures on management that would provide a reason to misstate the company's financial statements.

21. *Period-end Financial Reporting Process*. Because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following –

- Procedures used to enter transaction totals into the general ledger;
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements; and
- Procedures for drafting annual and quarterly financial statements and related disclosures.

22. As part of evaluating the period-end financial reporting process, the auditor should assess –

- Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;
- The extent of information technology involvement in the period-end financial reporting process;
- Who participates from management;
- The locations involved in the period-end financial reporting process;
- The types of adjusting and consolidating entries; and
- The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.

23. As part of evaluating the period-end financial reporting process, the auditor should perform a walkthrough of the process. Walkthroughs are further described beginning at paragraph 36.

Identifying Significant Accounts

24. The auditor should identify significant accounts and disclosures. To identify significant accounts, the auditor should start by considering financial statement line items or captions. When identifying significant accounts, the auditor should evaluate both qualitative and quantitative risk factors.

25. The factors that the auditor should evaluate in the identification of significant accounts are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts should be the same for both audits.

26. The risk factors the auditor should evaluate in identifying significant accounts include –

- Size and composition of the account;
- Susceptibility of misstatement due to errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account;
- Nature of the account;
- Accounting and reporting complexities associated with the account;
- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account;
- Existence of related party transactions in the account; and

- Changes from the prior period in account characteristics.

27. The auditor also should evaluate the components of a potential significant account using risk factors identified in the previous paragraph to determine whether they are subject to substantially differing significant risks. If so, different types of controls might be necessary to adequately address those risks. Accordingly, the auditor should take these substantially differing significant risks into account when selecting controls to test. (See paragraphs 41 through 46.)

> Note: Components of a significant account may be subject to differing risks that are neither significant nor sufficiently different to affect the auditor's selection of controls to test. In performing this evaluation, the auditor need not consider such risks.

28. The auditor should use the understanding of risk obtained as part of identifying significant accounts when identifying relevant assertions, **major classes of transactions** and significant processes, and also when selecting the controls to test.

29. When a company has multiple locations or business units, the auditor should determine significant accounts and their relevant assertions, major classes of transactions, and significant processes based on the consolidated financial statements. Having made those determinations, the auditor should then apply the direction in Appendix B for multiple locations scoping decisions.

Identifying Relevant Assertions

30. For each significant account, the auditor should determine which of these financial statement assertions is a relevant assertion[8/] –

- Existence or occurrence

- Completeness

[8/] See AU sec. 326, *Evidential Matter*, which provides additional information on financial statement assertions.

- Valuation or allocation
- Rights and obligations
- Presentation and disclosure

31. To identify relevant assertions, the auditor should determine the likely sources of those potential misstatements in each significant account that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account. The auditor may base his or her work on assertions that differ from those in this standard if the auditor has selected and tested controls over the pertinent risks in each significant account and over the representations by management that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.

Identifying Major Classes of Transactions and Significant Processes

32. The auditor should identify the company's major classes of transactions. Different types of major classes of transactions might have different inherent risks associated with them and, consequently, might require different levels of management supervision and involvement. These differences might affect the types of controls that are necessary to adequately address the risks.

33. The controls over major classes of transactions exist within the company's significant processes. Accordingly, the auditor should identify the significant processes affecting the major classes of transactions.

34. For each significant process identified, the auditor should –

- Understand the flow of major classes of transactions, including how these transactions are initiated, authorized, processed and recorded;
- Identify the points within the process at which a misstatement—including a misstatement due to fraud—could arise that, individually or in combination with other misstatements, would be material;

- Identify the controls that management has implemented to address these potential misstatements; and

- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.

35. As part of understanding a significant process, the auditor should understand how information technology affects the company's flow of transactions. Paragraphs .16 through .20, .30 through .32, and .77 through .79, of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, discuss the effect of information technology on internal control over financial reporting and the risks the auditor should assess. The auditor should apply this direction when auditing internal control over financial reporting.

36. *Performing Walkthroughs.* The auditor should perform a walkthrough for each significant process. In performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records. The auditor should follow the process flow of actual transactions using the same documents and information technology that company personnel use.

37. The objectives of the walkthrough are to provide the auditor with evidence to –

- Verify that the auditor has identified the points in the process at which significant risk of misstatement to a relevant assertion exists,

- Verify the auditor's understanding of the design of controls, including those related to the prevention or detection of fraud,

- Evaluate the effectiveness of the design of controls, and

- Verify whether controls have been placed in operation.

38. If a significant process affects multiple major classes of transactions, the auditor should determine, during the walkthrough, how the significant process addresses the risks unique to those major classes of transactions.

39. At the points at which important processing procedures occur, the auditor should question the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions are essential to the auditor's ability to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. These inquiries should go beyond a narrow focus on the single transaction used as the basis for the walkthrough so that the auditor gains an understanding of the types of significant transactions handled by the process.

> Note: The walkthrough performed by the auditor of the period-end financial reporting process may differ from the walkthroughs of significant processes. Because of the nature of the period-end financial reporting process, the auditor need not follow a transaction from initiation through to its reporting to achieve the objectives of the walkthrough. Instead, the auditor should use a combination of probing inquiries and the same documents and information technology used by company personnel to understand how transaction totals recorded in the general ledger are ultimately reflected in the company's financial statements and related disclosures.

40. Because of the degree of judgment required in performing a walkthrough, the auditor should either perform walkthroughs himself or herself or supervise the work of others who provide direct assistance to the auditor, as described in Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit.*

Selecting Controls to Test

41. The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

42. There might be more than one control that addresses the assessed risk of misstatement to a particular relevant assertion; conversely, one control might address

the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

43. When selecting the controls to test that sufficiently address the assessed risk of misstatement to each relevant assertion, the auditor should recognize that company-level controls vary in precision. Some company-level controls are designed to operate at the process, transaction, or application level and might adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. On the other hand, some company-level controls may be designed to operate in a manner that would identify possible breakdowns in lower-level controls but not at a level of precision that would, by itself, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis.

44. The auditor should focus on whether the selected controls, individually or in combination, sufficiently address the assessed risk of misstatement of a given relevant assertion rather than on how the control is labeled (e.g., company-level control, transaction-level control, control activity, monitoring control, **preventive control**, **detective control**). The auditor also should link the controls selected to test with the relevant assertions to which they relate.

45. *Fraud controls.* As part of testing those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion, the auditor should test the company's programs and controls that address identified risks of material misstatement due to fraud as well as controls intended to address the risk of management override of other controls.[9/]

46. In an audit of internal control over financial reporting, the auditor's evaluation of controls is related to the auditor's evaluation of controls in a financial statement audit. Often, controls tested by the auditor during the audit of internal control over financial

[9/] See paragraphs .35 through .42 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* regarding identifying risks that may result in material misstatement due to fraud.

reporting also address or mitigate fraud risks, which the auditor is required to consider in a financial statement audit. If the auditor identifies deficiencies in controls designed to prevent and detect fraud during the audit of internal control over financial reporting, the auditor should alter the nature, timing, or extent of procedures to be performed during the financial statement audit to be responsive to such deficiencies, as provided in AU sec. 316 .44 and .45.

Testing Controls

Testing Design Effectiveness

47. The auditor should test the design effectiveness of controls by determining whether the company's controls, if operating properly, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

48. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Additionally, the auditor should perform a specific evaluation of whether the controls are likely to prevent or detect errors or fraud if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively. The auditor ordinarily performs procedures sufficient to evaluate design effectiveness during the performance of the walkthrough.

Testing Operating Effectiveness

49. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

50. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, walkthroughs, and reperformance of the control.

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Relationship of Risk to the Evidence to be Obtained

51. For each control selected for testing, the auditor should assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. The evidence necessary to persuade the auditor that the control is effective depends on the risk associated with the control. As the risk associated with the control being tested decreases, the evidence that the auditor needs to obtain also decreases. On the other hand, as the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

> Note: Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

52. Factors that affect the risk associated with a control include –

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of company-level controls, especially controls that monitor other controls;
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);

- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;

- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and

- The complexity of the control.

  Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

53. When the auditor identifies deviations from the company's established controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, any individual control does not necessarily have to operate without any deviation to be considered effective.

54. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for any individual control, different combinations of the nature, timing, and extent of testing may provide sufficient evidence in relation to the risk associated with the control.

55. *Nature of Tests of Controls*. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation,

and reperformance of a control. Walkthroughs ordinarily consist of some combination of these types of procedures.

> Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control. When combined with another test, such as observation, inspection, or reperformance, however, inquiry might provide sufficient evidence about the effectiveness of a control.

56. The auditor should take into account the nature of the control when selecting the nature of the tests to perform, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist. In this case, to obtain sufficient evidence, the auditor should supplement inquiries of appropriate company personnel with observation of company activities.

57. *Timing of Tests of Controls*. Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the date of management's assessment provides more evidence than testing performed earlier in the year.

58. The auditor's testing of the operating effectiveness of controls should occur at the time the controls are operating. Controls "as of" a specific date include controls that are relevant to the company's internal control over financial reporting as of that specific date, even though such controls might not operate until after that specific date. For example, if controls over the period-end financial reporting process operate in the month following the period-end, the auditor should test the controls operating in the month following the period-end to have sufficient evidence of operating effectiveness as of the period-end.

59. For controls over higher risk accounts and transactions, such as significant non-routine transactions, controls over accounts or processes with a high degree of subjectivity or judgment in measurement, or controls over the recording of period-end adjustments, the auditor should perform tests of controls closer to or at the as-of date rather than at an interim date. However, the auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness.

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60. Prior to the date specified in management's assessment, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting. The auditor should, however, evaluate how the design and operating effectiveness of the superseded controls relate to the auditor's reliance on controls for financial statement audit purposes. (See additional direction on integration beginning at paragraph B1.)

61. *Extent of Tests of Controls*. The more extensively a control is tested, the greater the evidence obtained from that test.

62. In determining the extent of procedures to perform, the auditor should assess the following factors –

- *Nature of the control*. The auditor should assess the complexity of the controls, the significance of the judgments that must be made in connection with their operation, and the level of competence of the person performing the controls that is necessary for the controls to operate effectively. As the nature of the control indicates greater risk, the auditor should test the control more extensively to obtain sufficient evidence.

- *Frequency of operation*. Generally, the more frequently a manual control operates, the more operations of the control the auditor should test to obtain sufficient evidence.

  Note: Testing a single operation of an automated control might result in sufficient evidence that the control operated effectively, provided that relevant information technology general controls also are operating effectively.

Note: When sampling is appropriate and the population to be tested is large, increasing the population size does not proportionately increase the required sample size.

63. *Roll-Forward Procedures.* When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what, if any, additional evidence concerning the operation of the controls for the remaining period is necessary.

Note: The auditor's assessment of the risk associated with the control, as described in paragraphs 51 through 54 is essential to the auditor's decisions about what, if any, roll-forward procedures are necessary. The auditor should take into account the roll-forward procedures, if any, which will be necessary as part of determining the overall mix of the nature, timing, and extent of procedures that will provide sufficient evidence in relation to the risk associated with the control.

64. The auditor should evaluate the following factors when determining if additional evidence is necessary and, if so, the procedures to perform to update the results of his or her testing from an interim date to the company's year-end –

- The specific control tested prior to the as-of date and the results of those tests. The auditor should assess the risks associated with the control and the nature of the control.
- The sufficiency of the evidence of effectiveness obtained at an interim date.
- The length of the remaining period.
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

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Special Considerations for Subsequent Years' Audits

65. In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary. This decision-making process is described in paragraphs 51 through 64.

66. The auditor's assessment of the risk associated with a control in subsequent years' audits should include the factors described in paragraph 52 and the following additional risk factors –

- The nature, timing, and extent of procedures performed in previous audits;
- The results of the previous years' testing of the control; and
- Whether there have been changes in the control, or the significant process in which it operates, since the previous audit.

67. After taking into account the risk factors identified in paragraphs 52 and 66, the lower the risk associated with a control, the less evidence that the auditor needs to obtain in the subsequent years' audits.

68. The auditor may also use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B30.

69. In addition, the auditor should vary the nature, timing, and extent of testing of controls from year to year to introduce unpredictability into the testing and respond to changes in circumstances. For this reason, each year the auditor might test controls at a different interim period, increase or reduce the number and types of tests performed, or change the combination of procedures used.

Evaluating Identified Deficiencies

70. In planning and performing the audit, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness. The auditor must, however, evaluate the severity of each control deficiency that comes to his or her attention. As part of this evaluation, the auditor should determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses as of the date of management's assessment.

71. The auditor should evaluate the severity of a deficiency in internal control over financial reporting by determining the following –

- Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and

- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

72. The severity of a deficiency in internal control over financial reporting does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement that is either significant or material.

73. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following –

- The nature of the financial statement accounts, disclosures, and assertions involved;

- The susceptibility of the related asset or liability to loss or fraud;

- The subjectivity, complexity, or extent of judgment required to determine the amount involved;

- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;

- The interaction of the deficiencies, including whether a combination of two or more deficiencies affect the same financial statement accounts and assertions; and

- The possible future consequences of the deficiency.

Note: The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

74. Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in controls include, but are not limited to, the following –

- The financial statement amounts or total of transactions exposed to the deficiency; and

- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

75. In evaluating the magnitude of the potential misstatement, the auditor should recognize that the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

76. The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a significant deficiency or a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that is significant or material.

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77. When evaluating the severity of a deficiency in internal control over financial reporting, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that the deficiency would prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then the auditor should deem the deficiency to be at least a significant deficiency.

78. Deficiencies in the following areas ordinarily result in at least significant deficiencies in internal control over financial reporting –

- Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles,
- Antifraud programs and controls,
- Controls over non-routine and non-systematic transactions, and
- Controls over the period-end financial reporting process.

Strong Indicators of Material Weaknesses

79. The auditor should treat each of the following circumstances as a strong indicator that a material weakness in internal control over financial reporting exists –

- An ineffective control environment. Circumstances that may indicate that the company's control environment is ineffective include, but are not limited to –
  - Identification of fraud of any magnitude on the part of senior management.

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Note: The auditor is required to plan and perform procedures to obtain reasonable assurance that a material misstatement caused by fraud is detected by the auditor. However, for the purposes of evaluating and reporting deficiencies in internal control over financial reporting, the auditor should evaluate any fraud on the part of senior management of which he or she is aware. Furthermore, for the purposes of this circumstance, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of the Act as well as any other members of management who play a significant role in the company's financial reporting process.

– Significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after some reasonable period of time.

- Restatement of previously issued financial statements to reflect the correction of a misstatement.

  Note: The correction of a misstatement includes misstatements due to error or fraud; it does not include retrospective application of a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle.

- Identification by the auditor of a material misstatement in financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting.

- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

  Note: The company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee. This standard does not suggest that the auditor is responsible for performing a separate and distinct evaluation of the audit committee. However, because of the role of the audit committee within the control environment and monitoring components of internal control over financial reporting, the auditor should assess the effectiveness of the audit committee as part of understanding and evaluating those components.

The aspects of the audit committee's effectiveness that are important may vary considerably with the circumstances. The auditor should focus on factors related to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting, such as the independence of the audit committee members from management, the clarity with which the audit committee's responsibilities are articulated (e.g., in the audit committee's charter), and how well the audit committee and management understand those responsibilities. The auditor also might consider the audit committee's involvement and interaction with the independent auditor and with internal auditors, as well as interaction with key members of financial management, including the chief financial officer and chief accounting officer. The auditor also might evaluate whether the committee raises and pursues appropriate questions with management and the auditor, including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates, and the committee's responsiveness to issues raised by the auditor.

If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company.[10/] When a company is not required by law or applicable listing standards to have independent directors on its audit committee, the auditor should not consider the lack of independent directors at these companies indicative, by itself, of a control deficiency. In all cases, the auditor should interpret the terms "board of directors" and "audit committee" in this standard as

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[10/] See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

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being consistent with provisions for the use of those terms as defined in relevant SEC rules.

- The internal audit function or the risk assessment function is ineffective at a company for which such a function needs to be effective for the company to have an effective monitoring or risk assessment component, such as for very large or highly complex companies.

  Note: The evaluation of the internal audit or risk assessment functions is similar to the evaluation of the audit committee in that the evaluation is made within the context of the monitoring and risk assessment components. The auditor is not required to make a separate and distinct evaluation of the effectiveness and performance of these functions. Instead, the auditor should base the evaluation on evidence obtained as part of evaluating the monitoring and risk assessment components of internal control over financial reporting.

- For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective regulatory compliance function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.

Wrapping-Up

Forming an Opinion

80. The auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies.

81. After forming an opinion on the effectiveness of the company's internal control over financial reporting, the auditor should evaluate the presentation of the elements

that management is required, under the SEC's rules, to present in its annual report on internal control over financial reporting.[11/]

82. If the auditor determines that any required elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should follow the direction in paragraph C2.

83. The auditor may form an opinion on the effectiveness of internal control over financial reporting only when there have been no restrictions on the scope of the auditor's work. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement (See paragraphs C3 through C7).

Obtaining Written Representations

84. In an audit of internal control over financial reporting, the auditor should obtain written representations from management –

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;

b. Stating that management has performed an evaluation and made an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;

c. Stating that management did not use the auditor's procedures performed during the audits of internal control over financial reporting or the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting;

d. Stating management's conclusion, as set forth in its assessment, about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;

[11/] See Item 308(a) of Regulations S-B and S-K, 17 C.F.R. §§ 228.308(a) and 229.308(a).

e. Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's evaluation, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;

f. Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;

g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraph 87 have been resolved, and specifically identifying any that have not; and

h. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

85. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit. As discussed further in paragraph C3, when the scope of the audit is limited, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including those obtained in an audit of the company's financial statements.

86. AU sec. 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter.

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Communicating Certain Matters

87. The auditor must communicate, in writing, to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting. The auditor's communication should distinguish clearly between those matters considered to be significant deficiencies and those considered to be material weaknesses, as defined in paragraphs A12 and A8, respectively.

88. If the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors.

89. The auditor should communicate to management, in writing, all deficiencies in internal control over financial reporting (i.e., those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the audit and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that has been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization. Furthermore, the auditor is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the auditor should communicate deficiencies in internal control over financial reporting of which he or she is aware.

90. These written communications should state that the communication is intended solely for the information and use of the board of directors, audit committee, management, and others within the organization. When governmental authorities require furnishing such reports, the auditor may make specific reference to such regulatory agencies.

91. These written communications also should include the definitions of control deficiency, significant deficiency, and material weakness and should clearly distinguish to which category the deficiency being communicated relates.

92. Because the audit of internal control over financial reporting does not provide the auditor with assurance that he or she has identified all significant deficiencies, the auditor should not issue a report stating that no significant deficiencies were noted during the audit.

93. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. In such circumstances, the auditor must determine his or her responsibilities under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[12/]

Reporting on Internal Control

94. The auditor's report on management's assessment of the effectiveness of internal control over financial reporting must include the following elements[13/] –

a. A title that includes the word *independent*;

b. An identification of management's conclusion about the effectiveness of the company's internal control over financial reporting as of a specified date based on the control criteria;

c. An identification of management's assessment (the auditor should use the same description of the company's internal control over financial reporting as management uses in its annual report);

d. A statement that the assessment is the responsibility of management;

[12/] See 15 U.S.C. § 78j-1.

[13/] Appendix C provides direction on modifications to the auditor's report that are required 'in certain circumstances.

e. A statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on his or her audit;

f. A definition of internal control over financial reporting as stated in paragraph A5;

g. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

h. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

i. A statement that an audit includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;

j. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;

k. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate;

l. The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria;

m. The manual or printed signature of the auditor's firm;

n. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

o. The date of the audit report.

Separate or Combined Reports

95. The auditor may choose to issue a combined report (i.e., one report containing both an opinion on the financial statements and an opinion on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting.

96. The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8. We also have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements and an

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opinion on the company's internal control over financial reporting based on our audits.

[*Scope paragraph*]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or

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timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria,* for *example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

97. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph to the auditor's report on the financial statements –

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), W Company's internal control over

> financial reporting as of December 31, 20X8, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

The auditor also should add the following paragraph to the report on internal control over financial reporting –

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

Report Date

98. The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Because the auditor cannot audit internal control over financial reporting without also auditing the financial statements, the reports should be dated the same.

Material Weaknesses

99. Paragraphs 70 through 79 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement.[14/]

100. When expressing an adverse opinion on internal control over financial reporting because of a material weakness, the auditor's report must include –

- The definition of a material weakness, as provided in paragraph A8.

[14/] See paragraph C3 for direction when the scope of the engagement has been limited.

- A statement that a material weakness has been identified and an identification of the material weakness described in management's assessment.

  Note: If the material weakness has not been included in management's assessment, this sentence should be modified to state that a material weakness has been identified but not included in management's assessment. Additionally, the auditor's report should include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness, and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. In this case, the auditor also is required to communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's assessment. If the material weakness has been included in management's assessment but the auditor concludes that the disclosure of the material weakness is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe the material weakness.

101. The auditor should determine the effect his or her adverse opinion on internal control has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements was affected by the adverse opinion on internal control over financial reporting.

102. When the auditor's opinion on the financial statements is unaffected by the adverse opinion on the effectiveness of internal control over financial reporting, the report on internal control over financial reporting (or the combined report, if a combined report is issued) should include the following or similar language in the paragraph that identifies the material weakness –

> This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X8 financial statements, and this report does not affect our report dated [*date of report*] on those financial statements. [*Revise this wording appropriately for use in a combined report*.]

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Note: If the auditor issues a separate report on internal control over financial reporting in this circumstance, the report language described by this paragraph may be combined with the report language described in paragraph 100. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.

103. When the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting, the report on internal control over financial reporting (or the combined report, if a combined report is issued) should include the following or similar language in the paragraph that identifies the material weakness –

This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X8 financial statements.

Subsequent Events

104. Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors. As described in paragraph 84h, the auditor should obtain written representations from management relating to such matters. Additionally, to obtain information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following –

- Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period;

- Independent auditor reports (if other than the auditor's) of significant deficiencies or material weaknesses;

- Regulatory agency reports on the company's internal control over financial reporting; and

- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

105. The auditor might inquire about and examine other documents for the subsequent period. Paragraphs .01 through .09 of AU sec. 560, *Subsequent Events*, provide direction on subsequent events for a financial statement audit that also may be helpful to the auditor performing an audit of internal control over financial reporting.

106. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment, the auditor should issue an adverse opinion on internal control over financial reporting (and follow the direction in paragraph C2 if management's assessment states that internal control over financial reporting is effective). If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim an opinion. As described in paragraph C13, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

107. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date. If a subsequent event of this type has a material effect on the company's internal control over financial reporting, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report.

108. After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

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APPENDIX A *– Definitions*

A1. For purposes of this standard, the terms listed below are defined as follows –

A2. A **control deficiency** exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

A3. A **control objective** provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant assertion and states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented or detected by controls on a timely basis.

A4. **Financial statements and related disclosures** refers to a company's financial statements and notes to the financial statements as presented in accordance with GAAP. References to financial statements and related disclosures do not extend to the preparation of management's discussion and analysis or other similar financial information presented outside a company's GAAP-basis financial statements and notes.

A5. **Internal control over financial reporting** is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles ("GAAP") and includes those policies and procedures that –

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.[1/]

Note: The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal control over financial reporting.

Note: Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

[1/] See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f).

A6. **Major classes of transactions** are those transaction flows that have a meaningful bearing on the totals accumulated in the company's significant accounts and, therefore, have a meaningful bearing on relevant assertions.

> Note: For example, at a company whose sales may be initiated by customers through personal contact in a retail store or electronically through use of the internet, these types of sales would be two major classes of transactions affecting the company's reported sales if they were both important to the company's financial statements.

A7. **Management's assessment** is the assessment described in Item 308(a)(3) of Regulations S-B and S-K that is included in management's annual report on internal control over financial reporting.[2/]

A8. A **material weakness** is a control deficiency, or combination of control deficiencies, such that there is a **reasonable possibility** that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.

> Note: There is a **reasonable possibility** of an event, as used in the definitions of *material weakness* and *significant deficiency* (see paragraph A12), when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS No. 5").[3/]

A9. Controls over financial reporting may be **preventive controls** or **detective controls**. Effective internal control over financial reporting often includes a combination of preventive and detective controls.

- Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring.

[2/] See 17 C.F.R. §§ 228.308(a)(3) and 229.308(a)(3).

[3/] See FAS No. 5, Paragraph 3.

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- Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements.

A10. A **relevant assertion** is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion should be made without regard to the effect of controls.

A11. An account or disclosure is a **significant account** if there is a reasonable possibility that the account could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account is a significant account should be made without regard to the effect of controls.

A12. A **significant deficiency** is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a **significant misstatement** of the company's annual or interim financial statements will not be prevented or detected.

> Note: A **significant misstatement** is a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

A13. A **significant process** refers to those activities required to initiate, authorize, process, and record major classes of transactions.

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APPENDIX B ***– Special Topics***

Integration of Audits

B1. In an integrated audit of internal control over financial reporting and the financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously –

- To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end, and

- To obtain sufficient evidence to support the auditor's control risk assessment for purposes of the audit of financial statements.

B2. Obtaining sufficient evidence to support a control risk assessment of low for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements.

B3. *Tests of Controls in an Audit of Internal Control.* The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole*.

B4. To express an opinion on internal control over financial reporting as of a *point in time*, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting *taken as a whole*, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

B5. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on internal control over financial reporting, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

B6. *Tests of Controls in an Audit of Financial Statements.* To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

B7. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the company's internal control over financial reporting, as discussed in paragraph B4. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

B8. *Effect of Tests of Controls on Substantive Procedures.* If, during the audit of internal control over financial reporting, the auditor identifies a significant deficiency or material weakness, he or she should determine the effect on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

B9. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

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B10. *Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls.* In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum –

- The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud;
- Findings with respect to illegal acts and related party transactions;
- Indications of management bias in making accounting estimates and in selecting accounting principles; and
- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

B11. To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Multiple Locations Scoping Decisions

B12. In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk.

> Note: The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a

reasonable possibility of material misstatement to the company's consolidated financial statements.

B13. In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements. In lower-risk locations or business units, the auditor first might evaluate whether testing company-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient evidence.

B14. In determining the locations or business units at which to perform tests of controls, the auditor should take into account work performed by others on behalf of management. For example, if the internal auditors' plan includes relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of locations or business units at which the auditor would otherwise need to perform auditing procedures.

B15. The direction in paragraph 69 regarding special considerations for subsequent years' audits means that the auditor should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.

B16. *Special Situations.* The scope of the audit should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The auditor should follow the direction in this multiple-locations discussion in determining whether it is necessary to test controls at these entities or operations.

B17. For equity method investments, the scope of the audit should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The audit ordinarily would not extend to controls at the equity method investee.

B18. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not

be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AU sec. 722, *Interim Financial Information*. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure should be modified.

Use of Service Organizations

B19. AU sec. 324, *Service Organizations*, applies to the audit of financial statements of a company that obtains services from another organization that are part of its information system. The auditor may apply the relevant concepts described in AU sec. 324 to the audit of internal control over financial reporting.

B20. AU sec. 324.03 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, the auditor should include the activities of the service organization when determining the evidence required to support his or her opinion.

B21. AU sec. 324.07 through .16 describe the procedures that the auditor should perform with respect to the activities performed by the service organization. The procedures include –

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a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and

b. Obtaining evidence that the controls that are relevant to the auditor's opinion are operating effectively.

B22. Evidence that the controls that are relevant to the auditor's opinion are operating effectively may be obtained by following the procedures described in AU sec. 324.12. These procedures include –

a. Performing tests of the user organization's controls over the activities of the service organization (e.g., testing the user organization's independent reperformance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).

b. Performing tests of controls at the service organization.

c. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in AU sec. 324.24b). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in AU sec. 324.24a) does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU sec. 324, the auditor should

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evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

B23. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient evidence to support his or her opinion. In evaluating whether such a service auditor's report provides sufficient evidence, the auditor should assess the following factors –

- The time period covered by the tests of controls and its relation to the as-of date of management's assessment,

- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls, and

- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements as described in AU sec. 324.16.

B24. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures.

B25. In determining whether the service auditor's report provides sufficient evidence to support the auditor's opinion, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10a of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

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B26. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.

B27. The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors. As risk increases, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment,
- The significance of the activities of the service organization,
- Whether there are errors that have been identified in the service organization's processing, and
- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

B28. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures may include –

- Evaluating procedures performed by management and the results of those procedures.
- Contacting the service organization, through the user organization, to obtain specific information.
- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.
- Visiting the service organization and performing such procedures.

B29. The auditor should not refer to the service auditor's report when expressing an opinion on internal control over financial reporting.

Benchmarking of Automated Controls

B30. Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.

B31. If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.

B32. When using a benchmarking strategy for a particular control, the auditor should take into account the importance of the effect of related files, tables, data, and parameters on the consistent and effective functioning of the automated application

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control. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

B33. To determine whether to use a benchmarking strategy, the auditor should assess the following risk factors. As these factors indicate lower risk, the control being evaluated should be viewed as well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated should be viewed as less well-suited for benchmarking. These factors are –

- The extent to which the application control can be matched to a defined program within an application;

- The extent to which the application is stable (i.e., there are few changes from period to period); and

- The availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed.)

B34. Benchmarking automated application controls can be especially effective for companies using purchased software when the possibility of program changes is remote—e.g., when the vendor does not allow access or modification to the source code.

B35. After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be reestablished. To determine when to reestablish a baseline, the auditor should evaluate the following factors –

- The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations;

- The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls;

- The nature and timing of other related tests;

- The consequences of errors associated with the application control that was benchmarked; and

- Whether the control is sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

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APPENDIX C – *Special Reporting Situations*

Report Modifications

C1. The auditor should modify his or her report if any of the following conditions exist.

a. Elements of management's annual report on internal control are incomplete or improperly presented.

b. There is a restriction on the scope of the engagement.

c. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report.

d. There is other information contained in management's annual report on internal control over financial reporting.

e. Management's annual certification pursuant to Section 302 of the Sarbanes-Oxley Act is misstated.

C2. *Elements of Management's Annual Report on Internal Control Over Financial Reporting Are Incomplete or Improperly Presented.* If the auditor determines that elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should modify his or her report to include an explanatory paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about a material weakness is not fairly presented in all material respects, the auditor should follow the direction in paragraph 100.

C3. *Scope Limitations*. The auditor can express an opinion on the company's internal control over financial reporting only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion states that the auditor does not express an opinion on the effectiveness of internal control over financial reporting.

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C4. When disclaiming an opinion because of a scope limitation, the auditor should state, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. He or she should state that the scope of the audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal control over financial reporting (paragraph 94, g, h, and i); to do so might overshadow the disclaimer.

C5. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report also should include –

- The definition of a material weakness, as provided in paragraph A8.
- A description of any material weaknesses identified in the company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness, and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraphs 102 and 103.

C6. The auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

> Note: In this case, in following the direction in paragraph 98 regarding dating the auditor's report, the report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

C7. If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the audit, the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

C8. *Opinions Based, in Part, on the Report of Another Auditor*. When another auditor has audited the financial statements and internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion. AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements needs to participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

C9. When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by the other auditor. In these circumstances, the auditor's decision is based on factors analogous to those of the auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AU sec. 543.

C10. The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because management's assessment of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.[1/]

C11. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion on the company's internal control over financial reporting, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinion.

C12. *Management's Annual Report on Internal Control Over Financial Reporting Containing Additional Information*. Management's annual report on internal control over financial reporting may contain information in addition to the elements described in paragraph 81 that are subject to the auditor's evaluation.

C13. If management's annual report on internal control over financial reporting could reasonably be viewed by users of the report as including such additional information, the auditor should disclaim an opinion on the information.

C14. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. AU sec. 317, *Illegal Acts by Clients* and Section 10A of the Securities Exchange Act of 1934 may also require the auditor to take additional action.[2/]

> Note: If management makes the types of disclosures described in paragraph C12 outside its annual report on internal control over financial reporting and includes them elsewhere within its annual report on the company's financial statements, the auditor would not need to disclaim an opinion. However, in that situation, the auditor's responsibilities are the same as those described in this

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[1/] See paragraph B17, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

[2/] See 15 U.S.C. § 78j-1.

paragraph if the auditor believes that the additional information contains a material misstatement of fact.

C15. *Management's Annual Certification Pursuant to Section 302 of the Sarbanes-Oxley Act is Misstated.* If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[3/] the auditor should follow the communication responsibilities as described in AU sec. 722 *Interim Financial Information*, for any interim period. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in AU sec. 722, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Filings Under Federal Securities Statutes

C16. AU sec. 711, *Filings Under Federal Securities Statutes*, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should apply AU sec. 711 with respect to the auditor's report on management's assessment of the effectiveness of internal control over financial reporting included in such filings. In addition, the auditor should extend the direction in AU sec. 711.10 to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements to matters that could have a material effect on management's assessment of internal control over financial reporting.

C17. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on management's assessment of the effectiveness of

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[3/] See 17 C.F.R. §§ 240.13a-14(a) and 240.15d-14(a).

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internal control over financial reporting in the securities filing, the auditor's consent should clearly indicate that both the audit report on financial statements and the audit report on management's assessment of the effectiveness of internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

Appendix 2 – Proposed Auditing Standard

December 19, 2006
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

Considering and Using the Work of Others in an Audit

This proposed auditing standard will supersede SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements") if it is adopted by the Board and approved by the Securities and Exchange Commission.

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Introduction

1. This standard establishes requirements for and provides direction on the auditor's consideration and use of relevant work performed by others in an integrated audit of financial statements and internal control over financial reporting ("integrated audit") or in an audit of financial statements only. For these purposes, the work of others includes work performed by internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee.

> Note: The use of the work of others, as described within this standard does not include the auditor's use of the work of other independent auditors, as described in AU sec. 543*, Part of Audit Performed by Other Independent Auditors*, the auditor's use of a service auditor as described in AU sec. 324, *Service Organizations,* or the auditor's use of the work of a specialist, as described in AU sec. 336, *Using the Work of a Specialist*.

2. This standard distinguishes between two general types of work performed by others: 1) the auditor's consideration and use of work performed by others in the ordinary course of business (paragraphs 3 through 19); and, 2) work performed by others to directly assist the auditor in achieving the auditor's objectives in his or her audit (paragraphs 20 and 21).

The Effects of the Work of Others

3. The auditor should obtain an understanding of work performed by others sufficient to identify relevant activities.

4. *Relevant activities* are tests performed by others that provide evidence about the design and operating effectiveness of a company's internal control over financial reporting or that provide evidence about potential misstatements of the company's financial statements. Tests performed by others that provide such evidence typically are similar in nature, timing, and extent to the procedures that the auditor would have performed himself or herself as part of obtaining sufficient competent evidence to support the auditor's opinion.

> Note: Certain activities may not be relevant to the financial statements or internal control over financial reporting. For example, procedures performed to evaluate the efficiency of management decision-making processes ordinarily are not relevant activities. In addition, not all activities are tests that provide audit evidence. Only tests that provide audit evidence may be considered relevant activities.

5. The auditor should obtain an understanding of the relevant activities undertaken by others to determine how that work might alter the nature, timing, and extent of the procedures the auditor would have otherwise performed.

6. The auditor should determine whether the results of relevant activities undertaken by others identified control deficiencies, fraud, or financial statement misstatements. If so, the auditor should determine how such findings by others might affect the auditor's procedures and conclusions.

> Note: The auditor may limit this understanding to considering relevant activities that provide information about risks of material misstatement to the financial statements or risks that material weaknesses in internal control over financial reporting exist.

7. The auditor should evaluate the extent to which he or she will use the work of others. Areas in which the auditor might use the work performed by others to reduce the procedures the auditor otherwise would have performed include –

- Procedures the auditor performs when obtaining an understanding of the company's internal control over financial reporting;
- Procedures the auditor performs when assessing risk;
- Procedures the auditor performs when testing the effectiveness of controls; and
- Substantive procedures the auditor performs when testing account balances and disclosures.

8. *Responsibilities of the Auditor*. The auditor's responsibility to report on the financial statements or management's assessment of the effectiveness of internal control over financial reporting rests solely with the auditor; this responsibility cannot be shared with the other individuals whose work the auditor uses.

9. The auditor must obtain sufficient competent evidence [1/] in support of his or her opinion. Judgments about the sufficiency of evidence obtained, assessments of risk, the

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[1/] AU sec. 326, *Evidential Matter*, provides direction regarding the sufficiency of evidence. Evidence obtained through the auditor's direct personal knowledge, including observation, reperformance, and inspection, is generally more persuasive than information obtained indirectly from others.

materiality of misstatements, and evaluations of test results, must be those of the auditor.

Using the Work of Others

10. To use the work of others to reduce the nature, timing, or extent of the work the auditor would have otherwise performed, the auditor should –

a. Evaluate the nature of the subject matter tested by others;

b. Evaluate the competence and objectivity of the individuals who performed the work; and

c. Test some of the work performed by others to evaluate the quality and effectiveness of their work.

11. *Evaluating the Nature of the Subject Matter Tested by Others*. The auditor should assess the following risk factors when evaluating the nature of the subject matter tested by others. As these risks increase, the need for the auditor to perform more of the work himself or herself increases. As these risks decrease, the need for the auditor to perform more of the work himself or herself decreases.

- The risk of material misstatement in the accounts and disclosures subject to testing;

- The amount of judgment or estimation related to the account or disclosure subject to testing;

- The degree of judgment required to evaluate results of testing (i.e., the degree to which the evaluation relies upon subjective factors rather than objective testing); and

- The potential for management override of controls related to the subject matter of the testing.

12. When the auditor evaluates the nature of controls tested by others, he or she also should consider, as an additional risk factor, the pervasiveness of the controls being tested.

13. *Evaluating the Competence and Objectivity of Others*. The auditor should evaluate the competence and objectivity of the individuals performing tests of controls, accounts, or disclosures to determine the extent to which the auditor may use their

work. In performing this evaluation, the auditor should make judgments about the degree of competence and objectivity of the individuals rather than form an absolute conclusion about whether the individuals are competent or objective. The higher the degree of competence and objectivity, the greater use the auditor may make of the work; conversely, the lower the degree of competence and objectivity, the less use the auditor may make of the work.

> Note: The auditor should not use the work of individuals who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of individuals who have a low level of competence regardless of their degree of objectivity.

14. Factors relevant to the assessment of the competence of the individuals performing tests include, but are not limited to –

- Their educational level and professional experience;
- Their professional certification and continuing education;
- Practices regarding the assignment of individuals to areas of the business;
- Supervision and review of their activities;
- Quality of the documentation of their work, including any reports or recommendations issued; and
- Periodic evaluation of their overall performance.

15. Factors relevant to the assessment of the objectivity of the individuals performing tests include, but are not limited to –

a. Policies to address the individuals' objectivity about the areas being tested, and whether the policies are being complied with, including –

  - Policies prohibiting individuals from testing matters related to areas in which relatives are employed in important or internal control-sensitive positions.
  - Policies prohibiting individuals from testing matters in areas to which they are assigned, were recently assigned or are scheduled to be assigned upon completion of their testing responsibilities. For

purposes of this standard, "assigned" includes having supervisory responsibility for the area.

Note: The auditor should not use tests performed by the same personnel who are responsible for performing the control or for the completeness and accuracy of the information being tested because these individuals do not have sufficient objectivity as it relates to the subject matter.

b. The organizational status of the persons responsible for the work of others, including –

- Whether the board of directors or the audit committee oversees employment decisions related to the responsible persons.

- Whether the responsible persons have direct access and report regularly to the board of directors or the audit committee.

- Whether the responsible persons report to a person of sufficient status to ensure sufficient testing coverage and adequate consideration of, and action on, the findings and recommendations of the persons performing the testing.

c. Policies designed to assure that compensation arrangements for individuals performing the work do not adversely affect objectivity, and whether the policies are being complied with.

16. Personnel whose core function involves permanently serving as a testing or compliance authority at the company, such as internal auditors or loan review in a financial institution, normally are expected to have greater competence and objectivity than company personnel whose principal duties address other business objectives. Therefore, the auditor may be able to use the work of personnel assigned to a permanent testing authority to a greater extent than the work of other company personnel.

17. When determining how the work of others will alter the nature, timing, or extent of the auditor's work, the auditor should assess the relationship between the nature of the subject matter and the competence and objectivity of those who performed the work. As the risks described in paragraphs 11 and 12 increase, the auditor's ability to use the work of others decreases and the necessary level of competence and objectivity of those who perform the work increases.

18. *Testing the Work of Others*. If the auditor uses the work of others to reduce the procedures the auditor otherwise would have performed, the auditor should test some of the work of others to evaluate the quality and effectiveness of the work. The nature and extent of the tests that the auditor should perform depend on the effect of the work of others on the auditor's procedures but should be sufficient to enable the auditor to make an evaluation of the overall quality and effectiveness of the work the auditor is considering. The auditor also should assess whether this evaluation has an effect on his or her conclusions about the competence and objectivity of the individuals performing the work.

19. In evaluating the quality and effectiveness of the work of others, the auditor should evaluate such factors as –

- Nature, timing, and extent of the testing performed;
- Degree to which the testing performed by others relates to the control objectives or financial statement assertions;
- Adequacy of the work programs;
- Adequacy of documentation of the testing, including evidence of supervision and review;
- Appropriateness of the conclusions in the circumstances; and
- Consistency of the reports with the results of the testing.

Obtaining Direct Assistance from Others

20. In performing the audit, the auditor may request direct assistance from personnel that are sufficiently competent and objective to perform the work assigned. The auditor should determine whether personnel who might provide direct assistance are sufficiently competent and objective by following the direction in paragraphs 13 through 17.

21. Direct assistance means work that the auditor requests the others to perform to complete some aspect of the auditor's work, such as tests of controls or substantive tests. When direct assistance is provided, the auditor should supervise, review, evaluate, and test the work performed by others as described in AU sec. 311, *Planning and Supervision*.

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Appendix 3

Proposed Rule 3525: Audit Committee Pre-approval of Services Related to Internal Control Over Financial Reporting

In connection with seeking audit committee pre-approval to perform for an audit client any permissible non-audit service related to internal control over financial reporting, a registered public accounting firm shall –

(a) describe, in writing, to the audit committee of the issuer the scope of the service;

(b) discuss with the audit committee of the issuer the potential effects of the service on the independence of the firm; and

> Note: Independence requirements provide that an auditor is not independent of his or her audit client if the auditor is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Several principles guide the application of this general standard, including whether the auditor assumes a management role or audits his or her own work. Therefore, an auditor would not be independent if, for example, management had delegated its responsibility for internal control over financial reporting to the auditor or if the auditor had designed or implemented the audit client's internal control over financial reporting.

(c) document the substance of its discussion with the audit committee of the issuer.

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Appendix 4 – Amendments to Interim Standards

December 19, 2006
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Amendments to PCAOB Interim Standards

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Appendix 4

Amendments to PCAOB Interim Standards

Auditing Standards

AU sec. 230, "Due Professional Care in the Performance of Work"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures," AU sec. 230, "Due Professional Care in the Performance of Work," as amended by SAS No. 41, "Working Papers," SAS No. 82, "Consideration of Fraud in a Financial Statement Audit," and SAS No. 99, "Consideration of Fraud in an Financial Statement Audit" (AU sec. 230, "Due Professional Care in the Performance of Work") is amended as follows –

a. Paragraph .10 is replaced with –

The exercise of due professional care allows the auditor to obtain *reasonable assurance* about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether any material weaknesses exist as of the date of management's assessment. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Although not absolute assurance, reasonable assurance is a high level of assurance. Therefore, an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) may not detect a material weakness in internal control over financial reporting or a material misstatement to the financial statements.

b. The term "financial statements" within the first sentence of paragraph .13 is replaced with the term "financial statements or internal control over financial reporting."

c. The second sentence of paragraph .13 is replaced with –

Therefore, the subsequent discovery that either a material misstatement, whether from error or fraud, exists in the financial statements or a material

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weakness in internal control over financial reporting does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with the standards of the Public Company Accounting Oversight Board (United States).

AU sec. 310, "Appointment of the Independent Auditor"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures," AU sec. 310, "Appointment of the Independent Auditor," as amended by SAS No. 45, "Omnibus Statement on Auditing Standards-1983," SAS No. 83, "Establishing an Understanding With the Client," and SAS No. 89, "Audit Adjustments" (AU sec. 310, "Appointment of the Independent Auditor"), is amended, as follows –

a. The third bullet point of paragraph .06 is replaced with –

Management is responsible for establishing and maintaining effective internal control over financial reporting. If, in an integrated audit of financial statements and internal control over financial reporting, the auditor concludes that he or she cannot express an opinion on internal control over financial reporting because there has been a limitation on the scope of the audit, he or she should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

b. The eighth bullet point of paragraph .06 is amended as follows –

Under Integrated audit of financial statements and internal control over financial reporting, the last sub-bullet point is replaced with the following –

To the board of directors—any conclusion that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.

Under Audit of financial statements, the last sub-bullet is replaced with the following –

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To the board of directors—if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the audit committee is ineffective, that conclusion.

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision," as amended by SAS No. 47, "Audit Risk and Materiality in Conducting an Audit," SAS No. 48, "The Effects of Computer Processing on the Audit of Financial Statements," and SAS No. 77, "Amendments to Statements on Auditing Standards No. 22, 'Planning and Supervision,' No. 59, 'The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,' No. 62, 'Special Reports'" (AU sec. 311, "Planning and Supervision"), is amended as follows –

The reference to paragraph 39 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraph 6 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit," as amended by SAS No. 82, "Consideration of Fraud in a Financial Statement Audit," SAS No. 96, "Audit Documentation," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), is amended as follows –

a. Within the note to paragraph 3, the reference to paragraphs 22-23 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 14-15 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. Within the note to paragraph 7, the reference to paragraphs 24-26 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 45-46 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

c. Within the note to paragraph 12, the references to paragraphs 22-23 and 39 of PCAOB Auditing Standard No. 2 are replaced with references to paragraphs 14-15 and 6, respectively, of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

d. Within the note to paragraph 18, the reference to Appendix B, *Additional Performance Requirements and Directions: Extent of Testing Examples* of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B12-B18 of Appendix B, *Special Topics,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

e. Within the note to paragraph 30, the reference to paragraphs 147-149 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B3-B5 of Appendix B, *Special Topics,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards – 1983" (AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), is amended as follows –

The reference to paragraphs 98-103 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraphs 57-60 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors – (AU sec. 315, " Communications Between Predecessor and Successor Auditors"), as amended by SAS No. 93, "Omnibus Statement on Auditing Standards – 2000," is amended as follows –

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The last sentence of paragraph 16 is replaced with–

> Furthermore, the predecessor auditor is not a specialist as defined in AU sec. 336, *Using the Work of a Specialist* nor does the predecessor auditor's work constitute the work of others as described in Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*.

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), is amended as follows –

The reference to paragraphs 24-26 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraphs 45-46 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment of Statement on Auditing Standards No. 55," and SAS No. 94, "The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), is amended as follows –

a. The note to paragraph 2 is replaced with –

   Note: Refer to paragraph A10 of Appendix A, *Definitions,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* for the definition of relevant assertions and paragraphs 30-31 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* for discussion of identifying relevant assertions.

b. Within the note to paragraph 9, the reference to Appendix B, *Additional Performance Requirements and Directions: Extent of Testing Examples,* of PCAOB Auditing Standard No. 2 is replaced with a reference to

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paragraphs B12-B18 of Appendix B, *Special Topics,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

c. The last sentence of paragraph 55 is replaced with –

When obtaining an understanding of relevant work performed by others, the auditor should follow the direction in paragraphs 3 through 9 of Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*.

d. The note to paragraph 83 is deleted.

e. Within the note to paragraph 97, the reference to paragraphs 104-105 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 61-62 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

f. The appendix at AU sec. 319.110 is deleted.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standard No. 55," SAS No. 88, "Service Organizations and Reporting on Consistency," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 324, "Service Organizations"), is amended as follows –

The reference to Appendix B, *Additional Performance Requirements: Extent of Testing Examples,* of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraphs B19-B29 of Appendix B, *Special Topics,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements"[1/]

AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements" is amended as follows –

(a) The first bullet point in paragraph 1 is revised to read as follows: A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

(b) Paragraph 2 is replaced with –

A *significant deficiency* is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected.

> Note: There is a "reasonable possibility" of an event, as used in the definitions of *significant deficiency* and *material weakness* (paragraph 3), when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS No. 5").

[1/] When the Board adopted Auditing Standard No. 2, it superseded SAS No. 60 in the context of an integrated audit of financial statements and internal control over financial reporting by paragraphs 207-214 of Auditing Standard No. 2. See PCAOB Release No. 2004-008, *Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements"* (Sept. 15, 2004). As a result of superseding Auditing Standard No. 2, paragraphs 83 to 89 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements,* now supersede SAS No. 60 in the context of an integrated audit.

Note: A significant misstatement is a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

(c) Paragraph 3 is replaced with –

A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Note: In evaluating whether a control deficiency exists and whether control deficiencies, either individually or in combination with other control deficiencies, are significant deficiencies or material weaknesses, the auditor should follow the direction in paragraphs 70-79 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

(d) Paragraph 5 is replaced with –

If oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that circumstance should be regarded as a strong indicator that a material weakness in internal control over financial reporting exists. Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight in an audit of only the financial statements, if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that information in writing to the board of directors.

In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of a Material Weakness," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph A12 of Appendix A, *Definitions,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.* Within the example report within paragraph .04 of the interpretation, the fourth sentence is replaced with the definition of a material weakness in paragraph A8 of Appendix A, *Definitions,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation Process"), is amended as follows –

Footnote 3 to paragraph 28 is replaced with –

> The need to maintain control does not preclude the use of others in the confirmation process in accordance with Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*. That standard provides direction on considering and using the work of others and obtaining direct assistance from others.

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), is amended as follows –

a. The last two sentences of paragraph 7 are replaced with –

   The auditor also should obtain an understanding of work performed by others sufficient to identify any relevant activities in the area of derivatives, hedging, and securities. Direction on considering and using the work of others is contained in Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*.

b. Within the note to paragraph 11, the phrase "related to all significant accounts and disclosures in the financial statements" within the first sentence is deleted.

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AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations," as amended by SAS No. 89, "Audit Adjustments," and SAS No. 99 "Consideration of Fraud in a Financial Statement Audit" (AU sec. 333, "Management Representations"), is amended as follows –

> The reference to paragraphs 142-144 of PCAOB Auditing Standard No. 2 within the note to paragraph 5 is replaced with a reference to paragraphs 84-85 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements," as amended by SAS No. 64, "Omnibus Statement on Auditing Standards – 1990," SAS No. 79, "Amendment to Statement on Auditing Standards No. 58, 'Reports on Audited Financial Statements,'" SAS No. 85, "Management Representations," SAS No. 93, "Omnibus Statement on Auditing Standards – 2000," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 508, "Reports on Audited Financial Statements"), is amended as follows –

> The reference to paragraphs 162-199 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraphs 94-108 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* and Appendix C, *Special Reporting Situations,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. The sentence that reads "In addition, see Appendix A, *Illustrative Reports on Internal Control Over Financial Reporting,* of PCAOB Auditing Standard No. 2 which includes an illustrative combined audit report and examples of separate reports," is replaced with, "In addition, see paragraph 96 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* which includes an illustrative combined audit report."

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 530, "Dating of the Independent Auditor's Report," as amended by SAS No. 29, "Reporting

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on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 530, "Dating of the Independent Auditor's Report"), is amended as follows –

a. Paragraph 1 is replaced with –

The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Paragraph 5 describes the procedure to be followed when a subsequent event occurring after the report date is disclosed in the financial statements.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same date.

b. Paragraph 5 is replaced with –

The independent auditor has two methods for dating the report when a subsequent event disclosed in the financial statements occurs after the auditor has obtained sufficient competent evidence on which to base his or her opinion, but before the issuance of the related financial statements. The auditor may use "dual dating," for example, "February 16, 20__, except for Note __, as to which the date is March 1, 20__," or may date the report as of the later date. In the former instance, the responsibility for events occurring subsequent to the original report date is limited to the specific event referred to in the note (or otherwise disclosed). In the latter instance, the independent auditor's responsibility for subsequent events extends to the later report date and, accordingly, the procedures outlined in section 560.12 generally should be extended to that date.

c. The reference within the heading before paragraph 3 to "completion of field work" is replaced with "the date of the independent auditor's report."

<u>AU sec. 543, "Part of Audit Performed by Other Independent Auditors"</u>

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 543, "Part of Audit Performed by Other Independent Auditors," as amended by SAS No. 64,

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"Omnibus Statement on Auditing Standards – 1990" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), is amended as follows –

> The reference to paragraphs 182-185 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraphs C8-C11 of Appendix C, *Special Reporting Situations,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 560, "Subsequent Events"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 560, "Subsequent Events," as amended by SAS No. 12, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 560, "Subsequent Events"), is amended as follows –

> The reference to paragraphs 186-189 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraphs 104-107 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report," as amended by SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"), is amended as follows –

> The reference to paragraph 197 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraph 108 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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AU sec. 711, "Filings Under Federal Securities Statutes"

SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), is amended as follows –

The reference to paragraphs 198-199 of PCAOB Auditing Standard No. 2 within the note to paragraph 2 is replaced with a reference to paragraphs C16-C17 of Appendix C, *Special Reporting Situations,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), is amended as follows –

a. The following is inserted after the first sentence of paragraph 3 –

The SEC also requires management, with the participation of the principal executive officers (the certifying officers) to make certain quarterly and annual certifications with respect to the company's internal control over financial reporting.[2/]

[2/] See Section 302 of the Sarbanes-Oxley Act of 2002, and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), (17 C.F.R. § 240.13a-14a or 17 C.F.R. § 240.15d-14a), whichever applies.

b. The note to paragraph 3 is deleted.

c. The following is added to the end of paragraph 7 –

Likewise, the auditor's responsibility as it relates to management's quarterly certifications on internal control over financial reporting is different from the auditor's responsibility as it relates to management's annual assessment of internal control over financial reporting. The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

> Note: The auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting take effect beginning with the first quarter after the company's first annual assessment of internal control over financial reporting as described in Item 308(a)(3) of Regulations S-B and S-K.

d. The following lettered section is added to the end of paragraph 18 –

g. Evaluating management's quarterly certifications about internal control over financial reporting by performing the following procedures –

- Inquiring of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information;

- Evaluating the implications of misstatements identified by the auditor as part of the auditor's other interim review procedures as they relate to effective internal control over financial reporting; and

- Determining, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

e. Paragraph 29 is replaced with –

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As a result of conducting a review of interim financial information, the accountant may become aware of matters that cause him or her to believe that –

a. material modification should be made to the interim financial information for it to conform with generally accepted accounting principles;

b. modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies; and

c. the entity filed the Form 10-Q or Form 10-QSB before the completion of the review.

In such circumstances, the accountant should communicate the matter(s) to the appropriate level of management as soon as practicable.

f. Paragraph 32 is replaced by the following –

If the auditor becomes aware of information indicating that fraud or an illegal act has or may have occurred, the auditor must also determine his or her responsibilities under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[1/]

[1/] See 15 U.S.C. § 78j-1

g. Within paragraph 33, the third sentence is replaced by the following –

A *significant deficiency* is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected.

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Auditing Standard No. 4 – *Reporting on the Elimination of a Previously Reported Material Weakness*

Auditing Standard No. 4 – *Reporting on the Elimination of a Previously Reported Material Weakness* is amended as follows –

a. Paragraph 9 is revised as follows –

The terms *internal control over financial reporting, control deficiency, significant deficiency, and material weakness* have the same meanings as the definitions of those terms in Appendix A, *Definitions,* of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The first sentence of Paragraph 10 is revised as follows –

Paragraph 5 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* states that the auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting.

c. Within the note to paragraph 10, the last sentence is revised to read as follows –

More information about the COSO framework is included within the COSO report.

d. Paragraph 11 is revised to read as follows –

The terms *relevant assertion* and *control objective* have the same meaning as the definitions of those terms in Appendix A, *Definitions,* of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

e. Paragraph 13 is revised to read as follows –

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In an audit of internal control over financial reporting, the auditor should evaluate the design effectiveness of controls by determining whether the company's controls, if operating properly, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements of the financial statements.[2/]

[2/] See paragraph 47 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

f. Within paragraph 21, the last sentence is deleted.

g. Within paragraph 23, the reference to paragraphs 22 and 23 of Auditing Standard No. 2 is replaced with a reference to paragraphs 14 and 15 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Additionally, the second sentence is deleted.

h. Within paragraph 24, the reference to paragraph 39 of Auditing Standard No. 2 is replaced with a reference to paragraph 6 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

i. Within subparagraph a. of paragraph 26, the reference to paragraphs 47 through 51 of Auditing Standard No. 2 is replaced with a reference to paragraphs 17 through 22 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

j. Within subparagraph b. of paragraph 26, the reference to paragraphs 79 through 82 of Auditing Standard No. 2 is replaced with a reference to paragraphs 36 through 40 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

k. The note to paragraph 28 is deleted.

l. Within paragraph 31, the reference to paragraphs 88 through 91 of Auditing Standard No. 2 is replaced with a reference to paragraphs 47 and

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48 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

m. Within paragraph 32 –

- The reference to paragraph 92 of Auditing Standard No. 2 is replaced with a reference to paragraph 49 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

- The reference to paragraphs 93 through 102 and 105 through 107 of Auditing Standard No. 2 is replaced with a reference to paragraphs 55 through 62 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

n. Paragraph 33 is replaced with the following –

The auditor should perform tests of the specified controls over a period of time that is adequate to determine whether, as of the date specified in management's assertion, the controls necessary for achieving the stated control objective are operating effectively. The timing of the auditor's tests should vary with the risk associated with the control being tested. For example, a transaction-based, daily reconciliation generally would permit the auditor to obtain sufficient evidence as to its operating effectiveness in a shorter period of time than a pervasive, company-level control, such as any of those described in paragraphs 17 and 18 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Additionally, the auditor typically will be able to obtain sufficient evidence as to the operating effectiveness of controls over the company's period-end financial reporting process only by testing those controls in connection with a period-end.

o. Within paragraph 35, the reference to paragraphs B1 through B13 of Appendix B of Auditing Standard No. 2 is replaced with a reference to paragraphs B12 through B15 of Appendix B, *Special Topics,* of Proposed

Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

p. The second sentence of paragraph 36 is replaced with the following –

To determine the extent to which the auditor may use the work of others to alter the nature, timing, or extent of the work the auditor otherwise would have performed, the auditor should apply the direction in Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*.

q. The second sentence of paragraph 37 is replaced with the following –

Therefore, if the auditor has been engaged to report on more than one material weakness or on more than one stated control objective, the auditor must evaluate whether he or she has obtained sufficient evidence that the control objectives related to each of the material weaknesses identified in management's assertion are achieved.[4/]

[4/] See paragraphs 8 and 9 of Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*.

r. The first two sentences of paragraph 38 are replaced with the following –

Paragraph 17 of Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit,* should be applied in the context of the engagement to report on whether a previously reported material weakness continues to exist. Paragraph 17 states, in part, "As the risks described in paragraphs 11 and 12 increase, the auditor's ability to use the work of others decreases and the necessary level of competence and objectivity of those who perform the work increases."

s. The note to paragraph 39 is deleted.

t. Within paragraph 42, the reference to paragraph 140 of Auditing Standard No. 2 is replaced with a reference to paragraph 79 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

u. Paragraph 44f is replaced with the following –

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Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a misstatement in the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting and that has occurred or come to management's attention since the date of management's most recent annual assessment of internal control over financial reporting.

v. Within paragraph 63, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29 through 32 of AU Sec. 722, *Interim Financial Information*.

w. Within paragraph 64, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29 through 32 of AU Sec. 722, *Interim Financial Information*.

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BP p.l.c., Iain Macdonald, Group Vice President and Group Controller
Brown-Forman, Jane Morreau, Vice President and Controller; Andy Kim, Director Internal Auditor
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WithumSmith+Brown Global Assurance, LLC
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-----Original Message-----
From: dsallen2@mmm.com [mailto:dsallen2@mmm.com]
Sent: Monday, February 26, 2007 4:29 PM
To: Comments
Subject: PCAOB Rulemaking Docket 21

February 26, 2007

Request by PCAOB for comments on proposed auditing standard – An audit of internal control over financial reporting that is integrated with an audit of financial statements and other related proposals

I appreciate the opportunity to provide input on the draft auditing standard proposal from the PCAOB. I am the SOX Compliance Manager at 3M Company, a Fortune 500 company with revenue in excess of $22 billion.

In general, I support many of the proposed changes. The draft does address several of the points I requested for consideration when providing comments after the year 2 assessment. Specifically, I am pleased by the advancement of guidance on using risk assessment at company and lower levels, removing the principal evidence provision, and considering the work of others.

My experience is that good communication and relationships between the auditor and registrant are critical to ensure maximum benefit at the lowest cost. I believe this will continue to be the situation with the new guidance as well, specifically in the determination of risk assessment. The guidance provides several factors for consideration of risk. Risk will be assessed by management and by the auditor. Management may choose to do some work in areas it does not consider high risk just in case the auditor considers it to be high risk, to allow the auditor the option to use some of that work performed by management. Good alignment in risk consideration factors is important to an effective SOX program.

I have the following comments for your consideration.

· In the proposal, you refer to the standard being of benefit to smaller companies. I agree with the concept of scaling the audit. This seems relevant to companies of all sizes and I encourage the removal of the “smaller companies” reference.

· Enhance the guidance on risk assessment for information technology general controls to include relevant elements for assessing risk using a top down approach.

· Enhance the guidance on risk assessment for fraud – Consider clarifying the following: Is this independent of materiality? Focused on more than misappropriation of assets? Addressed through segregation of duties? Focused on manipulation of earnings?

· The standard clearly indicates that the concept of cycling through testing is not appropriate. I encourage clarification on practical ways to leverage prior year results, such as, what evidence is required to prove no change occurred to the process or controls since the prior testing? With good prior year results, would it be reasonable to suggest a reduction in the number of controls needing to be tested that year or a reduction in the sample size for the full complement of controls?

Eliminate the auditor opinion on internal controls and replace

(reinstate) the auditor opinion on management's process of internal controls over financial reporting.
The proposal eliminates the need for the auditor to opine on the management process over internal controls. While I support the removal of one of these auditor requirements, I believe it would further reduce cost and maintain benefits if the auditor opinion on management's process remained, but the auditor opinion (requiring retesting) was removed. The company must already have independent testing of the internal controls over financial reporting, so the auditor requirement is an unnecessary burden.

I appreciate the opportunity to provide input and look forward to realizing the benefits afforded by the change in the auditing standard (AS5).

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February 22, 2007

Office of the Secretary
Public Company Accounting Oversight Board ("PCAOB")
1666 K Street, N.W.
Washington, D.C.

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 Financials Statements*** and Related Auditing Standard ***Considering and Using the Work of Others in An Audit***

Ladies and Gentlemen:

Accretive Solutions ("Company") is a leading privately-held professional services firm which provides consulting, executive search, and interim solutions in the areas of accounting and finance, enterprise governance, and business and technology. Our services are provided via a growing network of offices located in 14 major metropolitan areas. Since the enactment and implementation of the Sarbanes-Oxley ("SOX") Act of 2002, the Company has provided SOX compliance services to hundreds of U.S.-based companies who either are or aspire to be public filers with the Securities and Exchange Commission ("SEC"). Working collaboratively with client management and our clients' external auditors, we have gained a unique perspective of the process by which SOX compliance is demonstrated from both the client and external auditor vantage points.

Accretive Solutions has a significant and continued interest in the rulemaking activities of the PCAOB and the SEC. We welcome this opportunity to provide our comments related to PCAOB Rulemaking Docket Matter No. 021 - proposed Auditing Standard, ***An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financials Statements*** and the related Auditing Standard, ***Considering and Using the Work of Others in An Audit.***

Executive Summary

We recognize and applaud the PCAOB's efforts to provide further clarification to existing SOX compliance guidance, most importantly Auditing Standard No. 2 ("AS No. 2") – ***An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements***, which was approved by the SEC on June 17, 2004. While AS No. 2 has been useful to the conceptual understanding of SOX Section 404 ("404") requirements, an overly conservative and often inconsistent interpretation of the 404 requirements has been followed by some external firms, as supported by the number of comments that the PCOAB and the SEC has received related to the perceived high cost related to the implementation and maintenance of 404 compliance.

Having reviewed the proposed Auditing Standard***, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financials Statements*** and ***Considering and Using the Work of Others in An Audit,*** Accretive Solutions believes that the proposed standard will facilitate a more consistent, practical approach to the implementation and maintenance of 404 compliance requirements.

We recognize that the PCAOB's intent is to utilize ***An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financials Statements*** and ***Considering and Using the Work of Others in An Audit*** to:

- Focus the audit on matters most important to internal control;
- Eliminate unnecessary audit procedures;
- Scale the audit for smaller companies; and
- Simplify SOX compliance requirements.

That being stated, we feel that the documented guidance and resulting interpretation of several critical paragraphs of the proposed standard may still be too ambiguous and overly subjective to effectively ensure consistent implementation among all public filers and external auditor firms. Our greatest concern relates to the following themes:

- **Top-Down Risk-Based Approach** - The documented concept / approach is sound; however, implementation of the standard as currently proposed will continue to require a high level of subjectivity due to a lack of definitive guidance as to the practical application of the top-down risk-based approach. This lack of definitive guidance will lead to inconsistent application by public filers and their external auditors.
- **Company-Level Controls** - More descriptive guidance is needed related to the level of reduction or elimination of substantive tests of internal controls in the event that company-level controls are found to be effective.
- **Sample Sizes for Smaller Companies** - The use of absolute sample sizes without appropriate consideration of total population size will continue to result in "over-sampling" in relatively smaller, non-accelerated companies, leading to relatively higher SOX costs for such companies.
- **Scope of Testing in Multi-Location Engagements -** The proposed auditing standard is too ambiguous related to the scope of testing in multi-location engagements. We feel that a combined coverage similar to AS No. 2, taken in combination with the proposed top-down risk approach, will allow for greater flexibility and increased efficiency for the audit.
- **Definition of the Term "Significant"** - In serving our clients, we have observed that the term "significant" is a highly subjective. We would like to see required communication between company management and external auditors regarding the definition (i.e. dollar amount) of materiality. We feel greater clarity in this regard will improve efficiency of the audit.
- **Definition of the Terms "Material Weakness" and "Significant Deficiency"** - The proposed standard does not provide significantly improved clarification of the definitions as previously documented in AS No. 2. As a result, we fear that the determination of whether internal control deficiency or aggregated deficiencies represent a "Material

Weakness" or "Significant Deficiency" will continue to be highly subjective and highly subject to each external auditor firm's interpretation.

Accretive Solutions supports the spirit and intent of the proposed standard. Nevertheless, we believe that the above points need additional consideration and clarification prior to finalization of the standard so as to prevent inconsistent application of future guidance by key SOX compliance stakeholders.

Accretive Solution's responses to the questions included in PCAOB Release No. 2006-007, dated December 19, 2006, are presented in the remainder of this document.

<u>Detailed Responses to Questions Included in PCAOB Release No. 2006-007</u>

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

   Yes, from a conceptual perspective. No, from the perspective of practical application by public filers and external auditors. We feel that more specific details and examples of practical application are needed, including specific parameters around what is or is not a significant account, significant process, etc. We would also appreciate clearer guidance on how to apply risk assessment within the top-down approach as discussed in paragraphs 16 to 46 of the proposed standard. Consistent guidance as to how to more effectively evaluate risk would be useful. We feel the proposed standard's discussion of risk assessment is too general and will be open to varied and inconsistent interpretation.

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

   Yes. We feel that appropriate emphasis has been placed on the prevention and detection of fraud within the proposed standard.

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

   We are optimistic that the top-down approach will better focus the auditor's attention on the most important controls. Since AS No. 2 was approved by the SEC, Accretive Solutions has been utilizing a top-down approach as the foundation for our methodology of assisting our clients to achieve SOX compliance.

   However, we remain concerned that the lack of definitive guidance on the practical application of the top-down approach will enable external audit firms to take an overly conservative audit approach and will lead to continued external auditor "overkill" related to controls that are not of greatest importance to financial reporting.

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?**

   No. We feel that more descriptive guidance is needed related to the level of reduction or elimination of substantive tests of internal controls when company-level controls are found to be effective.

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?**

   Yes. We feel that paragraphs 51 and 52 of the proposed standard adequately address the relationship between level of risk and necessary audit evidence.

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

   Yes. Additional clarification within paragraph 36 would be useful. Paragraph 36 states "The auditor should perform a walkthrough on each significant process." It would be helpful to truly define the term "significant" to enable consistent application of this section of the proposed standard.

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?**

   No. In serving our clients, we have observed that the term "significant" is a highly subjective term which means different things to different people. We would prefer to see more open communication between company management and external auditors regarding the definition of materiality as it relates to each unique company's audit. Greater clarity in this regard would significantly improve the efficiency of the audit.

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?**

   Identification of material weaknesses when an actual material misstatement has not occurred continues to be a highly subjective assessment which is often made by the external audit firm based on who identified the potential misstatement and at what point in the audit the deficiency was identified. Additional guidance related to indicators for the identification and disclosure of material weaknesses is appreciated as it relates to deficiencies that do not result in actual material misstatements.

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 are optimistic that the proposed changes to the definitions will have a positive impact in this regard. However, we remain concerned that a lack of definitive guidance in the proposed standard related to the aggregation and assessment of deficiencies will result in continued inconsistency in the assessment of the level of deficiencies by the external auditors.

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?

Yes. We feel that the standard should allow an auditor to conclude that no deficiency exists when one of the strong indicators is present. Based on our experience working with our clients to achieve SOX compliance under AS No. 2, we have noted that external auditors have generally felt uncomfortable utilizing "professional judgment" and instead have taken an overly conservative stance when strong indicators are present. We believe that "strong indicators" are not definitive circumstances that always require classification as a significant deficiency.

We have observed high levels of inconsistency in interpretation of AS No.2 and feel that this change will positively impact future audits.

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

Yes. Please see our previous comments to questions #1 and #4. It is our opinion that there should be more guidance on sample size requirements related to high risk controls versus low risk controls. In our opinion, low risk controls can be sufficiently covered by a walkthrough with no need for further detail testing. From a common-sense perspective, we believe that controls with mid-level risk should only require half the amount of testing as that of a high risk process controls. Without further definitive guidance, we believe certain external audit firms may continue to apply varying standards in an overly conservative manner.

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?

Yes. By applying the annual materiality threshold, the audit process will be more efficient and external auditors will be enabled to focus on more important items.

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

Yes. The current practice of many external audit firms is to audit all of company management's tests and conclusions and then perform additional independent tests utilizing separate samples. Although we feel the auditors need to have a clear understanding of the process that management has taken to arrive at their assessment, we feel that auditing the same transactions / controls multiple times is unnecessary, inefficient, and costly.

We feel that removing the requirement for an evaluation of management's process is a significant positive step in eliminating unnecessary audit work.

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

Yes. As mentioned in the response to question 13, assuming that the external auditor:

- has a clear understanding of the manner in which company management has identified key risks and controls related to significant accounts and processes;
- has a clear understanding of company management's testing approach / plan / activities; and
- has evaluated the competency level of the resources who have performed testing and evaluated test results,

the external auditor should be able to perform an effective audit of internal control without evaluating the quality of management's 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?

Yes. We believe that an opinion only on the effectiveness of internal control will more clearly communicate the scope and result of the external auditor's work. We feel that AS No. 2's requirement that the auditor opine on the effectiveness of company management's process of assessing internal control has contributed to the relatively high cost of SOX compliance for public filers, with limited incremental value to the audit process.

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

Yes. We are comfortable with the manner in which the value of cumulative knowledge has been addressed within the proposed standard.

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?

We feel that walkthrough procedures are sufficient for low risk areas, as defined during the scoping process. For moderate and high risk areas, we feel that walkthroughs should continue to be utilized to evaluate the design of the internal controls prior to initiation of testing of internal control effectiveness.

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?

No. The proposed auditing standard is too ambiguous. We feel that a combined coverage (similar to AS No. 2) in conjunction with the proposed top-down risk approach will allow for greater flexibility and increased efficiency for the audit. For example, if a location cannot materially affect the financial statements, other risks should not impact the conclusion to eliminate that location from the scope of the audit. In contrast, if the location is considered necessary for scope coverage but the inherent risks within the account or process are considered low, the auditor should be able to conclude that testing at the location is not necessary.

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?

Yes. We feel that the proposed standard's single framework for using the work of others is appropriate for both the integrated audit and the audit of only financial statements.

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?

Yes. We are comfortable with the proposed definition of relevant activities.

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. We believe that requiring the auditor to understand the results of relevant activities performed by others will improve audit quality.

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

Yes. It is our opinion that the principal evidence provision in AS No. 2 continues to be necessary to adequately address the auditor's responsibilities to obtain sufficient evidence.

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?

It is our opinion that the proposed standard provides an appropriate framework for evaluating the competence and objectivity of the persons performing internal control testing. We believe the framework will be sufficient to protect against the inappropriate use of work of others without being overly restrictive.

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

We are comfortable with the factors that the PCAOB has identified for assessing the competence and objectivity for the work of others.

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

We believe that company policies addressing compensation arrangements for individuals can be effectively considered in the auditor's consideration of the effectiveness of company-level controls.

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

Yes. We feel that requiring a walkthrough only for all significant processes will reduce the number and detail of the walkthroughs without impairing audit quality.

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?

Yes. Using the assistance of others who are competent and objective will improve the overall efficiency of the audit.

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?

No. More specific guidance related to approved sample sizes for smaller, less complex public filers is needed to ensure consistent application by all external audit firms. Without such guidance, we feel that external auditor sample sizes will continue to vary and the potential for external auditor testing "overkill" will remain high.

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

Yes. Further clarification on what is sufficient evidence of effective company-level controls in a smaller company is needed. Further guidance regarding alternative or corroborating controls in the event of lack of segregation of duties due to small staff sizes would be helpful.

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?

A principal difference regarding internal control at smaller, less complex companies relates to the general lack of company personnel which prohibits optimal segregation of duties. Allowances should be made for alternative or corroborating controls in the event of lack of segregation of duties so that costly headcount additions are not required to comply with SOX compliance requirements, assuming that other mitigating controls are in place.

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

No. We believe that the discussion of complexity with the section on scalability is appropriate, just not presented in enough detail to ensure consistent applicability.

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?

Based on our experience to date, we have not observed external auditors make a significant distinction in their audit approach based on market capitalization and/or revenue size. In fact, in many smaller organizations, we have observed the external auditor view risk as substantially greater due to the concentration of management oversight in a smaller company. As previously stated, the proposed auditing standard needs to give more guidance on reliance and testing of company-level controls in a small company environment to ensure consistency of application by all external audit firms.

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?

Yes. The external auditor should be required to provide the audit committee with a summary of proposed materiality levels (stated in dollars of percentage of selected financial metric) and detailed definitions of the terms “significant”, “Material Weakness”, and “Significant Deficiency” as part of the pre-approval process for internal control-related services.

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?

We believe that the PCAOB should structure the effective date of the proposed auditing standard as soon as possible once the guidance is finalized. We believe that the following opportunities for improvement should be addressed prior to finalization of the proposed standard:

- **Top-Down Risk-Based Approach** - The documented concept / approach is sound; however, implementation of the standard as currently proposed will continue to require a high level of subjectivity due to a lack of definitive guidance as to the practical application of the top-down risk-based approach. This lack of definitive guidance will lead to inconsistent application by public filers and their external auditors.
- **Company-Level Controls** - More descriptive guidance is needed related to the level of reduction or elimination of substantive tests of internal controls in the event that company-level controls are found to be effective.
- **Sample Sizes for Smaller Companies** - The use of absolute sample sizes without appropriate consideration of total population size will continue to result in “over-

sampling" in relatively smaller, non-accelerated companies, leading to relatively higher SOX costs for such companies.

- **Scope of Testing in Multi-Location Engagements** - The proposed auditing standard is too ambiguous related to the scope of testing in multi-location engagements. We feel that a combined coverage similar to AS No. 2, taken in combination with the proposed top-down risk approach, will allow for greater flexibility and increased efficiency for the audit.
- **Definition of the Term "Significant"** - In serving our clients, we have observed that the term "significant" is a highly subjective. We would like to see required communication between company management and external auditors regarding the definition (i.e. dollar amount) of materiality. We feel greater clarity in this regard will improve efficiency of the audit.
- **Definition of the Terms "Material Weakness" and "Significant Deficiency"** - The proposed standard does not provide significantly improved clarification of the definitions as previously documented in AS No. 2. As a result, we fear that the determination of whether internal control deficiency or aggregated deficiencies represent a "Material Weakness" or "Significant Deficiency" will continue to be highly subjective and highly subject to each external auditor firm's interpretation.

Accretive Solutions sincerely appreciates the opportunity to provide our comments to the PCAOB regarding Rulemaking Docket Matter No. 021. Please do not hesitate to contact our Company if you desire further feedback related to the proposed auditing standard. I can be reached by telephone at 214-453-7872 should you wish to discuss any of our comments in greater detail.

Respectfully Submitted,

Dirk A. Hobgood

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February 26, 2007

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

Dear Sirs

Re: PCAOB Release No. 2006-007; Docket Matter No. 021

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's (PCAOB) proposed new standard "An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements". ACE Limited's management and Audit Committee support the PCAOB's objective to create an auditing standard that preserves the intended benefits without resulting in unnecessary effort and costs so audits become more efficient, risk-based and scaled to the size and complexity of each company.

At ACE, we continue to support the concept of having external auditors assess and report on the effectiveness of Internal Controls over Financial Reporting (ICFR) each year and congratulate the PCAOB on taking steps to address the unintended consequences related to these external audits of ICFR. We agree that the proposed standard is easier to read and has particular benefits for smaller companies. It is also helpful in that it codifies earlier guidance calling for a risk-based approach to auditing ICFR. Furthermore, we recognize that the PCAOB is charged with overseeing audit firms that range in size and complexity, and the expected impact of proposed standards will differ between firms and companies. Thus, any impact from this proposed standard will ultimately need to be measured at the company level and we expect that companies will experience different degrees of savings and efficiencies based on this proposed standard.

The Sarbanes-Oxley Act was created in response to a number of significant frauds that had occurred relating to financial reporting. The activities that promulgated the fraudulent reporting were orchestrated by very senior members of management and had little relevance to transaction-level controls. However, both management's annual assessment and the external auditor's annual evaluation of ICFR currently focus significant resources on transactional-level controls. Fraudulent financial reporting of a material nature will normally involve the knowing approval and active involvement of executive management. Therefore, given the genesis of the Act, we would expect that our assessments would focus on the potential means of fraudulent financial reporting, including significant transactions such as late or unusual journal entries, improper related-party transactions, and over-riding of existing reports and financial data which are not routinely detected by transactional-level controls. We believe that without further focus on

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the key controls that pose the most significant risk to false financial reporting, there is little opportunity to reduce management and auditor testing efforts.

In other words, we believe testing should shift dramatically away from transactional-level controls to company-level controls in a way that impacts the required audit efforts in a similarly dramatic way. The PCAOB should provide guidance and examples to make it very clear that detailed transactional-level control testing deep in an organization is not required. The focus should be on assessing the types of company-level controls that, left unchecked, contribute to audit failures in cases of significant fraud.

With respect to the current proposed standard, in our view, there are three key questions that should be addressed:

1. Will the proposed standard preserve the intended benefits of the audit of ICFR?
2. Will the proposed standard cause auditors to create a more cost efficient approach to auditing ICFR, and, if so, will it result in a significant fee reduction?
3. Will the elimination of the requirement to evaluate management's process used to assess internal controls over financial reporting result in reduction of audit costs?

1. *Will the proposed standard preserve the intended benefits of the audit of ICFR?* The proposed standard suggests a risk-based approach that starts with assessing company-level controls and assesses transactional-level controls as necessary based on the level of residual risk remaining after the assessment of company-level controls. In our view, this approach not only preserves the intended benefits of the audit of ICFR but should enhance them by further focusing auditors on areas of risk to financial reporting. It is also generally consistent with the proposed interpretive guidance recently issued by the Securities and Exchange Commission.

2. *Will the proposed standard cause auditors to create a more cost efficient approach to auditing ICFR, and, if so, will it result in a significant fee reduction?* Based on a comparison of AS2 to the proposed standard we believe it provides for sufficient changes that, in our view, should drive significant reductions in hours and costs. However, much of what is contained in the proposed standard is formalizing concepts and ideas emanating from previous PCAOB roundtables and other public forums. These areas include identifying the scope of the assessment and using some flexibility in testing lower risk areas. As a result, based on discussions with peers and external audit firms, we do not expect this proposed standard to have a significant impact on future audit costs, principally because a good portion of this guidance has already been considered in current audit plans.

   Set out below are what we consider the more significant issues:

   - We believe the external auditor's evaluation is being adversely influenced by the current PCAOB inspection process. It is our view that there is a disconnect between the objectives of the PCAOB as publicly stated and the tone and content of the detailed inspections. The current timing of

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these reviews is also an issue in our view. The results of the PCAOB inspections are publicized as much as two years after the audits were performed and, in some cases, the results have generated more work for auditors by proscribing work in areas of judgment. We believe having the PCAOB reviews more timely and more focused on the publicly stated objectives would be beneficial to all constituents.

- While we believe greater reliance on company-level controls will enable improved effectiveness and efficiencies, the existing limitations within AS2 restricting the auditor's reliance on the testing of management for company-level controls inhibits the ability to reduce the audit efforts and place greater reliance on management's testing. If increased focus is to be given to company-level controls, specific guidance regarding the work of others in this area would be helpful.

- The proposed standard focuses on using the work of others as a way to reduce the cost of the integrated audit. We are pleased this area is a central theme as we see it as an area with potential for cost savings. However, as noted in our answer to question 23 in Appendix A, this efficiency will continue to be difficult to achieve. We think more should be done to find ways to place greater reliance on management activities including regular monitoring and testing. This could have a substantial impact on costs. Relying on the work of Internal Audit does result in some cost savings but they are much less significant as Internal Audit has to carry additional staff to meet the added demand versus relying on management activities that occur as part of management's control framework.

- A potential positive aspect of the proposed standard is the flexibility to use the work of others in the performance of walkthroughs. We do expect that this provision will allow external auditors to reduce the amount of time spent in this area.

3. *Will the elimination of the requirement to evaluate management's process used to assess internal controls over financial reporting result in reduction of audit costs?* We do not expect that the elimination of the opinion based on the current requirement to evaluate management's process will result in significant audit cost savings. Our understanding is that external auditors currently gain most of their evidence to support their opinion from their independent assessment of internal controls. Also the proposed standard indicates that the auditor should still understand management's process as a starting point to understanding a company's internal controls, assessing risk and determining the extent to which an auditor can rely on the work of others. We do believe this change will eliminate a level of confusion caused by having two opinions from the external auditor.

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In Appendix A, we have included our responses to the 34 questions posed in the proposed standard. We would be pleased to discuss our response with the PCAOB or its staff.

Sincerely

Robert Ripp
Audit Committee Chairman

Philip V. Bancroft
Chief Financial Officer

Appendix A

A. Focusing the Audit on the Matters Most Important to Internal Control

I. Directing the Auditor's Attention Towards the Most Important Controls

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

Response
The proposed standard emphasizes "risk-assessment" and "reliance on company-level controls" as essential elements of a top-down approach. However, few if any companies and their auditors feel they have not embraced both concepts. Implementation of both concepts to streamline the audit process is hindered by a lack of detailed examples or models from which to draw upon. Risk assessment has included a financial mapping exercise to determine materiality, but assessments that incorporate risk in the equation are fairly limited. For example, in the scoping of investment activities, materiality limits the auditor's ability to reduce activities in this area even though risk of a material error is very low. Reliance on company-level controls has proven even more troubling since auditors often view these controls as necessary components of a COSO framework, yet have not been able to draw linkage to the ability of company-level controls to reduce testing of transaction level controls. Further clarity on the definition of company-level controls and the ability to leverage associated testing would be useful.

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

Response
Yes, we think the emphasis placed on fraud in the proposed standard is appropriate.

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

Response
Yes, a top-down approach does provide better focus for the auditor. However, the top-down approach has already been implemented to some degree by companies and auditors so the impact of this may not be substantial.

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?*

Response
There are substantial benefits to be derived from increased reliance on company-level controls. Activities such as Balance Sheet Fluctuation analysis provide an important control in the identification of material errors. However, these company-level controls are more often viewed as additional compensating controls for other transaction level controls and not primary controls on which reliance can be placed. The standard does not sufficiently articulate how the company-level controls should affect the auditor's work as it does not provide specific examples of how a company-level control would reduce or eliminate transactional-level testing. In addition, there is a sense that the PCAOB inspection process may restrict auditor's ability to reduce testing and documentation of transactional-level controls.

2. Emphasizing the Importance of Risk Assessment

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?*

   Response
   Additional detailed examples are critical to allow both the auditor and companies to understand the extent to which "testing" and "reperformance" would not be required in lieu of a walkthrough or observation for areas with lower levels of risk.

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

   Response
   For areas that involve recurring activities with no substantive changes from prior years, walkthroughs would appear to be appropriate if management can also identify associated monitoring controls that would identify significant deviations from expected results or forecasts. Limited testing would be necessary in such cases if combined with a robust walkthrough process. Clarity regarding such examples would be helpful.

3. Revising the Definitions of Significant Deficiency and Material Weakness

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?*

   Response
   The proposed definition is helpful, but, in our opinion, does not significantly vary from the existing standard. Further detailed examples could be helpful in understanding the precise application of the proposed standard. Also, the risk of aggregation of deficiencies will continue to drive auditors to lower levels of detail.

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?*

   Response
   In our experience, auditors are highly cognizant of control weaknesses that could "potentially" result in a material misstatement regardless of the existence of an accounting error. This awareness should be driven from the risk assessment and associated audit planning process which evaluates areas of potential risk. This further assessment of material weaknesses should include a review of historical errors, changes in management personnel, and other factors that will reduce the overall risk an actual material misstatement would occur.

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?*

Response
Our interpretation of the revised standard suggests that auditors not being required to search for deficiencies that are less severe than a material weakness would result in substantial savings of effort. However, the implementation of this concept is substantially hindered by the requirement for the auditor to issue an opinion over the effectiveness of internal controls. In our experience, a significant number of control deficiencies are currently identified that do not have the potential to represent a material weakness, yet the audit process is not weighted to proportionately reduce control testing. Furthermore, the consideration of aggregation of deficiencies that could present a material weakness will require a lower level of testing and analysis of deficiencies. Additional guidance and detailed examples will be necessary to provide auditor's with the ability to take advantage of this element of the proposed standard.

As noted earlier in this response, the perception that the PCAOB inspection process focuses on non-material documentation matters creates a constraint in moving toward an increased "materiality" and "judgment-oriented" focus.

4. Revising the Strong Indicators of a Material Weakness

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?*

Response
The clarity provided regarding the existence of strong indicators is helpful to avoid the risk that auditors will be compelled to identify a significant deficiency when the actual control environment may suggest otherwise. This guidance will also have an impact in situations where a design deficiency existed in a previous period and is being substantially reengineered yet not completed during the current reporting period. Permitting a more judgmental evaluation of such situations would allow management to seek more strategic solutions to existing problems rather than being constrained to completely remediate significant control design issues within the existing reporting period.

6. Clarifying the Role of Interim Materiality in the Audit

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

Response
We do not believe that additional clarification is needed, other than those noted above and below.

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?*

Response
The reference to interim financial statements should be removed from the definitions to make the standard clearer. However, we do not believe that any significant scope changes would result from this action.

B. Eliminating Unnecessary Procedures

1. Removing the Requirement to Evaluate Management's Process

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

Response
The evaluation of management's process has been incremental to the overall audit effort and does not require a significant amount of additional time by auditors. The removal of this requirement is not expected to have a significant impact on the audit work as auditors are still required to render an opinion on the effectiveness of internal controls. If there is even reasonable coordination with the auditor during the execution of audit work, the auditor will have been continuously evaluating management's assessment process regardless of the requirements in the standard. Coordination between management, Internal Audit and external auditors has increased the synergies between companies and their auditors, making the evaluation of management's process less arduous.

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

Response
Yes. Many companies have significantly relied upon their Internal Auditors and other qualified individuals to coordinate their annual evaluation. On a quarterly and annual basis, both the auditor and management are also reporting on the progress of internal control assessments directly to the Audit Committee. Due to the continuous nature of the monitoring and reporting on ICFR, the evaluation process has become a more integrated process. Effective integrated audit planning and quarterly status reporting essentially fulfill the objectives set forth in the formal evaluation process. Therefore, we feel that not requiring a formal evaluation will not result in significant changes to existing audit plans.

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?*

Response

Yes

2. Permitting Consideration of Knowledge Obtained During Previous Audits

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

Response
Although the concepts in the proposed standard are articulated clearly, the application of this concept is more difficult to define. We believe that in areas such as payroll and other routine processes experiencing little change, there is no substantial risk that would necessitate testing each year. While management should retain the discretion to test more frequently, we believe that further guidance and examples may be necessary to provide the auditor with sufficient guidance to determine when testing is not necessary.

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?*

Response
As noted in question 16 above, situations with minimal change in people or processes, repetitive type processes or transactions, and low rates of historical control deficiencies would be well suited for walkthrough reliance. There may also be circumstances where significant systematized processes could rely on a walk-through if the IT General Controls over change management and user access processes are deemed effective. The requirement that auditors still issue an opinion with respect to the effectiveness of a company's ICFR makes it more unlikely auditors will forego testing in lieu of a walkthrough unless more specific guidance is provided.

3. Refocusing the Multi-Location Testing Requirements on Risk Rather than Coverage

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?*

Response
We do not feel this aspect of the proposed standard will significantly impact external audit efforts at ACE as we have captured the spirit of this guidance in our financial scoping efforts when considering remote locations. The proposed standard could result in more efficient audits for companies with different circumstances.

4. Removing Barriers to Using the Work of Others

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?*

Response
The proposed standard's single framework for using the work of others is appropriate for both types of audits. To apply different frameworks to an audit of financial statements only and an audit of financial statement balances in an integrated audit would be confusing and potentially lead to two standards for similar audits. We believe, the requirement to issue an opinion on the effectiveness over internal controls creates added risk to audit firms when placing further reliance on the work of others. Inherent limitations will continue to exist in expanding reliance on the work of others unless the "opinion" requirement is eliminated. Audit firms will continue to perform independent testing as long as they believe the PCAOB inspections will hold them to the standards imposed by the opinion requirement.

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?*

Response
Yes.

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

Response
Practical application of the reliance on the work of others has required that the audit firms understand the scope of controls being tested, testing methodologies, test results, and identified fraudulent activities. As a result, we don't foresee this requirement having a significant change in audit quality.

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

Response
No. The provision to, instead, obtain "sufficient, competent, evidential matter" should adequately address the auditor's responsibility to obtain sufficient evidence, while allowing more reliance on the work of others who are objective and competent.

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?*

Response
We believe that the proposed standard may be too restrictive, allowing reliance on Internal Audit and other objective testing groups, rather than providing for the ability to rely on embedded management testing that has been determined to be competent by an independent quality review process. ACE has considered "certifying internal control testers" within the business; however, if greater reliance by the external auditors can not be placed on the results of management testing due to lack of objectivity, these concepts are less attractive. We also believe the scrutiny faced by audit firms in the inspection process serves to limit the inappropriate use of the work of others but may also be causing them to adopt too conservative an approach to relying on the work of others.

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

Response
Historically, only Internal Audit has been perceived as qualified due to the relative independence provided by their direct reporting to the Audit Committee. Since the initial implementation of the Sarbanes requirements, many companies have created functional roles and compliance-related functions that serve to facilitate their internal attestation process. Although these functions may lack direct reporting to the Audit Committee, they serve as valuable resources in evaluating and reporting on the effectiveness of internal controls. Further description of the functional operations that can provide competent control testing would be helpful. Without a degree of relief in relying on the work of other qualified management personnel, organizations may be required to continue to hire additional Internal Audit staff or engage in external consulting resources at significant expense.

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?*

Response
This requirement infers that individuals performing testing would be motivated to obstruct or alter the accurate reporting of internal controls based on their own personal compensation metrics. It should be noted that there is no existing standard that has required auditors to evaluate the compensation requirements and metrics for Internal Audit functions. Therefore, such a requirement suggests that historical reliance on Internal Audit had mistakenly failed to consider this metric. We believe this logic to be flawed. The existing framework for the testing and evaluation of controls provides adequate guidelines to ensure quality assurance with respect to management's testing. Further requiring auditors to examine compensation requirements for management would force auditors to make subjective judgments on the adequacy of the performance planning and compensation process that would be intrusive to companies and require a high degree of subjective evaluation.

5. Recalibrating the Walkthrough Requirements

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

Response
Yes, we believe that eliminating repetitive walkthroughs should minimize business interruption without impairing audit quality. Increased focus on changes in processes and personnel would minimize the risk of impairing the quality of audit efforts and should continue to be the focus of audit planning and assessment of audit risk.

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?*

Response
Auditors should be able to use others as direct assistance when performing walkthroughs and they should be allowed to exercise judgment in determining to what extent they use others. Close alignment of the risk assessment conclusions and areas where walkthroughs would be completed should be an important part of the audit planning process.

C. Scaling the Audit for Smaller Companies

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?*

Response
As an accelerated filer, this question would not be relevant to our organization.

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

Response
As an accelerated filer, this question would not be relevant to our organization.

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?*

Response
As an accelerated filer, this question would not be relevant to our organization.

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

Response
As an accelerated filer, this question would not be relevant to our organization.

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?*

Response
No response provided.

D. Simplifying the Requirements

III. Proposed Rule 3525 – Audit Committee Pre-approval of Services Related to Internal Control

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?*

Response
We believe the current reporting and pre-approval procedures are adequate to address the Audit Committee reporting requirements.

VI. Effective Date

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?*

Response

Audit planning has already been initiated by many organizations. In order to realize the benefits of any aspects of the proposed standard, implementation of the proposed standard at the earliest possible date would be essential. Thus the effective date should be structured to allow, at a minimum, December year-ends (possibly September year-ends) to adopt the new standard in 2007. Auditors can use the proposed standard as a guide to start amending audit strategies now.

February 26, 2007

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

RE: Rulemaking Docket No. 021

Members of the Public Company Accounting Oversight Board:

As the Public Company Accounting Oversight Board (the "Board") initially noted in their "Report on the Initial Implementation of Auditing Standard No. 2", there have been misunderstandings on how to apply this standard, which have resulted in audit inefficiencies. Our experience with the independent public accounting firm that performs our audit is that they have appeared to have chosen to err on the side of being overly effective and, therefore, inefficient when confronted with uncertainties on how to apply this standard. We also hear from our auditors that the Board's inspection and reporting processes is heavily skewed towards testing for ineffective compliance with little consideration for efficiency.

The proposed 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" provide greater clarity on how to more efficiently perform audits of internal controls. However, these changes alone will not ensure that public accounting firms fully understand how to apply these standards both efficiently and effectively. A practical understanding will rely heavily upon communications between the firms and the Board, including an appropriate balance of effectiveness and efficiency comments provided to the firms during the inspection process.

The inspection process is a critical part of these interactions. While this process may have caused firms to be overly concerned with effectiveness, this same process identified concerns over audit inefficiencies that lead to these proposed standards. We appreciate the changes the Board already made to this process focusing more on how efficiently audits are performed, as noted in the "Statement Regarding the Public Company Accounting Oversight Board's Approach to Inspections of Internal Control Audits in the 2006 Inspection Cycle". These proposed standards and the continued emphasis during the inspection process on both effective and efficient compliance will reduce costs while preserving the benefits gained from performing audits of internal control over financial reporting.

Overall, we agree with the approaches and rules outlined in these proposed standards. Therefore, the following comments are restricted to questions asked in areas where we believe better clarity can be achieved.

Q1. Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?

Overall, the methodologies outlined under the section titled "Using a Top-Down Approach", paragraph 16, are clearly descriptive. This approach also appears consistent with that identified under the title "Scaling the Audit for Smaller Companies", paragraph 9. Because these sections are listed separately, this appears to indicate that a different approach should be taken when auditing smaller companies. This could lead some readers to interpret that the requirements for these companies are less stringent than larger ones, instead of simply noting the differences between them to consider when taking a top-down approach.

All companies should benefit from efficiencies gained using the top-down approach described. We believe that the considerations noted pertaining to smaller companies should be included within the top-down approach section to clarify the Board's intentions.

Q4. 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?

We agree that the proposed standard does provide appropriate consideration of company-level controls. However, within paragraph 21, the Period-end Financial Reporting Process examples appear to focus primarily on journal entry controls. We believe that controls related to account reconcilement procedures should also be emphasized. These types of controls often initiate the recording of journal entries, as well as validate the accuracy of those posted. Per the proposed standard, auditors should consider the results of substantive audit procedures performed in the financial statement audit when determining the overall risk related to a control.

Q7. 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?

Despite changes to the definition of "significant" in regards to a deficiency, this term is still not sufficiently descriptive. The Board has provided some examples of qualitative measures for determining significant deficiencies. However, no clear quantitative guidance has ever been provided in regards to determining a significant deficiency.

Within the proposed standard, paragraph 14, auditors are instructed to use the same materiality considerations used in planning the audit of the company's annual financial statements for the audit of internal control over financial reporting. While an auditor's determination of materiality should include qualitative factors, in practice this measure is primarily quantitative.

Auditors are still required to communicate, in writing, significant deficiencies, in addition to material weaknesses, identified during the audit, to management and the audit committee. The purpose of doing so is to inform those responsible for oversight of the company's financial reporting of "deficiencies important enough to merit their attention". However, the absence of a quantitative measure of a significant deficiency in context to a material weakness diminishes the substance of this type of finding. Noting their importance, we believe that the definition of a significant deficiency would be more descriptive if it were also provided in context to quantitative materiality.

Q9. 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 misstatement to the financial statements?

When planning an audit, auditors are also instructed to identify significant accounts and disclosures. Paragraph 25 states that "the factors that the auditor should evaluate in the identification of accounts are the same in the audit of internal control over financial reporting as in the audit of financial statements; accordingly, significant accounts should be the same for both audits".

Again, auditors generally determine materiality as a quantitative threshold, based upon a percentage of a numerical threshold, such as 5% of net income before tax. Auditors then determine tolerable misstatement, based upon materiality, as a quantitative measure, in addition to qualitative factors, to identify "significant" accounts during the planning process. The purpose of determining significant accounts and disclosures within a financial audit is to obtain reasonable assurance of detecting misstatements that could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements.

However, within this proposed standard, paragraph 8, references are made such as "it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements". This statement appears to contradict that within paragraph 25, as noted above. While we believe that the phrase "reasonable possibility of material misstatement" means that auditors only concern themselves with deficiencies that could individually or in combination become material weaknesses, this could be misinterpreted. Auditors may take such statements to indicate that they should only search for individual material weaknesses.

We believe that firms should not search for deficiencies that individually or in the aggregate could not present a reasonable possibility of being a material weakness. The objective of an audit of internal controls over financial reporting is to obtain reasonable assurance that material weaknesses do not exist. We recommend that these statements, such as that noted above, should emphasize that material weaknesses, as defined, can be an individual deficiency or a combination of deficiencies. The previous example should indicate that "it is not necessary to test controls that, even if deficient, would not present a reasonable possibility, <u>individually or in the aggregate,</u> of being a material misstatement to the financial statements".

This proposed revision also appears consistent with the definition of a significant account, "an account or disclosure is significant if there is a reasonable possibility that the account could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements".

Q8. 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 auditor to appropriately identify material weaknesses when an actual material misstatement has not occurred?

As noted above, statements within the proposed standard should be revised to ensure that auditors do not misinterpret them and plan their audits to only identify individual deficiencies that could be material weaknesses. The failure to adequately identify deficiencies that in combination could present a reasonable possibility of being a material weakness could hinder the Board's intention to further encourage auditors to appropriately identify material weaknesses when an actual material misstatement has not occurred.

Q18. Will the proposed standard's approach for determining the scope of testing in a multi-location engagement result in more efficient multi-location audits?

Applying the top-down approach to determine those locations and business units should result in more efficient audits of multi-location engagements. Particularly, the note after paragraph B12 that "the auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the company's consolidated financial statements" summarizes this top-down risk-based approach.

However, there is no reference to this approach within the section titled Multiple Locations Scoping Decisions. The guidance provided under the section "Using a Top-Down Approach" addresses considerations for the company-level controls, e.g., centralized processing and controls, monitoring of operations, and the control environment that when applied to individual locations or business units should reduce the scope of testing. We believe that the Multiple Locations Scoping Decisions section would be enhanced by including specific references to the top-down approach.

Similar to previous concerns noted, paragraph B13 notes that "in assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements". We suggest that this statement be revised accordingly, "the auditor should test controls over specific risks that present a reasonable possibility, <u>individually or in aggregate</u>, of material misstatement" to ensure that auditors use an effective approach to scoping their audits.

Again, we appreciate the Board's efforts to make audits of internal control over financial reporting more efficient, and we thank you for the opportunity to provide our comments on these proposed standards.

Sincerely,

Thomas C. Wilson,
Director of Internal Audit
Acuity Brands, Inc.

AIA
AEROSPACE INDUSTRIES ASSOCIATION

The Honorable John W. Douglass
President and Chief Executive Officer

February 26, 2007

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

Re: SEC File No. S7-24-06; PCAOB Release No. 2006-007 (12/19/06)
PCAOB Rulemaking, Docket No. 021

Dear Ms. Morris and Ms. Phillips:

The Aerospace Industries Association (AIA) appreciates the significant effort that the SEC and PCAOB have expended to further clarify and streamline guidance for compliance with Section 404 of the Sarbanes-Oxley Act of 2002. We are encouraged that there are many provisions in the draft documents (issued on 12/19 and 12/27/2006) that respond to previous comments and recommendations from industry, and specifically to suggestions from AIA provided in our letter of September 14, 2006.

We welcome the opportunity to respond again to your request for input. We are challenged, however, by the issuance of two separate, lengthy proposals from the SEC and the PCAOB that appear to contain differing guidance. Our member companies would be placed at risk by following the SEC guidance alone, without first reconciling it to the PCAOB auditor guidance and to reports of the PCAOB inspectors. Without the reconciliation and coordination with our external auditors on interpretation of the SEC and PCAOB proposals, our member companies could inadvertently reduce or seriously misalign their processes from that required by the auditors and PCAOB inspectors, resulting in added audit deficiencies and increases in auditing costs.

It would be valuable to management at our member companies, and to the firms that audit our companies, if the SEC and PCAOB were to align and reconcile the two sets of guidance.

Because of the length of the two documents, AIA has not had time to conduct a thorough side-by-side review in order to provide responses to all of the individual questions in both documents.

In review efforts that we have been able to conduct, we noted that there are many policy statements which are consistent in both documents and welcomed, such as: acceptance of the concept of a top-down, risk-based approach; focus on the most important controls to prevent material misstatement; more flexibility for external auditors to rely on the work of others; and reduced testing in lower risk controls. However, there are other aspects of the two documents such as multi-location specifics, definitions, types of IT controls, and other items listed in the attachment to this letter that appear to be inconsistent or are in need of further clarification.

As a final point, we would like to comment on the question of the application of SEC and PCAOB guidance to all firms that must comply with the Act. The intent of the Sarbanes-Oxley Section 404 legislation is to enhance the reliability of financial statements for investors by requiring the establishment and monitoring of a more robust system of internal controls. Such a system should be required at all companies, regardless of size and complexity. We believe that internal control, risk assessment and key controls are applicable to large and small companies alike. A "one size fits all" approach which identifies minimum requirements would be best to avoid compliance confusion.

If you have any questions concerning the comments above and in the attachment, please contact Mr. Dick Powers of my staff. Dick can be reached on 703-358-1042. His email address is dick.powers@aia-aerospace.org.

Sincerely,

John

John W. Douglass
President & CEO

Attachment

JWD:srs

Attachment

We believe further clarification from both the SEC and PCAOB should be provided in the following areas:

- **Multi-location specifics** - Particularly for those companies that have locations (subsidiaries, divisions, etc.) which alone do not pose a risk of material misstatement but could when unremediated deficiencies are aggregated. For example, consider a $10 billion company with 10 Business Units, with separate controls, which generate $1 billion in revenue each. Independently, no unremediated deficiencies at single business units would pose a risk of material misstatement to consolidated financial statements. However, when the deficiencies are aggregated, the question of material misstatements could arise. As a result companies are forced to test near 100% of financial statement and footnote disclosure items, causing overly redundant and costly testing.

- **Definition of critical controls** - A more descriptive definition of a critical control would relieve ambiguity between the external auditor and management processes. Also, on the general subject of definitions, we believe all key definitions in the PCAOB proposal should be consistent with all key definitions in the SEC proposal. In that regard, the PCAOB glossary format is easier to reference, and we prefer that format to the inclusion by the SEC of key definitions in the footnotes of its proposal.

- **IT general computer controls** - Company internal and external costs are disproportionate to the benefits received. There has been no change in any guidance with respect to the evaluation of general IT controls. The PCAOB continues to refer to Codification of Statements of Auditing Standards (AU) section 319 without further discussion of its application to the prevention and detection of material misstatements. We believe it is unlikely the level of effort expended by accounting firms and fees for that effort will decrease unless further guidance clarifying the inter-relationship of IT controls, entity-level, and process controls is provided. The Sarbanes-Oxley Act excluded operational controls from its scope, as does the proposed SEC guidance. However, this exclusion has not been consistently applied to the IT operational controls, which are still included. Therefore, to be consistent to the Sarbanes-Oxley scope, operational and physical IT controls should also be excluded.

- **The work of PCAOB inspectors and its effect on management's approach and testing** - The PCAOB inspectors often hold external audit firms to a higher standard than PCAOB AS2, or other guidance documents. We understand from our external auditor that while they believe that their methodologies are compliant with AS2, upon review by the PCAOB inspectors, differences materialize that are not part of any guidance. This causes the external auditor to not fully embrace the top-down, risk-based approach, and develop test plans that go beyond what is necessary. Further, this causes a departure in the methodologies between management and the external auditors that result in increased cost and effort to our member firms. We suggest that the PCAOB inspectors issue more timely feedback to the external audit firms, and that a review of the inspectors' findings be conducted in due course.

- **Materiality thresholds** - The PCAOB directs public accounting firms to use the same materiality thresholds when planning audits of internal controls over financial reporting and financial statements. SEC guidance does not provide specific direction on materiality; however, we expect by applying a top-down, risk-based approach, management may conclude one element of its financial statements has a higher materiality threshold than another based on various qualitative factors. We recommend the SEC retain the concept of materiality as it relates to management's assessment of its system of internal control, but add emphasis that it is not the intent of the guidance to restrict management's system of internal control to only those items that are material. Management's adopted recognized framework should be applied at various levels to provide management an appropriate level of operational reliance.

  We also noted the PCAOB applies the term 'significant' throughout its description of the auditor's process, including its evaluation of significant processes, accounts, locations, and business cycles. We believe PCAOB's continued emphasis on significant processes, accounts, etc., coupled with the continued requirement to evaluate significant deficiencies, will have the unintended consequence of reducing the auditor's threshold of materiality when evaluating controls. We recommend the PCAOB revise its description of the auditor's process to reflect the overall objective of obtaining reasonable assurance regarding the effectiveness of controls to prevent and detect material weaknesses. We believe this will help ensure management and auditors' evaluations are more closely aligned.

- **Effective date for guidance 2007 vs. 2008** - The effective date for both the SEC interpretive guidance and the PCAOB proposed standard should coincide and be effective by mid-year 2007. This would allow external auditors enough time to potentially adjust their assessment approach.

- **Rotational Testing** - Guidance should re-emphasize that management and auditors, without performing additional year-end testing, may rely on its direct and ongoing monitoring of the operation of controls tested earlier in the year to support its annual assessment. Guidance should also stress that management and auditors may rely on prior year tests for controls that have not changed and are of lower risk.

  This guidance would be particularly beneficial for companies with automated controls, including information technology general controls, and manual controls which remain stable from year to year. This would allow these types of controls to be tested at a level which better correlates to their overall risk to the financial statements.

AKZO NOBEL

Memorandum
PT In Control

To
Nancy M. Morris
Secretary
Securities Exchange Commission
100 F Street, NE
USA - Washington DC 20549-1090
Email: rule-comments@sec.gov

J. Gordon Seymour
Office of the Secretary
Public Company Accounting
Oversight Board
1666 K Street, NW
USA - Washington D.C.
20006-2803
Email: comments@pcaobus.org

From Mrs M.J.L. van Ool, project manager "In Control"

Date 27 February 2007

Ref MvO/07.02

Copies to CFO, Director Corporate Control, General Counsel, Director Internal Auditing Service

Subject **Securities and Exchange Commission Release on Management's Report on Internal Control over Financial Reporting**

Public Company Accounting Oversight Board Proposed Auditing Standard on An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals

Dear Ms Morris and Mr Seymour,

Akzo Nobel NV is both a Dutch listed company, as well as a (large) foreign issuer by being listed on the NASDAQ and has been confronted with the consequences of the Sarbanes-Oxley Act of 2002 to its full extent.

AkzoNobel is pleased to comment on:

- the Securities and Exchange Commission (SEC) Release Nos. 33-8762 and 34-5476 on Management's Report on Internal Control over Financial Reporting (the SEC's proposals); and
- the Public Company Accounting Oversight Board (PCAOB) Rulemaking Docket Matter No. 021 of 19 December 2006 – Proposed Auditing Standard on An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals (the PCAOB's proposed standard).

AKZO NOBEL

Akzo Nobel notes with interest the SEC's proposals and the PCAOB's proposed Auditing Standard in view of Akzo Nobel's own recent discussions over the future direction of requirements and guidance relating to risk management and internal control.

We are supportive of the proposed objectives of the SEC and the PCAOB which we believe include:

- improving the effectiveness and efficiency with which management and auditors assess a company's internal control over financial reporting;
- adopting a top down, risk-based approach with emphasis on the control environment;
- providing flexibility in the approach to assessing internal control;
- increasing the focus on the exercise of judgment, rather than encouraging a check-list mentality; and
- considering issues related to multi-location companies such as Akzo Nobel is.

However, we have some points of concern we would like to share.

1. Unclarity how the introduction paragraph "companies are supposed to be in control (reference to FCPA and COSO etc)", which in essence is the basic assumption on which the SEC's proposals are being built, will be verified by the SEC. In other words: will the SEC, in future, ask proof from the companies to assure that this basic assumption is valid for that particular company?
If yes, how can we show/proof this without very detailed documentation of the design of controls, including routine transactions?

2. Will the US GAAS regarding materiality for financial statements be adopted by the SEC to at least have an objective calculated amount as a basic reference to set the materiality level? The "prudent governmental official" being the reference for materiality is a difficult concept to translate for a multi-national company dealing with numerous different cultural forms of prudence exercised by governmental officials.

3. Will the SEC and the PCAOB agree on one set of requirements for coverage in the case of multi-locations companies? Currently the external auditors follow the PCAOB guidance on coverage as 70% of material financial statement lines and more or less the company has been forced to ensure that we have documented the controls in line with that coverage. If and when the risk based top-down (qualitative) approach is the basis for management's selection of multi-locations a pre-defined coverage will thus not be guaranteed.

4. By adopting a "Risk based approach" to identify which risks need at least documented controls for which also proof of effectiveness should be provided, should we consider typically the residual risks? In other words take into account the basic control design as set by management, or should we consider inherent risks and refrain from allowing for our assumed solid design of controls to mitigate most of the generic inherent risks?

AKZO NOBEL

5. And finally some specific questions to the PCAOB: The external auditor may rely on and use work of others. It is understood that the work of others should achieve a certain standard of quality. Will there still be a number of qualitative demands to the professionalism exercised by and (the format of the) working papers of these others, that force companies to prepare full audit working papers as part of their management's assessment documentation?
Will there be any guidance on how the cooperation between External and Internal Auditor should be formalized? And more specifically regarding using the work of the Internal Auditor for the Audit of Internal Control over Financial Reporting that is integrated with an Audit of Financial Statements?

We would be pleased to discuss with you any aspect of this letter you may wish to raise with us.

Yours sincerely,
Akzo Nobel

Mrs M.J.L. van Ool
Project Manager "In Control"

Dennis M. Stevens
Director, Internal Audit
Alamo Group
1502 E. Walnut
Seguin, TX 78155
January 3, 2007

Rep. Nancy Pelosi
Speaker Elect
House of Representatives
2371 Rayburn HOB
Washington, DC 20515-0508

Rep. Charles B. Rangel
Chairman Designate
Committee on Ways and Means
1106 Longworth HOB
Washington. DC 20515

Rep. Barney Frank
Chairman Designate
House Financial Services Committee
B-301C Rayburn HOB
Washington, DC 20515

Senator Chris Dodd
Chairman Designate
Senate Committee on Banking,
Housing and Urban Affairs
534 Dirksen SOB
Washington, DC 20510

CC: Nancy M. Morris
Secretary, SEC
100 F Street, NE
Washington, DC 20549-1090
Re: SEC File Number S7-24-06

Office of the Secretary
PCAOB
1666 K Street NW
Washington, D.C. 20006-2803
Re: Rulemaking Docket No. 021

Honorable Members of Congress:

On December 19, 2006 the Public Company Accounting Oversight Board (PCAOB) issued Release 2006-007 proposing changes to rules governing external auditor responsibilities under the Sarbanes-Oxley Act of 2002 Section 404 (SOX 404)[1]. At the same time the Securities and Exchange Commission (SEC) proposed Release 33-8762 to clarify responsibilities for the related management assessment of internal control[2]. These proposals have been exposed to public comment through February 26, 2007 after which they may be adopted by the PCAOB, approved by SEC and supersede present requirements.

The PCAOB/SEC proposals perpetuate the existing requirement for a full-blown external 'audit of internal control,' which in our experience has been the single largest contributor to the extraordinarily high expense associated with SOX 404 compliance. Over the past three years this requirement has resulted or contributed to huge audit fees, a massive transfer of wealth, a continuing erosion of shareholder value, a substantial shift to private from public financing and possible loss of U.S. global competitiveness.

We urge you to use the power of your office on or before February 26, 2007 to halt adoption of PCAOB Release 2006-007. Further, we urge the Congress to consider amendments to the Sarbanes-Oxley Act that would either better define or limit requirements presently imposed on public accounting firms under the Act. Such amendments should reinforce the notion that the maintenance of a system of internal control, its assessment, and reporting on that assessment is primarily a management responsibility that management must satisfy as management considers necessary and appropriate to protect and enhance shareholder value.

January 3, 2007

The PCAOB's external 'audit of internal control' is *not* required by SOX 404 and represents an approach to protecting the interests of investors that has been specifically considered *and rejected* in the UK, Canada and perhaps other international jurisdictions, yet the PCAOB has never encouraged any serious public debate about the need for or value of an external 'audit of internal control' in the United States. The PCAOB's proposed Release 2006-007 perpetuates this trend by providing 131 pages of redefinition and redirection on *how auditor's should perform* an external 'audit of internal control' without ever addressing *the need for and value of the service itself*.

The manner in which this matter has been handled causes serious concern about the independence and objectivity of the PCAOB, its focus on protecting the public interest and the controls surrounding the standards-setting process itself. After three years of waiting, it no longer appears the PCAOB alone is capable of the innovative thinking and bold action needed to address the serious problems the American business community has experienced with SOX 404. **We need assistance from Congress and revisions to the Sarbanes-Oxley Act itself.**

This might be accomplished by relatively minor amendments limited to Section 103(a)(2)(A) and Section 404(b) of the Sarbanes-Oxley Act of 2002. After these amendments are in place, both the PCAOB and the SEC can develop and propose revised requirements. Further detail on amendments and requirements that might be considered is provided in the following pages.

Should the changes we suggest be made, we believe public accounting firms will be able to report on management's assessment in much the same way, and investors should benefit from the same level of protection <u>or more</u>, than is provided in other international jurisdictions. Costly and unnecessary redundancy in the internal control assessment process would be removed for <u>all</u> registrant's, accelerated filers would enjoy a substantial reduction in audit fees, and non-accelerated filers would have a much more practical approach to satisfying the requirements of SOX 404. We believe that with assistance from Congress, management teams, Boards of Directors and public accounting firms can and will work together much more efficiently to design, implement, assess and report on internal control systems as needed to protect the interests of shareholders and investors.

Again, we urge you to use the power of your office on or before February 26, 2007 to halt adoption of PCAOB Release 2006-007. **Further, we urge the Congress to consider amendments to the Sarbanes-Oxley Act** that would either better define or limit requirements presently imposed on public accounting firms under the Act while reinforcing the notion that maintaining, assessing and reporting on internal controls is primarily a *management* responsibility that *management* must satisfy as *management* considers necessary and appropriate to protect and enhance shareholder value.

Thank your for your consideration.

Respectfully submitted,

Dennis M. Stevens
Director, Internal Audit
Alamo Group

dstevens@alamo-group.com

Background

In March 2003 the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued a proposal to have an external 'audit of internal control' performed to comply with SOX 404[3]. The full-blown external 'audit of internal control' proposed by the AICPA appeared to be a far broader scope of service than the more focused report on management's assessment contemplated in SOX 404(b). Subsequent to the ASB proposal, the PCAOB was organized and assumed responsibility for setting auditing standards. Nevertheless one year later, in March 2004, the PCAOB issued their Auditing Standard 2 (AS2), which adopted the AICPA's proposal requiring a full-blown external 'audit of internal control'[4]. The estimated aggregate annual cost of implementation was $1.24 billion or $91,000 per registrant.[5]

The Alamo Group, with operations in five countries and roughly $360 million in annual sales, was defined as an "accelerated filer" to whom the provisions of SOX and AS2 have been applied for the past three years. During those three years Alamo had **18** internal control reviews, assessments and audits performed, consisting of:

- management's review and update of approximately 1,000 control procedures each quarter (12 reviews as required by SOX Section 302),
- management's annual assessment, inspection and test of these controls (3 assessments as required by SOX Section 404), and
- the external 'audit of internal control' performed each year (3 audits as required by AS2).

Additionally, our external auditors have reviewed and reported on management's assessment each year, also as required by SOX 404. In total **21** internal control related projects have been managed and performed at Alamo in the past three years. Our costs have been substantial. External audit fees associated with Section 404 work represent about 40% of those costs, with the majority of those fees related to the full-blown external 'audit of internal control' required by AS2. We believe only a small portion of those fees relate specifically to the external auditor's report on management's assessment as required by SOX 404.

Every accelerated filer in the United States has been subjected to essentially this same level of scrutiny for the past three years, resulting or contributing to huge audit fees, a massive transfer of wealth, a continuing erosion of shareholder value, a substantial shift to private from public financing and possible loss of U.S. global competitiveness[6]. In contrast to the original estimate of $91,000, the Committee on Capital Markets Regulation recently estimated the average first-year cost for companies to comply at $4.36 million[7]. Venture capitalists suggest the average compliance cost for smaller portfolio companies is in the area of $1 million to $3 million[8].

There have been benefits. Through an array of comment letters and roundtable discussions sponsored by the SEC and PCAOB, many report a focus on corporate governance that had not existed in the past and improvements in the quality and efficiency of important corporate processes and controls. Corporate board members note an improvement in audit committee oversight, while investors suggest public company financial reporting is of higher quality and transparency.

The PCAOB Proposal

The benefits noted above are among those cited by the PCAOB in the introduction to its proposed Release 2006-007, which SEC Chairman Christopher Cox recently characterized as a "proposal to repeal the unduly expensive and inefficient auditing standard under Section 404 of Sarbanes-

Oxley"[9]. The unduly expensive and inefficient auditing standard to which Chairman Cox refers is the PCAOB's AS2 issued in March, 2004 which adopted the AICPA's earlier proposal to have a full-blown external 'audit of internal control' as a means of satisfying the requirements of SOX 404.

Incredulously, in it's Release 2006-007 the PCAOB attributes all benefits noted above solely to the external 'audit of internal control' required by the PCAOB's unduly expensive and inefficient AS2. The PCAOB suggests the work of others is irrelevant - neither the Congress nor management teams nor Boards of Directors throughout the United States contributed to these benefits. This arrogant presentation is symptomatic of a much more significant problem – **the PCAOB has never encouraged any serious public debate about the need for or value of an external 'audit of internal control'**.

Of the **21** internal control related projects that Alamo has been subjected to in the past three years, the PCAOB proposal would eliminate those three that have had the **least** impact on our SOX 404 related expenses. In its Release 2006-007 the PCAOB proposes to maintain and clarify requirements for the external 'audit of internal control' while eliminating an existing requirement for the external auditor's evaluation of management's assessment process. The external auditor would continue to report on management's assessment as required under SOX 404(b), but that report would apparently be based on written representations from management and a comparison of results from the external audit and the management assessment of internal control.

In our experience, the requirement for an external 'audit of internal control' promulgated by the PCAOB in AS2 has been the single largest contributor to SOX 404 compliance expense. It is significant to note that an external 'audit of internal control' was **NOT** required by the elected members of Congress through SOX 404; it is solely an invention of the appointed members of the PCAOB. **Further, the external "audits of internal control" we have experienced have been entirely redundant with our own management assessments**, which WERE required by Congress through SOX 404(a). In each of the past three years we have had a management team doing an assessment and external auditors performing an audit of internal control – essentially two teams doing the same thing at the same time. Again, **due to the requirements of the PCAOB's unduly expensive and inefficient AS2, every accelerated filer in the United States has been subjected to essentially this same redundant exercise**.

Under the terms of the PCAOB and related SEC proposals, every accelerated filer in the United States *will continue* to be subjected to redundant management assessments and external "audits of internal control" each year. Smaller firms, who have not yet had to comply with SOX 404, are to perform a management assessment in their first year of compliance efforts, and then enjoy redundant management assessments and full-blown external "audits of internal control" in all subsequent years.

Justification

Title I of the Sarbanes-Oxley Act established the PCAOB in part to protect the interests of investors and further the public interest. Nevertheless there is not now, nor has there ever been, any indication of how or why an external 'audit of internal control', when performed in addition to the verifiable management assessment of internal control contemplated in the SOX 404(a), better protects those investors or their interests.

Further there is not now, nor has there ever been, a cost-benefit justification for this redundancy provided by the PCAOB. "AS2 is a big, vague document that requires a lot of interpretation," said

David Chavern, Vice President of the Capital Markets Program at the U.S. Chamber of Commerce. "Here we are, tens of billions of dollars later, and I have not heard an argument that the benefit even comes close to a small portion of the cost," Chavern said.[10]

The historical record however does provide some insight as to why the PCAOB continues to require an external 'audit of internal control' in addition to the management assessment required by SOX. In a Financial Times article titled "Auditors In Fight with Regulators" dated August 3, 2003, Adrian Michaels in New York reported as follows:

> US businesses and the large accountancy firms are fiercely lobbying regulators in a dispute over corporate governance reform that has millions of dollars in fees at stake.
>
> The two sides are arguing about the reach of a crucial part of last year's Sarbanes-Oxley Act, sweeping legislation passed in the wake of corporate scandals.
>
> The Act says that a company's auditor has to sign off on management's assessment of internal controls - the mechanisms by which financial statements are assembled, fraud is detected and other monitoring operations are carried out.
>
> But the audit firms argue they need to go further. If investors see they have signed off on the controls, they will believe that the auditors have tested them.
>
> This expectation gap could harm the profession's already battered reputation if companies have to restate earnings. Partners at KPMG and Deloitte Touche Tohmatsu were last week lobbying regulators on the issue.

As this article suggests, the external 'audit of internal control' is focused less on direct concern about the public interest and more on alleviation of the audit firms' concerns about their potential liability. The external audit community has long held the view that any public assurance they provide on internal control could carry with it enormous potential liability, since virtually any subsequently discovered problem could be attributed to a failure of internal control.

This is a valid concern. In November 2006 the CEOs of the six leading global audit networks provided a paper[11] which in part described in painful detail the problems caused by the U.S. litigation environment and their concomitant risk of liability. The Committee on Capital Markets Regulation recently reported that the nearly "open-ended responsibility of auditors in complying with Section 404 has made an already consolidation-shriveled profession virtually uninsurable for this work".[12] Public accounting firms have an important function in the global economy and clearly the interests of investors would not be better protected by letting them sink under the weight of extensive litigation.

The proposed PCAOB Release 2006-007 however will NOT resolve the audit firm's valid concerns about potential liability. The PCAOB indicates their proposal is designed, among other things, to clarify requirements for the external 'audit of internal control' by "directing the auditor's testing to the most important controls, emphasizing the importance of risk assessment", revising an array of definitions, "directing the auditor to tailor the audit to reflect the attributes of smaller, less complex companies", and "reducing detail and specificity". These may be laudable objectives, but if achieved they **will NOT change the U.S. litigation environment** and they will NOT reduce the audit firm's valid concerns about their concomitant risk of liability.

Effects

The PCAOB and SEC proposals will however result in some changes, and not all will be desirable. The proposals give both the external auditor and management considerable latitude in determining what each will do to satisfy their respective responsibilities. When considered together and projected over time along with the audit firm's continuing concerns about potential liability, we might reasonably expect the effects of these proposals to be as follows:

- Management of accelerated filers may determine that they can, in the absence of other considerations, reduce the amount of documentation and testing that supports their assessment. They may also find that the firm performing the external 'audit of internal control' can rely upon management's work if that work is performed and documented to the level of detail required by the external auditor. In an effort to reduce the combined expense of management's assessment and the external 'audit of internal control', management will perform and document their assessment to the level of detail required by the external auditor. **This is essentially the same situation that has existed for the past three years.** The principal difference is a de-emphasis on the need for a management assessment that is independent of the external 'audit of internal control'. In time the work may be combined into one project performed to the level of detail dictated by the external audit firm, thus resulting in a subtle shift of responsibility from management to the external auditor.

- Management of smaller firms, who have not yet had to comply with SOX 404, will turn to their external auditors for advice. They will undoubtedly be advised to implement, document and test control procedures to the level of detail required by the audit firm. In time the external auditor becomes responsible for the review and test of a system of internal accounting control that the external auditor has designed or influenced to a significant degree, thereby compromising the external auditor's independence and objectivity and reducing the value of both the external 'audit of internal control' and the financial audit itself.

The PCAOB recognizes the potential effect of its proposals on auditor independence and on page 33 of Release 2006-007 appears to address these concerns in a novel way:

> (The existing AS2) includes discussion of the application of principles of independence to internal control-related services and specifically notes that designing or implementing an issuer's controls would place the auditor in a management role and result in the auditor auditing his or her own work. The Board proposes to not repeat this independence guidance in the auditing standard or in a separate independence rule. . . . (Instead the) Board proposes to add a Note to this portion of the pre-approval rule …

Standards-Setting

Those responsible for developing and setting *new* auditing standards may reasonably be expected to abide by *existing* standards in executing their responsibilities. Among the existing standards is the need to maintain independence in fact and appearance, which in this case would serve to encourage the independent, objective evaluation of alternatives to the unduly expensive and inefficient full-blown external 'audit of internal control.'

The PCAOB's appearance of independence however appears compromised with regard to this matter. The PCAOB's present Chief Auditor and Director of Professional Standards was the Deputy Chief Auditor when the PCAOB's unduly expensive and inefficient AS2 was developed. Prior to joining the PCAOB he was a partner with a major public accounting firm that was reported to be lobbying regulators on the issue. Prior to joining that firm, he was the senior technical advisor to the AICPA's Auditing Standards Board[13], the group that initially proposed the full-blown external 'audit of internal control' as a means of addressing the requirements of SOX 404. In fact it appears he served on the Internal Control Reporting Task Force of the Auditing Standards Board – the group that in 2003 wrote the original proposal.[14]

Further, the original cost estimate of $91,000 per registrant has proven to be so grossly in error that it raises questions about whether those who prepared the estimate had the necessary training and proficiency to do so. While the original estimated annual aggregate cost was $1.24 billion, AMR Research estimates that companies will spend $6 billion on complying with Sarbanes-Oxley Act (SOX) requirements in 2006, on par with the $6.1 billion spent in 2005.[15] If the experience of other accelerated filers is similar to our own, some 40% of those dollars can be attributed to the PCAOB's unduly expensive and inefficient AS2 and its insistence on a full-blown external 'audit of internal control'.

After the first year of compliance efforts the PCAOB knew of this error and was repeatedly advised that the costs of SOX 404 compliance appeared to far exceed related benefits. As stated on page 3 of PCAOB Release 2006-007, "Over the last two years, the Board has heard a consistent message that compliance with the internal control provisions of the Act has required greater effort and resulted in higher costs than expected." Nevertheless, during those two years the PCAOB response was more verbiage and further "guidance" – their response did not appear to include reexamination of the fundamental need for and value of their full-blown external 'audit of internal control'. As other international jurisdictions considered *and rejected* the PCAOB approach they did not waiver, and now propose in their Release 2006-007 that still more verbiage will resolve significant concerns about redundant work, high costs, the erosion of shareholder value, a substantial shift to private from public financing and the competitive disadvantage of U.S. companies.

These matters would appear to suggest a need for reconsideration of the composition, internal procedures and supervision of the PCAOB itself.

Comments

The international business community does *not* universally see value in the full-blown external 'audit of internal control' required by the PCAOB. Such services have been considered by regulatory authorities in Canada, the UK and perhaps other international jurisdictions. None mandated them.

***Canadian Securities Administrators Notice 52-313, Status Of Proposed Multilateral Instrument 52-111 - Reporting On Internal Control Over Financial Reporting**,* dated March 10, 2006

> On February 4, 2005, the securities regulatory authorities in every Canadian jurisdiction, other than British Columbia, published for comment Proposed MI 52-111 . . . (which) was substantially similar to the requirements of the SOX 404 Rules.
>
> After extensive review and consultation . . . we have determined not to proceed with proposed Multilateral Instrument 52-111. . .

> (Instead) The CEO and CFO of a reporting issuer, or persons performing similar functions, will be required to certify in their annual certificates that they have evaluated the effectiveness of the issuer's internal control over financial reporting as of the end of the financial year. They will also be required to certify that, based on their evaluation, they have caused the issuer to disclose in its annual MD&A their conclusions about the effectiveness of internal control over financial reporting as of the end of the financial year. . . .
>
> The issuer will not be required to obtain from its auditor an internal control audit opinion . . .
>
> This will contribute towards achieving our objectives while balancing the costs and benefits associated with the internal control reporting requirements.

Chris Hodge, Corporate Governance Unit, Financial Reporting Council, the independent regulator responsible for promoting confidence in corporate reporting and governance in the United Kingdom, in comments to the SEC/PCAOB dated April 28, 2006:

> In the UK external auditors of listed companies are required under the Listing Rules to review the board's compliance statement relating to its review of the internal control system, and to add an additional paragraph to their audit report if they believe that the board's internal control statement is inconsistent with the auditors' knowledge. . . . There is no requirement on the auditor to express a view publicly on the effectiveness of the company's internal control system.
>
> There was virtually no demand from investors or companies for an increased role for external auditors. The existing powers and remit of the external auditors were considered sufficient; in particular, there was no support for the external auditor being required to attest as to the effectiveness of the company's internal controls.

David L. Shedlarz, Executive Vice President & CFO, Pfizer Inc., writing as Chairman - Principle Financial Officers Subcommittee, Corporate Governance Coordinating Committee of the Business Roundtable, an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues, in comments to the SEC/PCAOB dated November 26, 2003:

> . . . the Proposed Standard appears to expand the scope of the auditor's responsibility beyond that contemplated under Section 404. By proposing at the outset that the auditor's attestation required under Section 404 be characterized as "an integrated audit of the financial statements and internal control over financial reporting," we believe that the Proposed Standard proceeds from an incorrect premise. . . .
>
> by proposing that the auditor conduct an audit of the internal control over financial reporting, the Proposed Standard embraces a level of testing that is more extensive than that contemplated under the statute. . . . Accordingly, we urge the Board to revisit the scope of the Proposed Standard.

Richard M. Whiting, Executive Director and General Counsel of The Financial Services Roundtable, representing 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer, in comments to the SEC/PCAOB dated May 1, 2006:

> Section 103 (of the Sarbanes-Oxley Act) does not require an audit of a company's internal control structure.
>
> Section 404, likewise, does not require an independent audit of management's assessment of internal controls. The statute only requires the external auditor to "attest to and report on the assessment made by management of the issuer." Nonetheless, the PCAOB has interpreted the statute to call for a "full-blown" audit. The elimination of the separate audit would significantly lessen the compliance burdens imposed by Section 404, without impairing the integrity of the Section 404 process as envisioned by Congress and set out in Section 103 of Sarbanes-Oxley.

Paul A. Sharman, ACMA, president and CEO of the Institute of Management Accountants (IMA®), writing on behalf of their worldwide network of nearly 65,000 professionals in response to the Committee on Capital Markets Regulation interim report released on November 30, 2006, stating in part:

> IMA believes the way the PCAOB has interpreted Section 404 Part B (the external auditor attestation) must be significantly changed to align with what Congress asked for – a report on management's risk and control assessment process.
>
> Current PCAOB rules require auditors to arrive at the subjective pass-fail opinion on "how much control is enough". This regulatory interpretation is at the root of an inordinately high burden on management and litigation-wary auditors, leading to excessive testing and record audit fees. . . .
>
> It is time that audit firms cooperated in this endeavor in a serious and thoughtful manner for the benefit of investors, corporations and the U.S. economy.

David A. Richards, CIA, CPA, President, The Institute of Internal Auditors, representing more than 124,000 members across the globe, in comments to the SEC/PCAOB dated September 18, 2006:

> The IIA continues to recommend a fundamental change be considered to legislation and PCAOB's Auditing Standards Number 2 be modified accordingly. Currently three attestations are being produced to provide assurance on internal controls over financial reporting . . . We believe the intent and the benefit of the Sarbanes-Oxley Act are met with only two attestations . . .
>
> This approach (two attestations) is prevalent in other securities trading markets and would provide for international consistency, harmonization, and fair treatment for corporations in a global economy. Requiring all three attestations creates a competitive disadvantage for U.S. companies, especially for those doing business abroad.

> We further believe that the third attestation – the auditors own report on internal control over financial reporting – represents a fundamentally unrealistic and unfair expectation on the part of the auditors, which in turn leads to operating inefficiencies and costs. . . . Making statements about operations status, financials, internal controls accomplishments, tone at the top, and strategy, is the sole responsibility of management and are duties that solely management has capacity to fulfill. For the auditors, the best auditing methodologies and techniques cannot compete nor make up for
>
> - Management position in an organization
> - Management responsibility over operations and processes
> - Management accountability

Arguments

There is however a wide range of opinion as to the need for and value of a full-blown external 'audit of internal control'. One extreme might be represented by the CFO of a $76 million company: "This has turned into a check-the-box process. The work is being done by individuals – often only 22 to 26 years old – with very little business knowledge. They just don't know where to begin."[16] Here the feeling is that the external 'audit of internal control' as performed for the past three years provides little value to shareholders and has little to do with the problems inherent in the corporate accounting scandals that gave rise to Sarbanes-Oxley.

On the other hand, groups that represent consumers and large institutional investors see any attempt to water down the SOX provisions as shortsighted. These groups might argue that a full-blown external 'audit of internal control' is critical to restoring and maintaining investor confidence. Without it, management is free to use what the proxy research firm Glass, Lewis & Co., characterized as "a rubber stamp to certify the effectiveness of internal controls".[17]

It is significant to note that the SEC's currently proposed Release 33-8762 is the first guidance provided directly to management since the Sarbanes-Oxley Act itself became effective. For the past three years there has been no guidance whatsoever as to the depth and scope of procedures to be included in management's annual assessment as required under SOX 404. In the interim much has been learned, and an entire industry appears to have developed around SOX 404 and the provision of assistance when needed. Any management team that finds it necessary to get assistance in performing their management assessment will surely find that assistance readily available.

While there may be wide-ranging arguments about *how* to satisfy the requirements of SOX 404, there is no argument about the importance of restoring and maintaining investor confidence. To date, efforts to restore and maintain investor confidence have proven to be unduly expensive and inefficient. The PCAOB proposes to maintain the fundamental approach inherent in those efforts. **Bold action is needed to develop a better way of providing management with the ability to assess and report on internal controls while also providing investors with reasonable assurance that results have substance and are not in fact a "rubber stamp".**

Amendments

The concerns of public accounting firms appear to center on existing requirements for them to provide public reports that suggest they have tested or "signed off " on controls. In their experience, doing so evidently gives rise to an "expectation gap" and substantial potential liability.

Thus they attempt to protect themselves by performing a full-blown external 'audit of internal control' at great expense to all registrants.

The external auditor's report on management's assessment of internal control is required by Section 404(b) of the Sarbanes-Oxley Act. Section 103(a)(2)(A)(iii) of the Act provides specific requirements for that report. Those requirements in part include a description of "the scope of the auditor's testing of the internal control structure and procedures of the issuer" as well as other references to external auditor testing.

It would seem that the concerns of the public accounting firms can be effectively addressed by focusing on just these two sections of the Sarbanes-Oxley Act. The external auditor's participation in the annual internal control assessment process could for example be eliminated entirely by deleting the two sections of the Act referenced above. While expedient, this would be an extreme measure that would not inure to the benefit of investors.

Investors benefit by receiving independent assurance that management's annual assessment has substance. This we believe was the original intent of Congress. **We would hope that the public accounting firms can find a way to provide such assurance at a more reasonable cost by making a determination as to whether management's assessment meets standards established be the SEC.** This should be a much more focused service compared to the broad, all inclusive, full-blown external 'audit of internal control' that is currently required.

To facilitate a determination as to whether SEC standards were met, it would be incumbent upon the SEC to establish certain benchmarks that management must meet. These benchmarks must be verifiable to permit public accounting firms to objectively determine if they have been met. Should this approach be pursued, the existing Section 103(a)(2)(A)(iii) of the Act might be deleted in its entirety and replaced with new wording as follows:

> (iii) provide in each audit report their conclusion as to whether management's assessment of internal control for financial reporting performed as required under Section 404(a) met standards established by the Securities and Exchange Commission.

Section 404(b) of the Act could be reworded to read as follows:

> With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall report on the assessment made by the management of the issuer. Any such report shall not be the subject of a separate engagement.

As stated on page 38 of the SEC's proposed Release 33-8762, "Management's assessment must be supported by evidential matter that provides reasonable support for its assessment." The SEC should expand its proposal to establish benchmarks that reasonably define that evidential matter and represent the minimum level of verifiable support that management of all registrants must provide. These benchmarks might include for example:

1) A written plan that is submitted to and approved by the registrant's Board of Directors or its Audit Committee at least annually, describing in reasonable detail:

    a) the risks to reliable financial reporting that management has identified,

b) the degree to which those risks are affected by multiple locations of the registrant, if any,
c) management's evaluation as to whether the design of the controls that address each of those risks is such that there is a reasonable possibility that a material misstatement in the financial statements would be prevented or detected in a timely manner,
d) the methods and procedures management plans to utilize to gather and evaluate evidence as to the effectiveness of those controls as well as any entity-wide or other pervasive elements of internal control that management considers applicable in the circumstances.

2) Reports provided by management to the registrant's Board of Directors or its Audit Committee, on a schedule that is acceptable to the Board of Directors or its Audit Committee, describing in reasonable detail progress against managements plans to gather and evaluate evidence as described above,

3) A written description and evaluation, provided to the registrant's Board of Directors or its Audit Committee in a timely manner, of any control failings or weaknesses that management considers significant, including the impact those failings had or may have had on any information reported or to be reported by the registrant in compliance with any known requirement or request of the Securities and Exchange Commission,

4) A written description and evaluation, provided to the registrant's Board of Directors or its Audit Committee in a timely manner, of any control failings or weaknesses that management considers to be material, including their root cause, the impact those failings had or may have had on any information reported or to be reported by the registrant in compliance with any known requirement or request of the Securities and Exchange Commission, as well as management's plans to rectify and report upon each such control failing or weakness.

Should these relatively simple amendments be made and benchmarks provided, public accounting firms should be able to report on management's assessment in much the same way, and investors should benefit from the same level of protection <u>or more</u>, than is provided in other international jurisdictions. Redundancy in the internal control assessment process would be removed for <u>all</u> registrant's, accelerated filers would enjoy a substantial reduction in audit fees, and non-accelerated filers would have a much more practical approach to satisfying the requirements of SOX 404. We believe that with assistance from Congress, management teams, Boards of Directors and public accounting firms can and will work together much more efficiently to design, implement, assess and report on internal control systems as needed to protect the interests of shareholders and investors.

Again, the proposed PCAOB Release 2006-007 and SEC Release 33-8762 have been exposed to public comment through February 26, 2007, after which they may be adopted by the PCAOB, approved by SEC and supersede present requirements. **We urge you to use the power of your office on or before February 26, 2007 to halt adoption of PCAOB Release 2006-007**. **Further, we urge the Congress to consider amendments to the Sarbanes-Oxley Act** that would either better define or limit requirements presently imposed on public accounting firms under the Act while reinforcing the notion that maintaining, assessing and reporting on internal controls is primarily a *management* responsibility that *management* must satisfy as *management* considers necessary and appropriate to protect and enhance shareholder value.

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1 For full text of Release 2006-007 see http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf

2 For full text of Release 33-8762 see http://www.sec.gov/rules/proposed/2006/33-8762.pdf

3 AICPA Auditing Standards Board, Proposed Statements on Auditing Standards, *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, March 18, 2003

4 For full text of AS2, see http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_2.pdf

5 American Electronics Association, *Sarbanes-Oxley Section 404: The Section of Unintended Consequences and its Impact on Small Business*, February 2005, page 6

6 The *Summary of the Interim Report of the Committee on Capital Markets Regulation*, November 30, 2006, reports on page 2 as follows:

- 5% of the value of global initial public offerings was raised in the U.S. last year, compared to 50% in 2000.
- The U.S. share of total equity capital raised in the world's 10 top countries has declined to 27.9% so far this year from 41% in 1995.
- The decrease in U.S. listing premiums erodes the traditional edge maintained by the U.S. on cheaper cost of capital.
- Private equity firms, almost non-existent in 1980, sponsored more than $200 billion of capital commitments last year alone.
- Since 2003, private equity fundraising in the U.S. has even exceeded net cash flows into mutual funds and going private transactions have accounted for more than a quarter of publicly announced takeovers. The increased use of private markets disadvantages the average investor, who typically cannot participate in such markets.
- The dramatic increase in the use of private U.S. markets is important evidence that regulation and litigation are keeping them out of the public market.

7 *Interim Report of the Committee on Capital Markets Regulation, November 30, 2006, page 5*

8 Sean Wolfe, "SEC Shifts SOX Strategy–Can SOX really be scalable?," *Red Herring The Business of Technology*, December 14, 2006

9 U.S. Securities and Exchange Commission, Press Release 2006-213, *Statements of SEC Chairman Christopher Cox and Chief Accountant Conrad Hewitt Regarding PCAOB's Proposed Section 404 Auditing Standard*, December 19, 2006

10 David Raths, "Backlash Against Sarbanes-Oxley - Is the cost of compliance too high?," *The CRO* , 2006

11 *Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks*, November 2006

12 *Summary of the Interim Report of the Committee on Capital Markets Regulation*, November 30, 2006, page 3

13 PCAOB News, *Board Names Thomas Ray as PCAOB Chief Auditor, Succeeding Douglas R. Carmichael*, December 16, 2005

14 AICPA Auditing Standards Board, Explanatory Memorandum to Proposed Statements on Auditing Standards, *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, March 18, 2003, page 4 of 10, lists the following members of the Internal Control Reporting Task Force: Garrett L. Stauffer, Chair, Robert Dohrer, John A. Fogarty, Lynford Graham, William F. Messier, Jr., Keith O. Newton, Thomas J. Ray, George H. Tucker, Michael T. Umscheid

15 Kevin Reilly, "AMR Research Estimates Sarbanes-Oxley Spending Will Exceed $6 Billion in 2006," *AMR Research Press*, November 29, 2005

16 American Electronics Association, *Sarbanes-Oxley Section 404: The Section of Unintended Consequences and its Impact on Small Business*, February 2005, page 5

17 Melissa Klein Aguilar, "SOX 404 Deficiencies Preceded By "Effective" 302 Reports", *Compliance Week*, July 26, 2005

February 23, 2007

Office of the Secretary, PCAOB
1555 K Street N.W.
Washington, DC 20006-2803
Attn: Laura Phillips, Deputy Chief Auditor

Reference: Rulemaking Docket Matter No. 021

Ms. Phillips,

Alcoa Inc. would like to provide feedback on the proposed changes to *Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements.*

Alcoa is the world's leading producer of primary aluminum, fabricating aluminum, and alumina, and is active in all major aspects of the industry: technology, mining, refining, smelting, fabricating and recycling. Alcoa is a global company with 129,000 employees operating in 42 countries.

Alcoa management supports Section 404 of the Sarbanes Oxley Act and believes that the focus on internal controls has enhanced investor confidence in financial statements and disclosures. The costs associated with implementing Sarbanes Oxley requirements, however, has been greater than expected. We are encouraged by the Board's decision to propose changes to the audit of internal controls in order to achieve efficiencies and reduce costs. We believe that the following comments related to the proposed changes should be considered and are essential to reducing compliance costs while ensuring that a strong control environment is maintained.

1. Focusing the Audit on Matters Most Important to Internal Control

We agree that the audit of internal controls have more recently been more focused on detailed testing at the lowest level of the organization and that an emphasis on following a top down approach is warranted. However, we believe that the proposed standard does not clearly express at what precision the company-level controls should be operating and how the effectiveness of these controls impact the reduction or elimination of other controls. We recommend that a clear definition of precision be developed and included in new standard in order to provide better guidance to all constituents regarding how and when testing at the process level can be reduced.

2. Revising the Definitions of Significant Deficiency and Material Weakness

We believe that the process of evaluating deficiencies is the most challenging aspect of an audit of internal controls. Although we feel that professional judgment must be exercised when evaluating deficiencies, this concept does not appear to be embraced by external auditors. Instead, the evaluation process focuses primarily on quantitative measurements which are defined in the auditors' "Framework for Evaluating Control Exceptions and Deficiencies" (Framework) issued in December 2004 as follows:

- Potential misstatements equal to or greater than 20% of overall annual or interim financial statement materiality, whichever is appropriate, are presumed to be more than inconsequential. Financial statement materiality is defined as 5% of pre-tax income before minority interest.

Because of the concentration on quantitative factors, we do not believe that the proposed changes to the terms "more than remote likelihood" and "more than inconsequential" are appropriately defined to be applied in practice. Without additional guidance on what constitutes a reasonably possible likelihood, we do not believe that the change will improve the level at which auditors are evaluating likelihood during issue evaluation. Furthermore, we do not believe that the definition of "significant" which replaces the term "more than inconsequential" is adequate to provide the auditors with the necessary guidance in evaluating deficiencies. Again, because of the auditors' concentration on quantitative factors to determine significance, we recommend that the Board define and clearly articulate as to the quantitative and qualitative factors that should be considered in analyzing deficiencies. Without this guidance, we believe that the amount of effort and time spent on identifying and remediating issues of little significance will not be addressed.

3. Clarifying the Role of Interim Materiality in the Audit

We believe that the reference to interim financial statements should be removed from the definitions of significant deficiency and material weakness. Since management is required to assess the effectiveness of internal controls as of the end of the year, we recommend that the Board communicate that the deficiency evaluation should be based on the potential impact to the annual financial statements only.

4. Removing the Requirement to Evaluate Management's Process

We support removing the requirement for an evaluation of management's annual evaluation process but believe that the change will have a minimal impact on eliminating unnecessary audit work. We believe that the external auditors focus more on auditing internal controls directly to determine the operating effectiveness of management's controls rather than auditing management's testing.

5. Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage

We believe that a significant increase in efficiency is only attainable for multi-location audits if the audit firms embrace the move away from adopted coverage ratios. By switching focus from minimum coverage to a risk based approach, management and the auditors should be able to focus on the areas with the greatest exposure from an internal control perspective.

6. Removing Barriers to Using the Work of Others

The proposed standard provides a framework for evaluating the competence and objectivity of the individuals performing the testing, which includes education and experience level. We suggest that the Board provide guidance to the auditors regarding the type of experience, regardless of educational background, that would be appropriate to meet these requirements. For instance, if an issuer uses management to document and test internal controls, could the auditors rely on this testing if it is conducted by a party with experience in the process which is being tested, even though they do not have an auditing background? We feel it is important that the work performed by management is leveraged if the auditors have determined in prior years that management's assessment of internal controls is designed and operating effectively.

7. Recalibrating the Walkthrough Requirements

Management supports the proposed change regarding utilizing others when performing the walkthroughs. However, we believe that using the work of others should be broader than providing direct assistance in the walkthrough process. At a minimum, we suggest that the Board clarify what activities are included in "providing direct assistance".

In summary, we would like to reaffirm that Alcoa Inc. supports the Sarbanes Oxley Act and believes that the proposed changes to *Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, will decrease the burden of implementing Section 404 while ensuring that a strong internal controls are maintained.

Thank you for considering our feedback.

Sincerely,

Kelly Pasterick
Manager, Sox Compliance

Allstate
You're in good hands.

February 23, 2007

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

Subject: Rulemaking Docket No. 021

Dear Sir or Madam:

The Allstate Corporation ("Allstate") appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed Auditing Standards regarding internal controls over financial reporting ("ICFR") and the use of the work of others when conducting an audit, which is anticipated to supersede the PCAOB's current Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* ("AS No. 2").

The PCAOB's primary objective in proposing the new standard is to make audits of ICFR more efficient and effective. To that end, the proposal focuses on implementing a top-down, risk-based approach wherein independent auditors would focus attention on the most significant internal control matters. The proposed standard also seeks to enhance the audit process through the elimination of unnecessary procedures and by permitting the independent auditor to consider and use the work of others. In addition, the proposed standard focuses on the potential reliance on entity-level controls where they are effective at preventing or detecting material misstatements to relevant financial statement assertions.

Allstate supports the PCAOB's basic objectives in proposing the new standard and believes it will contribute toward achieving an enhanced level of efficiency and effectiveness of ICFR audits. Having said that, we believe that additional efficiencies and effectiveness could be attained if the PCAOB were to better conform the nature and scope of its proposed guidance with that proposed by the Securities and Exchange Commission ('SEC") regarding management's design and conduct of ICFR assessments which we found to be presented in a more principle based form and more consistent with the objective of implementing a top-down, risk-based approach.

In addition to any proposed modifications aimed at enhancing the efficiency and effectiveness of ICFR audits, we believe there should also be a reconsideration of the interpretive authority delegated by both the PCAOB and SEC to independent audit firms in their audits (i.e. financial statement and ICFR) of SEC registrants. More specifically, while enhancing the efficiency and effectiveness of ICFR audits is vitally important, we believe it is equally, if not more important, that the PCAOB and SEC restore independent auditors' ability to provide reasoned interpretive judgments both in their completion of Section 404 attestations as well as in the completion of financial statement audits. In lieu of the preceding, we believe the PCAOB and SEC should make themselves, and their respective staff as appropriate, more readily accessible to registrants, who need access to parties with sufficient authority to discuss financial accounting, reporting, disclosure and control issues, alternatives, and interpretations that arise in the normal course of business.

In connection with the preceding, it is important to consider that historically, registrants were able to discuss financial accounting, reporting, disclosure and control issues, alternatives, and interpretations with their independent auditors and could rely on the reasoned interpretive judgments of their independent auditors. However, in the existing regulatory environment, the reasoned judgments of independent auditors are often nullified, modified, or otherwise overturned by the PCAOB and SEC in favor of very restrictive interpretations of accounting and auditing guidance. As a result of this high degree of supervisory scrutiny being applied to the judgments of independent auditors, in both financial statement and ICFR audits, independent auditor interpretations of financial accounting and audit guidance have become excessively restrictive, and in some instances may not be consistent with the original intentions of the regulatory authorities that drafted the guidance.

In summary, we fully support the goals and objectives of the proposed guidance concerning the efficiency and effectiveness of ICFR audits which would rely on a top-down, risk-based approach. At the same time, we believe the full benefits of this approach cannot be obtained without integrating the PCAOB's proposed guidance concerning modifications to AS No. 2 with those proposed by the SEC concerning management's evaluation of the design and operational effectiveness of ICFR. Similarly, we urge the PCAOB and SEC to consider our thoughts as it relates to restoring the authority of independent auditors in providing interpretive professional judgments, or alternatively making yourselves and your respective staff's, as appropriate, more accessible to registrants in an effort to replace the consultative mechanism that previously existed with independent audit firms and thereby enhance investor confidence in the reliability of both financial statement and internal control audits.

Sincerely,

Samuel H. Pilch

Samuel H. Pilch

Controller, Chief Accounting Officer
The Allstate Corporation

American Accounting Association ♦ Auditing Section
Auditing Standards Committee

February 23, 2007

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

Via email to comments@pcaobus.org

RE: Invitation to Comment on PCAOB Rulemaking Docket Matter No. 021

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association welcomes the opportunity to comment on PCAOB Release 2006-007. We offer the attached comments to address the objectives and substance of the proposed standards; we also provide suggestions to enhance the clarity of the proposed standards. We have focused our comments on the proposed auditing standard that would supersede Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements*, and on the related proposed auditing standard, *Considering and Using the Work of Others in an Audit*.

The views expressed in this letter are those of the Auditing Standards Committee members and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist in finalizing the guidance. Please feel free to contact our committee chair for additional follow-up.

Finally, we appreciate the opportunity to provide input into the Board's standard setting process. The public input component of the standards setting process greatly adds to the credibility of the PCAOB's activities. We strongly encourage the PCAOB to provide opportunity for additional public comment if the Board intends to introduce new concepts, including auditor liability issues, into the standard.

Respectfully Submitted,

Auditing Standards Committee
Auditing Section, American Accounting Association

Committee Members:
Audrey A. Gramling, Kennesaw State University (Chair)
770-423-6495, agramli1@kennesaw.edu

Robert Allen, University of Utah (Past Chair)
Randy Elder, Syracuse University
Thomas M. Kozloski, Wilfrid Laurier University
Evelyn Patterson, Indiana University
Robert J. Ramsay, University of Kentucky
Sandra Shelton, DePaul University
Mark Taylor, Creighton University (Vice-Chair)

Appendix 1 – Proposed Auditing Standard ***An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements***

Our committee supports the PCAOB's overall objective of simplifying the standard for audits of internal control, clarifying certain definitional items, and responding to concerns voiced by stakeholders of the audits of internal control. The changes embodied by the proposed standard are especially important in light of the thousands of non-accelerated filers that have yet to comply with Section 404 of the Sarbanes-Oxley Act of 2002, and which represent the majority of publicly traded companies. We comment the PCAOB for its efforts in developing this standard. The decision to develop a new standard, rather than revise the existing standard, also seems appropriate. The proposed standard appears to maintain the key requirements for an effective audit of internal control, while reducing unnecessary effort.

From an overall perspective, the PCAOB Release 2006-007, Page 30, refers to core principles necessary for an effective audit of internal control and indicates that the proposed standard retains these core principles. However, such principles are not explicitly identified in the Release or in the proposed standard. We believe that the Introduction to the Standard should explicitly identify these core principles, while the remainder of the Standard would then provide guidance on how these principles are to be achieved. By providing a principles-based perspective as part of the Introduction, the readers of the Standard will have an appropriate framework for implementing the Standard.

A. Focusing the Audit on the Matters Most Important to Internal Control

Risk Assessment: In discussing the concept of risk assessment, references are made to the "evaluation of the risk of material weakness" (e.g., see paragraph 8) and to the risk of misstatement (e.g., see paragraph 9). Does the standard intend for the auditor to perform two risk assessments? Or is the auditor to perform one risk assessment that evaluates both the risk of material weakness and misstatement? Greater specificity of the expectations on this issue would be useful.

Top Down Approach and Company Level Controls: The emphasis placed on company-level controls as part of a top-down approach is a key aspect of the proposed standard. As to adequate articulation, the proposed standard could be modified in places to provide greater clarity. For example, paragraph 18 identifies specific company-level controls, the first of which is the control environment. Next, paragraphs 19 and 20 address the control environment (the first company level control itemized in paragraph 18). The reader might anticipate that the following paragraphs would address the other company level controls listed in paragraph 18. But that is not the case. Rather, paragraphs 21, 22, and 23 address only one additional company level control: period-end close. Our concern is that the discussion of company level controls is short-changed in that the proposed standard does not address all of the company level controls listed in paragraph 18. We recognize that providing guidance that was not as lengthy as the guidance in AS2 was one objective in developing this proposed standard. However, the company-level control analysis and testing are such key aspects of an internal control audit, that additional coverage of its specific parts is warranted. Clearly, placement of the discussion of company level controls early in the standard assists with the emphasis, but additional articulation of specific company-level controls beyond the control environment would be very appropriate.

With respect to the top-down approach, we are concerned that the proposed standard does not adequately articulate the link between company-level controls and the risk of misstatement to a particular account or relevant assertion. More specificity is needed as to the effect of company-level controls on the reduction or elimination of control testing at the process, transaction, or application levels.

Definitions: We appreciate the Board's revisions with respect to the definitions of types of control deficiencies. Our committee believes that the term "significant" is sufficiently descriptive and is preferable to the term "more than inconsequential." We note that "more than remote likelihood" was too conservative a threshold and likely resulted in auditors performing too much testing. On the other hand, we have concerns regarding the term "reasonable possibility" and whether it would be interpreted as intended by the Board. For example, Amer Hackenbrack and Nelson (1994) report that the mean (median) probability judgment of audit managers for the term "remote" was 12.33 (10) and the mean (median) judgment for "reasonably possible" was 58.57 (60). They also provide numerical interpretations for a number of other probability expressions (Table 2, p.131). (See Amer et al. 1995, p. 27, for a review of other accounting studies on probability expressions.

Although the desire to use the likelihood judgments from SFAS No. 5 that already exist in the literature is understandable, it is not obvious that they should be applied to audits of internal control. If the Board feels it is appropriate to adopt this terminology, we encourage the Board to strengthen the link, if possible, between the terminology in SFAS No. 5 and internal control auditing. We also encourage the Board to discuss the rationale for using the terminology in SFAS No. 5.

Strong Indicators of a Material Weakness: We commend the Board for providing greater opportunities for auditors to use professional judgment in their conclusions. Our committee members believe this is an important improvement in the new standard. Further, we support the elimination of many of the "musts" and "shoulds" which we believe will enhance auditors' ability to conduct an efficient audit of internal controls, while still maintaining effectiveness. However, on a related note, the board should consider requiring that auditors document the basis for their judgment that a significant deficiency does not exist when a strong indicator is present.

With respect to specific indicators, we find the statement in paragraph 79 suggesting that the lack of independent directors is not necessarily indicative of a control deficiency to be puzzling. We recognize that this guidance only applies when a company is not required by law or listing standards to have independent directors on its audit committee. However, we note that research has demonstrated overwhelmingly a direct relationship between independent directors and lower incidence of misstatements (e.g., DeChow et al. 1996; Beasley 1996; Farber 2005). The COSO framework is clear that independence from management is an important part of the control environment. Perhaps in some limited situations, auditors can conclude that the lack of independent directors is not a significant deficiency or material weakness; but we recommend that they should be required to explain the factors that mitigate the lack of independence in allowing them to arrive at such a conclusion.

Clarifying the Role of Materiality: The proposed standard is clear that materiality is in relation to the annual financial statements. Although eliminating the reference to interim financial statements would simplify matters, it is not clear that this is preferable, since material misstatements in interim information are also a concern. One way to address this is to modify the definition of a material weakness as follows:

> "A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a misstatement in the company's annual or interim financial statements that is material to the company's annual financial statements will not be prevented or detected."

B. Eliminating Unnecessary Procedures

Requirement to Evaluate Management's Process: The revised opinion is an improvement in clarity. The opinion on management's assessment was unnecessary, and the proposed standard preserves the ability for the auditor and management to disagree on the effectiveness of internal control.

However, we are concerned with the language that discusses eliminating the evaluation of management's assessment process. Much of the benefit from Section 404 is derived from management's efforts. Although it is true that "the auditor can perform an effective audit of internal control without evaluating the effectiveness of management's process" (p. 16), the most efficient audit will include this evaluation, as "the quality of management's process is inherently linked to the amount of work the auditor will need to do" (p. 16). Evaluating management's process should not involve extensive effort beyond understanding management's process, and will provide a basis for reliance on some of management's testing and reduced auditor testing. We encourage the Board to modify the standard to highlight the importance of having the auditor understand and evaluate management's process as part of the auditor's opinion formulation process.

Knowledge Obtained During Previous Audits: The concept of cumulative knowledge is appropriate, but insufficiently developed. For example, many auditors may interpret the standard as allowing for reduction of effort in all areas in subsequent years. On the other hand, paragraph 67 seems to suggest this reduction occurs only through the reduction in risk. If the Board does not intend to permit rotation of testing (see Release, page 19), the Board should ensure that the standard contains language explicitly prohibiting the use of rotation.

Walkthroughs: We recognize that allowing for reliance on walkthroughs as sufficient evidence of operating effectiveness could result in enhanced efficiency. However, we encourage caution in this area in that we believe a walkthrough would be sufficient to test the operating effectiveness in limited cases, such as for some lesser important controls in some lower risk areas. We further note that paragraph 37 does not indicate that an objective of a walkthrough is to obtain evidence of operating effectiveness, while paragraph 50 indicates that a walkthrough can be viewed as a test of operating effectiveness. Perhaps these two paragraphs should be better aligned.

Our position is that the proposed standard should reduce the number of walkthroughs without impairing audit quality. However, the auditor should not be allowed to use the direct assistance of others in performing walkthroughs, at least for significant processes involving significant accounts. Although the proposed standard indicates that the walkthroughs would be performed under the direct supervision of the auditor, it is not clear how this would be accomplished. Because the walkthrough is critical to understanding both the design and implementation of a control, it seems appropriate to require the auditor to gain direct knowledge for significant processes.

C. Scaling the Audit for Smaller Companies

Guidance for Smaller Companies: The guidance in the standard provides a description of some of the factors auditors should consider in scaling the audit, but it is not clear whether this guidance will result in meaningful reductions in effort. Other provisions in the proposed standard that affect all companies are likely to have a greater effect on the level of effort in auditing internal control at smaller companies. Notwithstanding the Board's goal of ensuring that audits are appropriately scaled for smaller companies, unless the Board is prepared to accept a different opinion on internal control for smaller companies, it should not dictate different procedures for those audits. For example, should the auditor consider interaction of senior management with company personnel a control for small engagements, but not larger ones? Should the auditor accept limited documentation for a smaller company, but not a larger one? Auditors must be allowed to determine the procedures they believe are necessary to provide an opinion on internal control over financial reporting.

If an auditor does not consider the size and complexity of his/her client, market forces will result in the removal of that auditor. However, if the board wishes to emphasize that auditors should evaluate the size and complexity of the company, then paragraph 9 without the note is sufficient. The board can also refer to the COSO Guidance for Smaller Public Companies.

Size Thresholds: It is not clear that market capitalization and revenue cutoffs are necessary or appropriate. We believe it is a mistake for the Board to provide such specific measures. Provision of such measures potentially implies a different level of assurance for companies over the threshold compared to those under the threshold. Further, it is likely these measures will change over time. If the Board does provide such measures it would probably be preferable to link the measures to SEC defined measures so that they can be revised administratively over time.

With respect to scalability, an issue that is probably more relevant is the issue of complexity. For example, consider a distributor whose revenues are larger than the cutoffs noted in the proposed standard. Further, the company has only one line of business. Although its revenues exceed the cutoff, the company's margins are thin, which limits its coverage of administrative functions such as corporate accounting, etc. From a complexity perspective this company is a "smaller public company," but from a threshold perspective this company would not be viewed as a "smaller public company."

Other Issues Noted in our Review of the Proposed Standard:

- In Paragraph 22, the Board should consider specifically discussing the importance of controls over spreadsheets used to develop numbers for financial reports.
- The use of the term "control objectives" - A3 provides a definition of control objectives that indicates that a control objective provides a target against which to evaluate the effectiveness of controls. Isn't COSO the target against which internal control effectiveness is being assessed? Is the term "control objective" meant to be synonymous with "objectives of the control criteria" that is described in paragraph 60? How does the definition in A3 relate to the discussion in paragraph 11 of having a company achieve its control objectives? A3 notes that a control objective relates to a relevant assertion. What is the relation between control objectives and assertions? If the concept of control objectives is important then greater specificity, including examples, would be very helpful.
- Paragraph 80 – Should the standard specifically indicate that one source would be any evidence obtained by the client?
- The Board should elaborate on the requirement in paragraph 84c that auditors obtain representation that management did not use the auditor's procedures in their evaluation. What is the auditor to do if management did use the auditor's procedures? Would this require a disclaimer of opinion? In conjunction with this concern we would like to see language in the standard that makes it absolutely clear that it is appropriate for management to communicate with the auditor about the engagement and its components.
- Paragraph 94 refers to the auditor's report on management's assessment of the effectiveness of internal control. Also, the introductory paragraph in the sample opinion in paragraph 96 refers to an audit of management's assessment. However, paragraph 80 indicates that the auditor will be providing an opinion on the effectiveness of internal controls.
- Paragraphs 94 b and c appear to be redundant. What is the difference between "management's conclusion" and "management's assessment"?
- The definition of an operating deficiency in paragraph A2 should be clarified. Suppose a control does not operate as designed, but operates better than the design. For example, an employee performs extra checking procedures than required by the controls as designed. Perhaps the clarification could incorporate the concept of effectiveness, such as "A deficiency in operation exists when a properly designed control operates *less effectively* than designed."
- The third sentence in paragraph B6 should be reworded to say "To assess control risk for *relevant* financial statement assertions…."
- Paragraph C7 should be broadened to require auditors to list any known material weaknesses even if the opinion is disclaimed. This is similar to the reporting requirement for financial statement audits that auditors disclose any known material departures from generally accepted accounting principles when giving a disclaimer of opinion.

Appendix 2 - Proposed Auditing Standard ***Considering and Using the Work of Others in an Audit***

We are pleased to see the development of a single, unified framework for using the work of others. We do offer a few observations regarding the language in the proposal.

- Paragraph 13. Second sentence states, "In performing this evaluation, the auditor should make judgments about the degree of competence and objectivity of the individual rather than form an absolute conclusion about whether the individuals are competent or objective."

  However, we think that paragraph should explicitly note that the auditor should make an absolute judgment that the work of the individual should not be relied upon if the individual does not possess some basic competencies.

- The Note to paragraph 15a should be revised to state "The auditor should not use tests performed by the same personnel who are responsible for ***developing or*** performing the control…."

- Paragraph 18 – We recognize that the purpose of testing the work of others is to allow the auditor to assess the quality of the work performed by others, as well as provide additional evidence about the competence or objectivity of those performing the work. However, we believe that the proposed standard should explicitly state that the auditor's testing of this work can not be considered as audit evidence obtained directly by the auditor; that is, the items tested should not be included as part of the sample being tested by the auditor.

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February 26, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

The American Bankers Association (ABA) appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) proposed auditing standards for auditors of public companies, *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* (the proposals). ABA brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

We applaud the PCAOB for its commitment to streamline the audit process for Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404) and for its proposal to replace Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*. The series of roundtables and public comment documents that the PCAOB has sponsored and solicited have resulted in the identification of a host of Section 404 issues, many of which the PCAOB has addressed in the proposals. The PCAOB has also recognized and responded to interpretations by auditors and filers of previous PCAOB guidance that resulted in inefficient and unnecessary costs. The proposals accomplish the promulgation of efficient guidance for auditors that has the potential to reduce costs of compliance for filers while retaining the strong investor protections and risk focus of Section 404, essentially a win-win for investors and the companies in which they invest.

We continue to have concerns about the practical application of the proposals:

- the willingness of the auditing firms to implement the proposals and the ongoing monitoring that will be necessary to ensure the benefits of the changes, and
- the comment period during which the proposals were exposed for public comment.

Implementation

An overriding concern with respect to implementation involves the uncertainty as to auditor acceptance of the Securities and Exchange Commission's (Commission) final management guidance and the final auditing standards. In May 2005, the PCAOB issued guidance that included many of the provisions that are now being proposed for inclusion in the final auditing standards. Although there was some improvement with regard to the audit firms' reactions to the May 2005 guidance, the level of improvement was insufficient. Clearly, time has passed and new audits are underway, which could result in further improvements; however, what is the incentive for audit firms to relinquish more business, even if many clients and shareholders view it as over-auditing?

The Commission and the PCAOB are proposing important changes that should help streamline both the work and costs of Section 404, while maintaining the integrity of the internal control audit. However, these proposals will only be successful if the auditing firms accept these streamlining efforts. The realization of the goals of these efforts will be measured by: (1) an evaluation by individual filers as to whether the work and costs are reduced, and (2) the efficiency inspections of auditing firms by the PCAOB. We believe that the Comission and PCAOB have achieved the proper balance with their proposals, but monitoring the results will be extremely important in determining the success of the changes.

Timing
We are also concerned about the timing of the PCAOB proposals, which were published at calendar year-end, when most filers are busy closing books and preparing for annual audits. Further, the comment periods ran the length of time that most companies are under audit and when public company filings for accelerated filers are due. This comment period did not allow filers sufficient time to analyze and respond to the proposals and, therefore, may result in less robust responses from affected companies. That said, the relief that the proposals could provide is promising and needed, and for those reasons the final issuance should not be delayed.

Conclusion
We recognize the significant work that the PCAOB has undertaken in order to improve the Section 404 process and we thank you for addressing our concerns in the proposal. Please contact Charlie Gilman, ABA's Accounting Policy Advisor (202-663-4986 or cgilman@aba.com), or me with any questions.

Sincerely,

Donna J. Fisher

Donna Fisher

ABA

AMERICAN BAR ASSOCIATION

Defending Liberty
Pursuing Justice

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March 6, 2007

via e-mail to:comments@pcaobus.org

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.

<u>Definitions</u>

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.

<u>*"Reasonably possible" standard.*</u> 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.

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[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

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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 Committee on Federal Regulation of Securities

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Bill Gradison, Member
Charles D. Niemeier
Thomas Ray, Chief Auditor and Director of Professional Standards
Nancy M. Morris, Secretary, Securities and Exchange Commission

Exhibit A: Recommended Definition of Material Weakness

EXHIBIT A

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.

From: sjcleaver@aep.com [mailto:sjcleaver@aep.com] **On Behalf Of** ramueller@aep.com
Sent: Monday, February 26, 2007 3:20 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 021

February 26, 2007

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

Subject: **PCAOB Rulemaking Docket Matter No. 021**

Dear Secretary, PCAOB:

American Electric Power Company, Inc. (AEP) appreciates the opportunity to comment on the Board's Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements. AEP, a Columbus, Ohio based energy company, is one of the largest investor-owned utilities operating in the United States, with revenues of over $12 billion and more than 20,000 employees. We provide energy to approximately 5 million customers in Arkansas, Indiana, Kentucky, Louisiana, Michigan, Ohio, Oklahoma, Tennessee, Texas, Virginia, and West Virginia.

Our primary concern is that the SEC's proposed interpretation, Management's Report on Internal Control over Financial Reporting (ICFR) and the proposed PCAOB guidance do not send a consistent message to management and the external auditors. The PCAOB guidance and related inspection program do not send a consistent and equally strong message to external auditors to focus their work on risks of material misstatements which would allow them to reduce work in lower risk areas. If the message to management and external auditors is not consistent, then improvements in the efficiency and effectiveness of assessments of ICFR will not be optimized. The PCAOB and the SEC should coordinate their efforts to ensure that the guidance that is issued for both external auditors and public companies is properly aligned.

Realization of efficiencies and cost effectiveness

We believe that the SEC issued their interpretive guidance to provide management with the opportunity to perform more cost effective and efficient assessments of ICFR. Management will have the opportunity to exercise judgment and utilize the specialized knowledge of their business in the completion of their evaluation. The proposed changes to the PCAOB guidance require public accounting firms to continue to follow a more prescriptive approach versus the principles based approach provided by the SEC. This discrepancy may result in one of the following scenarios:

- Public companies will comply with the SEC interpretive guidance, which will make management's assessment of ICFR more cost effective and efficient, while external auditors will follow the more prescriptive guidance provided by the PCAOB. In this situation, management may experience reduced internal costs by relying on things such as self-assessments and on-going monitoring, but external auditor costs may rise since they will be required to perform a more detailed audit than management because of the guidance provided by the PCAOB.

- Public companies will not follow the interpretive guidance provided by the SEC since they will be compelled by their external auditor to follow the PCAOB guidance. This may result in lower external audit fees, but internal costs will not decrease because of the additional work that will need to be performed by management so that the external auditor can rely on management's work. The use of evaluation tools such as self-assessments and on-going monitoring may not be used since the external auditor cannot rely on them as sufficient testing evidence. In addition, the external auditor may identify key controls not identified by management. These controls will subsequently be documented and tested by management, which will reduce the internal cost benefit. The efficiencies outlined in the SEC interpretive guidance related to self-assessment, on-going monitoring and use of the knowledge of day-to-day operation of the business are not clearly defined in the PCAOB guidance.

We encourage the PCAOB to approve changes to the PCAOB guidance that will mirror the SEC guidance to more closely align evaluation procedures and allow management to take advantage of internal efficiencies.

Basis for scoping assessments of Internal Control over Financial Reporting

We appreciate the SEC recognizing that evaluations among companies will vary based on the circumstances of the company, including the size, complexity, and organizational structure of the company and its processes. The SEC guidance emphasizes that management's judgment of high risk areas that could produce a material misstatement should be a primary factor used to scope the audit, while the PCAOB guidance seems to be based more on quantitative factors.

Sufficiency of testing evidence in lower risk areas

The SEC guidance states that on-going monitoring activities, such as self-assessments, are acceptable testing methods in lower risk areas, while the PCAOB guidance requires direct testing of controls. The PCAOB guidance allows the external auditors to rely on the work of management, which will require the auditor and management to coordinate their efforts. We are concerned that management will not be able to exercise professional judgment and rely on their knowledge of the company to focus and perform the audit but will instead be required to follow the more structured PCAOB guidance so that the auditors can rely on management's testing. Currently, in the absence of public company specific guidance from the SEC, for transactional areas that are lower risk (e.g. payroll), the Company is performing extensive testing so that the external auditor can rely on the testing and reduce their fees. With the issuance of the SEC interpretive guidance, management would like to rely on self-assessments and on-going monitoring for these lower risk areas. In addition, we believe that the external auditor should be able to rely on the self-assessments and on-going monitoring performed by management, instead of completing their own detailed testing of the lower risk areas.

Potential disconnect between the spirit of SEC and PCAOB proposed guidance and the PCAOB inspection program

There is an old saying "You can expect what you inspect." The external auditors historically have been very cautious in interpreting PCAOB guidance. We believe this is due in part to issues and feedback given to the external auditors as a result of the PCAOB inspection program. Generally, it seems the PCAOB inspections may drive the external auditors to do more work rather than reducing work in lower risk areas. We would encourage the PCAOB to revise their inspection program to ensure it reflects the spirit of the new proposed standards. If the inspection program reflects the intent of the new guidance, we believe the external auditors will interpret the guidance as it is meant to be and will then be more in alignment with the SEC guidance.

Thank you for the opportunity to comment on this proposed auditing standard and for considering our recommendations. We believe there is significant opportunity to create a more efficient process for compliance with Section 404 requirements, without reducing the effectiveness of the process. The recommendations we have provided should assist in this effort.

Sincerely,

Richard A Mueller

Richard A. Mueller
American Electric Power
Vice President--Audit Services
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February 26, 2007

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

AeA is the nation's largest high-tech trade association, representing nearly 2,500 U.S.-based technology companies. Membership spans the industry product and service spectrum, from semiconductors and software to computers, Internet and telecommunications systems and services. With 18 US offices, and offices in Brussels and Beijing, AeA brings a broad industry and grassroots perspective to the public policy arena.

AeA has particular insight to small and micro-cap technology companies through our two widely respected annual investor conferences that we sponsor for issuers, analysts, and portfolio managers. The stratum of American companies that have "graduated" from venture or bootstrap capitalization to the NASDAQ or NYSE constitute a crucible of risk-taking that reflects the best of America's market economy. For these companies, the impact of Section 404 of the Sarbanes-Oxley Act ("SOX") has had a devastating impact.

AeA appreciates the current efforts by the SEC and PCAOB to make SOX implementation more cost-effective and scalable, and we respectfully submit the following comments in response to the SEC's proposed interpretive guidance and rule amendments to Section 404 and the PCAOB's proposed Auditing Standard Number 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("AS5").

Millions of dollars are being drained annually from the innovative and productive activities of businesses that have merited access to our public capital markets. The incremental SOX 404 cost burden that has been added to the many small public companies who must now comply with cumbersome, annually recurring administrative expenses, including professional fees for inexperienced outside auditors, continues – and thus far this is only for accelerated filers.

Although the proposals attempt to address current implementation problems, we do not believe they will be effective in their current form in significantly reducing the excessive compliance burdens our member companies, and in particular smaller companies, face. If the problems associated with Section 404 continue, they will negatively impact U.S. competitiveness by hindering the ability of smaller, innovative companies to grow and compete in global markets and by encouraging companies to list on foreign exchanges.

Scalability

We applaud the SEC and PCAOB for recognizing the unique attributes of smaller and less complex companies by stressing the importance of “scalability.” That said, the current proposals do not provide sufficient guidance as to how smaller companies may scale their compliance activities. The list of characteristics and attributes of a smaller company is a start; however, additional guidance and examples are absolutely necessary. Smaller companies continue to have less leverage than larger companies when working with their external auditors and greater specificity as to how these companies can tailor their internal controls activities would better provide companies with the certainty they need. Without this guidance, smaller public companies will continue to face unnecessary costs, particularly as they relate to documentation. In addition, we believe that the SEC should clarify that the characteristics of smaller companies, such as a lack of segregation of duties, do not necessarily result in a material weakness in internal control.

It is imperative that the SEC not allow a multi-year “test” of AS5, compelling additional years of extremely excessive audit fees that yield dubious value to the capital markets. We implore you to reconsider the micro-cap and small-cap exemptions proposed by the SEC’s Advisory Committee on Smaller Public Companies (“Advisory Committee”), at least until the cost-effectiveness of AS5 has been proven over sufficient time. These companies should continue to be exempt *at least* until a thorough examination of both the new interpretive guidance and AS5 has been conducted to ensure that smaller companies are not disproportionately burdened.

AeA believes the Advisory Committee’s recommendations take an appropriate approach to Section 404 compliance necessary for smaller public companies. The recommendations represent an understanding of the unique circumstances that smaller companies face in complying with Section 404, based on a thorough analysis of inputs by professionals directly engaged in efforts to comply. The recommendations balance the need to provide investor protection with the desire to ensure that smaller companies continue to have access to the American capital markets. In addition, smaller companies could choose to fully comply with Section 404 in its current form, which would allow the financial markets to determine whether there is a benefit for smaller companies that decide to comply with Section 404 in its entirety.

Further Delay for Non-Accelerated Filers Necessary

As a practical matter, non-accelerated filers will not have sufficient time to understand and comply with the new guidance after they are released in their final form. Should the SEC reject the aforementioned recommendation relating to exemptions, AeA urges the SEC to, at the very least, delay the non-accelerated filer compliance dates for an additional year so that these companies and their auditors have additional time to interpret and implement these complex Section 404 proposals.

Better Alignment of SEC and PCAOB Proposals Needed

The SEC's proposed interpretive guidance is a step in the right direction as the lack of guidance for management has resulted in management's reliance on AS2. The goal of keeping the interpretive guidance less detailed so that it remains flexible is commendable; however, the proposal is ultimately too ambiguous to provide companies with the certainty they need. Although shorter than AS2, AS5 is far more prescriptive in its approach in comparison to the more principles-based SEC proposal. Making determinations relating to information technology ("IT") controls has been particularly problematic for smaller companies, and AS5 does provide auditors with specific points to consider; however, the SEC's discussion of IT controls is broader, making it difficult for managements and auditors to work together.

When coupled with the proposed AS5 – which is far more granular – companies will likely end up following AS5 as external auditors are the ones who will continue to decide whether or not to give a company a passing grade. Because of the differing approaches to the guidance, external auditors will remain in control of the implementation process, and this will undermine the flexibility and effectiveness of any new SEC guidance for issuers. We recommend that the SEC and PCAOB better align their proposals to help ensure that management's assessment of internal controls is emphasized and that AS5 does not become the *de facto* guidance for management as is the current situation with AS2.

Illustrative Examples

AeA recommends the SEC provide companies, and in particular smaller issuers, with clearer guidance and examples so that companies can have a reasonable degree of certainty when they tailor and evaluate their internal controls, and in particular, their documentation activities. This will help ensure that the external auditor's needs do not supersede management's professional judgment and needs.

Illustrative examples of how the SEC's proposed guidance should be implemented would be particularly beneficial in the area of defining "material weakness." This term continues to be vague and there is concern that it will create even greater confusion unless the guidance provides examples and real life case studies.

Safe Harbor Proposal

In an effort to provide management with greater certainty, the SEC's proposed amendments to the Securities Exchange Act of 1934 rules 13a-15(c) and 15d-15(c) would provide companies that perform an evaluation of their internal controls in accordance with the SEC's issuer guidance with a non-exclusive safe harbor. In theory, this should add greater certainty to the compliance process; however, the current SEC proposal is too vague to effectively assist companies in creating and evaluating their internal controls. The safe harbor is similarly insufficient in minimizing the uncertainty that exists for companies that would like to comply.

* * * * *

Thank you for the opportunity to comment on this important matter. I would be happy to discuss our recommendations in further detail. If you have any questions, please feel free to contact me at (202) 682-4448 or marie_lee@aeanet.org.

Sincerely,

Marie Kalamaras Lee
Director and Counsel, Finance and Tax Policy
AeA (American Electronics Association)

American Federation of Labor and Congress of Industrial Organizations

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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

Dear Sir or Madam:

On behalf of the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"), I appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements And Other Related Proposals* ("Proposal"). We believe that the auditors' report on management's assessment of internal controls over financial reporting is an integral part of the shareholder protections provided by Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX") and that, in general, the PCAOB has provided appropriate guidance to auditors and managed the issues surrounding Section 404 and its application to smaller companies in a thoughtful and balanced manner.

We support the PCAOB's adherence to the statutory language of Section 404 by proposing standards that:

- apply a single standard to all companies regardless of size;
- require companies to test all material controls annually;
- recognize that a company's complexity is not simply a function of revenue or market capitalization; and
- require the outside auditor to perform a genuine test of controls.

We urge the Commission in the strongest possible terms to maintain these requirements in the final rule.

Union members participate in benefit plans with over $5 trillion in assets. Union-sponsored pension plans hold approximately $400 billion in assets, and union members also participate in the capital markets as individual shareholders. In particular, union members' pension funds are broadly invested in a variety of small-cap index funds and are sizable shareholders in many smaller public companies.

The AFL-CIO recognizes that small businesses are an engine of job creation and economic growth. However, we continue to believe that our members and their pension funds should not assume unmanageable risks when investing in smaller public companies. More than 18 percent of smaller public companies, defined by the Advisory Committee on Smaller Public Companies as those with a market capitalization less than $787.1 million,[1] reported material weaknesses in their first year of reporting on internal controls.[2] Smaller public companies have also historically accounted for the vast majority of SEC accounting fraud cases.[3] Recent studies reveal that the number of restatements by large public companies, who implemented Section 404 in 2004, fell by nearly 20 percent in 2006.[4] We look forward to similar decreases in smaller companies' level of restatements after the Proposal's implementation.

We appreciate the opportunity to comment on the Proposal and would like to call your attention to several areas where we believe modifications will enhance audit quality and better serve the interests of the investing public.

We are concerned that the Proposal's focus on efficiency will be misinterpreted by some issuers and auditors as a license to perform inadequate assessments of internal controls. The Proposal recommends a "top-down" approach that "directs the auditor's attention to accounts, disclosures, and assertions that present a *reasonable* possibility of material misstatement to the financial statements and related disclosures," allows auditors to rely solely on internal controls to address the risk of material misstatements in smaller companies' financial reports, and allows control testing at a single central location when multiple locations are in operation.[5] While we support efforts to enhance efficiency, we continue to believe that the primary role of the PCAOB is to prescribe a minimum level of effectiveness. In view of these concerns, we would respectfully request that the final rule emphasize that the top-down, risk-based approach does not permit less rigorous evaluation methods and procedures.

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[1] *Final Report of the Advisory Committee on Smaller Public Companies*, S.E.C. (April 23, 2006) (available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf) (accessed February 26, 2007).
[2] Remarks of Charles D. Niemeier on the Proposed Auditing Standard on an Audit of Internal Control Over Financial Reporting. PCAOB Open Meeting (December 19, 2006); Audit Analytics.
[3] *SOX and Small Business*, Letter to the Editor, Wall St. J., August 19, 2005
[4] David Reilly, *Restatements Still Bedevil Firms*, Wall St. J. February 12, 2007, at C7.
[5] *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements And Other Related Proposals*. PCAOB Release 2006-007 (December 19, 2006).

While we recognize the financial burden smaller companies face in implementing Section 404 and the desire to avoid duplicative efforts by management and external auditors, we are concerned that allowing auditors to rely excessively on issuers' internal reports may not fulfill the requirements of Section 404. A 2005 report released by the American Institute of Certified Public Accountants stated that "because management is primarily responsible for the design, implementation, and maintenance of internal controls, the entity is always exposed to the danger of management override of controls."[6] Increased reliance on internal audits creates a substantial risk that, in situations where management is not both competent and honest, external auditors will not detect misconduct that would affect the financial statements. We continue to believe that allowing the independent auditor to rely excessively, without testing, on representations of the issuer's internal audit staff undermines the critical concept that independent audits are conducted by independent auditors, not the employees of the preparer.[7]

In light of the significant potential for weaknesses in smaller companies' internal controls, we respectfully request that the final rule emphasize that the opportunity to scale the audit of a smaller, less complex company does not permit less rigorous evaluation methods and procedures. Auditors should be on notice that they may need to increase their analysis of a company's particular circumstances including its corporate governance structure, incentives and opportunities for members of senior management to commit misconduct, or the competence of personnel when more traditional, concrete evidence is unavailable. For example, the final standard should enunciate that in situations where auditors are forced to test controls through inquiry and observation or rely on monitoring performed by senior management the auditors should consider opportunities and incentives for misconduct faced by top management.

We generally support the Proposal's provisions that allow auditors to incorporate prior years' assessments of the risks of material misstatements and the competency and objectivity of management and employees in subsequent audits. Auditors, in the exercise of their professional judgment, should be permitted to use their knowledge of a company's internal controls and procedures to determine what testing is necessary to identify material weaknesses in management's internal controls over financial reporting. We believe that the Proposal strikes the proper balance between effectiveness and efficiency without violating the annual testing requirement of Section 404 and we would

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[6] *Management Override of Internal Controls: The Achilles Heel of Fraud Prevention.* American Institute of Certified Public Accountants, The Audit Committee and Oversight of Financial Reporting. (2005).
[7] Damon A. Silvers. Speech. *Statement of the American Federation of Laborers and Congress of Industrial Organizations*, S.E.C. Roundtable on Internal Controls (April 13, 2005) (Copy of transcript on file with the Securities and Exchange Commission).

strongly oppose any amendments that allow key controls to be tested on a rotational basis as both unwise and contrary to the statute.

We also support the Proposal's application of the same definition of materiality for auditors reviewing both annual financial statements and management's internal control over financial reporting. We believe that the Proposal's qualitative approach to determinations of materiality are supported by the SEC, the Financial Standards Board, and the US Supreme Court and would oppose any revisions to the Proposal that would establish a rules-based, numerical formula to calculate materiality. [8]

We commend the PCAOB for formulating an auditing standard that fulfills the statutory requirements of Section 404 and specifically addresses the concerns smaller companies face in implementing Section 404. We believe that implementation of the Proposal will go a long way toward restoring investor confidence in the quality and reliability of audited financial statements. We thank you for this opportunity to comment on this Proposal, and hope that the PCAOB will consider our comments in formulating its final rule.

If you have any questions regarding our comments, please feel free to contact Damon A. Silvers at (202) 637-3953.

Sincerely,

Richard L. Trumka

RLT/me
opeiu #2, afl-cio

cc: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel Campos
Commissioner Annette L. Nazareth
Chairman Kathleen L. Casey
Chairman Mark. W. Olson
Board Member Kayla J. Gillan
Board Member Daniel L. Goelzer
Board Member Bill Gradison
Board Member Charles D. Niemeier

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[8] *See, e.g.,* SEC Staff Accounting Bulletin: No. 99 – Materiality, 17 C.F.R. § 211 (Aug. 12, 1999).

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Gregory J. Junemann
Nancy Wohlforth

February 26, 2007

VIA FACSIMILE (202) 772-9324

Ms. Nancy M. Morris
Committee Management Officer
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9309

Re: File Number S7-24-06

Dear Ms. Morris:

On behalf of the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"), I appreciate the opportunity to comment on the Securities and Exchange Commission's ("SEC") proposed interpretive guidance, Management's Report on Internal Control Over Financial Reporting ("Proposal"). We believe that the effective internal controls ensured by Section 404 are the backbone of high-quality financial statements, and that, in general, the Commission has managed the issues surrounding Section 404 in a thoughtful and balanced manner.

I. Background

Union members participate in benefit plans with over $5 trillion in assets. Union-sponsored pension plans hold approximately $400 billion in assets, and union members also participate in the capital markets as individual shareholders. In particular, union members' pension funds are broadly invested in a variety of small-cap index funds and are sizable shareholders in many smaller public companies.

We support the Commission's adherence to the statutory language of Section 404 by proposing guidance that:

- applies a single standard to all companies regardless of size;
- requires companies to test all material controls annually;
- recognizes that a company's complexity is not simply a function of revenue or market capitalization; and
- requires the outside auditor to perform a genuine test of controls.

We urge the Commission in the strongest possible terms to maintain these requirements in the final rule.

II. Specific Comments

While we believe that the Commission's proposed guidance generally responds to investor and small business concerns in a thoughtful and substantive manner, we would like to offer the following comments.

A. Reliance on Internal Reports

While we recognize the financial burden smaller companies face in implementing Section 404 and the desire to avoid duplicative efforts by management and external auditors, we are concerned that allowing auditors to rely excessively on issuers' internal reports may not fulfill the requirements of Section 404. A 2005 report released by the American Institute of Certified Public Accountants stated that, "because management is primarily responsible for the design, implementation, and maintenance of internal controls, the entity is always exposed to the danger of management override of controls."[1] Increased reliance on internal audits creates a substantial risk that, in situations where management is not both competent and honest, external auditors will not detect misconduct that would affect the financial statements. We continue to believe that allowing the independent auditor to rely excessively, without testing, on representations of the issuer's internal audit staff undermines the critical concept that independent audits are conducted by independent auditors, not the employees of the preparer.[2]

B. Focus on Efficiency

We are concerned that the Commission's focus on efficiency will be misinterpreted by some issuers and auditors as a license to perform inadequate assessments of internal controls. The proposed guidance recommends a "top-down, risk-

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[1] *Management Override of Internal Controls: The Achilles Heel of Fraud Prevention.* American Institute of Certified Public Accountants, The Audit Committee and Oversight of Financial Reporting. (2005).
[2] Damon A. Silvers. Speech. *Statement of the American Federation of Laborers and Congress of Industrial Organizations*, S.E.C. Roundtable on Internal Controls (April 13, 2005) (Copy of transcript on file with the Securities and Exchange Commission).

based evaluation" that allows auditors to rely solely on company-level controls to identify financial reporting risks.[3] It also states that in selecting which controls to test "management may consider the efficiency with which evidence of the operation of a control can be evaluated," and allows control testing at a single central location when multiple locations are in operation.[4] While we support efforts to enhance efficiency, we continue to believe that the primary role of the Commission is to prescribe a minimum level of effectiveness. In view of these concerns, we would respectfully request that the final rule emphasize that the top-down, risk-based approach does not permit less rigorous evaluation methods and procedures.

C. Further Extensions

We appreciate the efforts of both the Commission and the PCAOB to clarify their expectations for management and auditors, and have supported the need to allow a modest extension to non-accelerated filers to allow them to implement policies and procedures in compliance with the new guidance. The AFL-CIO is keenly aware of the particular hardships that smaller public companies face in implementing Section 404, however, public companies have been required to establish and maintain internal controls over financial reporting since Congress passed the Foreign Corrupt Practices Act in 1977. In light of these considerations, we do not support any further extensions of the compliance deadline for any part of Section 404 beyond this modest proposed extension.

III. Limitation on Auditor Liability

In a recent speech at *The SEC Speaks in 2007*, SEC Chief Accountant Conrad Hewitt raised the possibility that either the SEC or the PCAOB would seek to limit auditors' liability through this rulemaking. In light of the fact that neither the Proposal, the PCAOB's AS-5, nor any prior proposed rules introduced this concept, any change to the standard of auditor liability is impermissible absent compliance with the notice and comment requirements of the Administrative Procedures Act. We are unable to comment on this matter absent further information about "either the terms or substance of the proposed rule or a description of the subjects and issues involved."[5]

IV. Conclusion

We commend the Commission for formulating comprehensive guidance to instruct issuers struggling with the implementation of Section 404. We believe that

[3] *Management's Report on Internal Control Over Financial Reporting.* Release Nos. 33-8762; 34-54976; File No. S7-24-06 at 24**.** (December 20, 2006).
[4] *Id* at 25, 40.
[5] 5 U.S.C § 553.

implementation of the proposed guidance and rapid implementation of Section 404 for all publicly traded companies will go a long way toward restoring investor confidence in the quality and reliability of audited financial statements. We thank you for the opportunity to comment on this proposal, and hope that the Commission will consider our comments in formulating its final rule. If you have any questions regarding our comments, please feel free to contact Damon A. Silvers at (202) 637-3953.

Sincerely,

Richard L. Trumka

RLT/me
opeiu #2, afl-cio

cc: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel Campos
Commissioner Annette L. Nazareth
Chairman Kathleen L. Casey
Chairman Mark. W. Olson
Board Member Kayla J. Gillan
Board Member Daniel L. Goelzer
Board Member Bill Gradison
Board Member Charles D. Niemeier

February 26, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 021

The American Gas Association (AGA) is pleased to submit its comments concerning the Public Company Accounting Oversight Board proposed auditing standard ***An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements.*** The American Gas Association, founded in 1918, represents 200 local energy utility companies that deliver natural gas to more than 64 million homes, businesses and industries throughout the United States. A total of 69 million residential, commercial and industrial customers receive natural gas in the US, and AGA's members' deliver 92 percent of all natural gas provided by the nation's natural gas utilities. AGA is an advocate for natural gas utility companies and their customers and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international natural gas companies and industry associates. Natural gas meets almost one-fourth of the United States' energy needs.

We appreciate the opportunity for public comment on the proposed auditing standard. We also welcome the board's approach to reducing the complexity of the existing Auditing Standard No.2. And we generally feel that these changes will aid in its scalability and efficient implementation. For the most part we feel that the new standard sets out what the board intended to achieve; therefore, we have focused our comments on those areas where we recommend modifications to improve its overall effectiveness.

Eliminating Unnecessary Procedures

The proposed standard goes a long way towards eliminating unnecessary procedures by eliminating the requirement to evaluate management's process. However, the proposed auditing standard could better address audit integration. This, we believe, is integral to creating an efficient and lasting process. Further, we do not feel audit hours will be significantly reduced unless the standard better defines the requirement.

When reading the language in Appendix B to the proposed standard, it conveys two separate and distinct audits. It is understood that the auditor must opine on two subjects: the financial statement and internal control over financial reporting. However, the wording in Appendix B suggests bifurcation. Specifically, the separate referencing of controls testing adds to the implication that the audits be separate in practice. For the purpose of clarifying that the objectives should be achieved simultaneously, we recommend deleting paragraphs B3 to B7. The requirements of assessing Internal Control Over Financial Reporting are outlined in the body of the standard; so, the reiteration here is unnecessary. And adopting this edit would still convey the necessity of cross-referencing control tests and substantive tests in assessing risk and testing requirements.

In the main body of the standard under Identifying Significant Accounts, it also suggests bifurcation. If scope on the financial statements is the same as the audit of the financial statements, then the paragraphs that comprise this section are not necessary. We suggest eliminating all of the paragraphs in this section with the exception of paragraph 25, which simply states the significant accounts should be the same in both audits. If it is necessary to codify how an auditor should select significant accounts, then that would seem more relevant to a standard concerning an audit of financial statements since the audit of internal control over financial reporting inherits that scope.

Revising the Strong Indicators of a Material Weakness

The proposed standard still contains too much granularity when defining significant deficiency and material weakness. Specifically, the de facto significant deficiencies defined in paragraph 78 as well as the strong indicators of a material weakness section limit the judgment of an auditor and management. All of the factors stated are common knowledge to accounting professionals; thus, the necessity of explicitly stating them does not add any particular value. Instead of enhancing deficiency evaluation, these are used to circumvent a thoughtful, reasoned process for evaluating deficiencies. In our opinion, simply stating the definition of a significant deficiency and material weakness is enough guidance. This would better meet the intention of a thoughtful process in evaluating deficiencies.

If the board feels that it is necessary to keep this language to facilitate a reasoned evaluation process, we would still strongly recommend eliminating the factor concerning the company's regulatory compliance function. The main point of contention here is that this can be construed to expand the audit outside the scope of internal control over financial reporting. In order to assess whether the regulatory compliance function at a company was ineffective, an auditor would need to evaluate the process in place to comply with the applicable regulation. Given the confusion that this can lead to, we feel that eliminating this paragraph would more clearly define the scope of the audit.

Finally, the focus on eliminating unnecessary procedures is laudable, and the proposals put forth go a long way towards achieving that objective. And we feel that clarifying the language in the aforementioned sections would aid in achieving that objective. These changes would assist by underscoring the requirement for an efficient audit process and by focusing the evaluation process on the reasoned judgment of the auditor.

Revising the Benchmarking Guidance

The proposed standard also introduces a benchmarking strategy for testing automated application controls which can be used as an area of potential audit efficiency for those companies that have made investments in effective Information Technology ("IT") general controls. IT software is often updated either by vendor provided updates or company developed enhancements that would be covered under the company's change control procedures. However, it may be noteworthy that without some additional guidance and depending on how audit firms implement this issue, the following line in paragraph B31 in the proposed standard may actually impede the practical implementation of the benchmarking strategy:

> "if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control."

In this particular circumstance, an audit firm could interpret this guidance to mean that there should be an enhanced and more rigorous testing of change controls and change documentation as it relates to software updates where such software is used to implement the mechanized controls. We believe that the auditor should be able to rely on several factors to avoid significant amounts of detail testing such as, and not limited to a review of the essential change controls used for such updates and software changes and on some selective testing. The ultimate guidance might provide an allowance for such steps in order to insure that an unintended consequence is not additional detail auditing and testing of every software change that might be processed in a given period, but rather a broader reliance on the company's IT general and its change controls instead of a more detail review and testing of all IT change actions. The use of a broader reliance on techniques such as selected testing of IT general controls would allow the benchmarking strategy to become a practical approach to improve audit efficiency. We believe such an indication in this section of the proposal would be useful guidance for the auditor.

Conclusion

We are supportive of the PCAOB's efforts and appreciate the opportunity to comment on the proposed standard. If you would like to discuss any of our comments, we would be pleased to discuss them further at your convenience. If any of our comments need further explanation, please contact me or Joseph L. Martin, American Gas Association at 202-824-7000.

Sincerely,

American Gas Association

[s] *James W. Eldredge*

James W. Eldredge
Chairman, American Gas Association Accounting Advisory Council.

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ASQ
AMERICAN SOCIETY FOR QUALITY™

February 23, 2007

Laura Phillips
Deputy Chief Auditor PCAOB
C/O Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021
Subject: Comments on Draft SEC / PCAOB SOX Proposals

Dear Ms. Phillips:

The American Society for Quality (ASQ) is pleased to submit the attached comments on the PCAOB's proposed auditing standards relating to internal control over financial reporting.

ASQ recognizes the importance of the Sarbanes-Oxley Act (SOX) to the global economy and the role it plays for investors by providing transparency in organizational finances. To this end, in 2004 ASQ instituted a new organization, the Sarbanes-Oxley (SOX) Community. The goal of this community is to provide dialogue in understanding the role quality and environmental management systems can play in supporting organizations' compliance to the Act.

Much of the dialogue has centered on Section 404 of the Act. The requirement that organizations must have and be able to demonstrate an effective system of control led to research of various methods of providing effective quality and environmental management systems. The Community reviewed the Malcolm Baldrige Award criteria, the Six Sigma methodology and the ISO standards ISO 9001:2000 and ISO 14001:2004. The ISO standards were selected as a pair because of their closeness to the structure of the COSO guidance used by most organizations to satisfy Section 404 and because many public companies are registered to ISO 9001 and 14001.

With this background in mind, the Community formed a "SOX Team" to review the recent SEC and PCAOB draft documents published on December 19, 2006. We applaud your efforts to re-focus industry responses to a "risk-based, top down approach." The result will be that organizations will focus on the key controls which can indicate the possibility of material misstatements in financial statements. This will surely reduce the cost of compliance, but will also allow an organization to focus on its important business processes. It will also foster the use of quality improvement tools on these processes and will result in a more effective operation of the organization.

A major part of the SOX Team effort has been to look for ways of "building quality" into the development of financial reports. Our review of your December 19 publications has given us an opportunity to put specificity on this term. The SOX Team has found opportunities in the two documents which include the following key practices of the quality and environmental communities:

- Continual improvement techniques
- The use of data analysis to identify and correct potential risks
- Methodology for assuring personnel competence
- Controls to manage an organization's documentation and records
- Clarification of management's roles and responsibilities.

The American Society for Quality would like to applaud your efforts to reduce the impact of Sarbanes-Oxley on industry and your special attention to small businesses. Quality practices have been very important to small organizations because the reduced staff in these organizations make their effective operation crucial. It is also proper that external auditors use the work of others, including procedures and records of internal quality and environmental managers, engineers, and auditors.

I would like to offer the services of the SOX Team to support your future efforts. We recognize the great importance of Sarbanes-Oxley to the well being of our country and are quite willing to help as your committees move forward.

Thank you,

Ronald D. Atkinson
President
American Society for Quality

Attachment: The American Society for Quality Sarbanes-Oxley Team Comments on "An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements"

About the American Society for Quality
The American Society for Quality (www.asq.org) is the world's leading authority on quality. With more than 90,000 individual and organizational members, the not-for-profit professional association advances learning, quality improvement and knowledge exchange to improve business results, and to create better workplaces and communities worldwide. As champion of the quality movement, ASQ offers technologies, concepts, tools and training to quality professionals, quality practitioners and everyday consumers, encouraging all to Make Good Great®. ASQ has been the sole administrator of the prestigious Malcolm Baldrige National Quality Award since 1991. Headquartered in Milwaukee, Wis., the 60-year-old organization is a founding partner of the American Customer Satisfaction Index (ACSI), a prominent quarterly economic indicator, and also produces the Quarterly Quality Report.

To: **Public Company Accounting Oversight Board**

Re: **PCAOB Rulemaking Docket Matter No. 021**

Subject: **The American Society for Quality Sarbanes-Oxley Team Comments on "An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements"**

1.0 Introduction

The PCAOB is proposing a new auditing standard, *An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements*, that would supersede its Auditing Standard No. 2.

The PCAOB has invited interested parties to comment on the document. The Sarbanes-Oxley (SOX) Team consisting of five members of the American Society for Quality (ASQ) SOX Community[1] was asked to comment on the new audit standard. Over the past two years, the "Team" has conducted 2 ASQ Sarbanes-Oxley (SOX) conferences, a webinar and 6 workshops and presented numerous papers at conferences and in publications such as ASQ's *Quality Progress* and The Institute of Internal Auditors (IIA)'s the *Internal Auditor*.

The Team has shown that the quality and environmental management systems (QMS/EMS) of public companies can directly support SOX compliance. Many public companies are registered to the QMS standard ISO 9001:2000[2] and the EMS standard

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[1] The five members are Dr. Sandford Liebesman, ASQ Fellow and Chairman-Elect ASQ Electronics and Communications Division, Paul Palmes, Vice-Chairman US Technical Advisory Group to ISO TC 176 (the developer of ISO 9001:2000), John Walz, The Sutton Group, Donna Spencer, The NORDAM Group and Marty Jaeger, Jaeger-Holland.

[2] ISO 9001:2000 Quality Management System Requirements. As of December 2005, the number of ISO 9001 registrations was 776,608 worldwide, 59,663 in North America and 44,270 in the United States. Registered organizations are audited every six months by an accredited registrar. The United States accreditation agency is the RABQSA.

ISO 14001:2004[3]. We will show how satisfying these standards provides valuable inputs to the SOX auditing process.

A member of the Team published articles in the September 2005 issue of *Quality Progress*[4] and the October 2005 issue of the *Internal Auditor*[5] linking the ISO standards to COSO, the most common system used to comply with the SOX Section 404 requirement to have an effective system of internal control. The Team has pointed out the roles that QME/EMS can play in support of financial management systems compliance efforts.

The proposed auditing standard uses the phrase "work of others" 77 times. Much of this information can be acquired from Operations, and Quality and Environmental Management systems. The comments below describe specific parts of the proposed auditing standard where valuable QMS/EMS support applies. The comments focus on the strengths that quality and environmental management and auditors bring to the table: continual improvement techniques, monitoring and measurement of processes, analysis of data and identification of risks to the organization's objectives, corrective and preventive action methodology, auditing support, personnel competence methodology, assistance with walkthroughs, controls to manage the organization's records, and clarification of management's roles and responsibilities.

2.0 Comments on "An Audit of Internal Control over Financial Reporting (ICFR) That Is Integrated with an Audit of Financial Statements"

Comment # 1: page 2: "First, the audit of internal control over financial reporting has produced significant benefits. Issuers and auditors have described a focus on corporate governance that had not existed in the past and improvements in the quality and efficiency of important corporate processes and controls."

QMS/EMS Comment:

- **QMS:** ISO 9001, Clause 8.5.1 provides a methodology for continual improvement of a management system.

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[3] ISO 14001:2004 Environmental Management System Requirements. As of December 2005, the number of ISO 14001 registrations was 56,593 worldwide, 7,119 in North America and 5,061 in the United States. Registered organizations are audited every six months by an accredited registrar. The United States accreditation agency is the RABQSA.

[4] Sandford Liebesman, "Mitigate SOX Risk with ISO 9001 and 14001," Standards Outlook, Quality Progress, September 2005, 91-93.

[5] Sandford Liebesman, "Quality in the Mix," Risk Watch Column, The Internal Auditor, October 2005, 73-77.

Comment # 2: **page 18: Question 14**: "Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?"
QMS/EMS Comment: No. the following QMS/EMS clauses provide valuable inputs:

- **QMS**: ISO 9001, Clause 8.2.3 requires "Monitoring and measurement of [the organization's] processes" and Clause 8.4 requires analysis of data obtained as a result of Clause 8.2.3. The results of the analysis are used in the identification of risks and in corrective and preventive actions.
- **EMS**: ISO 14001, Clause 4.5.1 requires monitoring and measurement, on a regular basis, of the key characteristics of its operations that can have a significant environmental impact and Clause 4.5.2 requires evaluation of compliance.

Comment # 3: **page 21**: "When the auditor duplicates high-quality, relevant work that already has been performed by competent and objective individuals; he or she risks increasing effort without enhancing quality."
QMS/EMS Comment: The SOX audit effort can be reduced by using the "work of others" from the results of QMS/EMS audits:

- **QMS**: ISO 9001, Clause 8.2.2, "Internal Audit," provides a methodology for conducting internal quality audits.
- **EMS**: ISO 14001, Clause 4.5.5, "Internal Audit," provides a methodology for conducting internal environmental audits.
- **QMS/EMS**: In some instances, an audit of ICFR duplicates inquiries made during ISO 9001 and ISO 14001 audits.

Comment # 4: **page 25**: **Question 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? **page 23** **"**Definition of relevant activities: Relevant activities are defined as those that provide evidence about design and operating effectiveness of internal control over financial reporting or that provide evidence about potential misstatements of the company's financial statements."
QMS/EMS Comment: Yes, if QMS/EMS activities are included in relevant activities.

Comment # 5: **page 25**: **Question 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?"
page 25: **Question 24**. "Has the Board identified the right factors for assessing competence and objectivity? Are there other factors the auditor should consider?"
page 24. "Factors related to competence include such things as the education and experience level of the individual performing the testing, as well as the quality of his or her work".

QMS/EMS Comment: The framework is very general as it should be. The framework should include evaluation of the effectiveness of training provided by the organization.

- **QMS**: ISO 9001, Clause 6.2.2, "Competence, Awareness and Training," and **EMS**, "ISO 14001: 2004, Clause 4.4.2, "Competence, Training and Awareness," require determination of competence, provision of training and evaluation of the effectiveness of the training.
- In particular, with respect to internal quality and environmental auditors, RABQSA and ASQ provide certification of these auditors, so their work can be used by others.

Comment # 6: **page 26**: "Walkthroughs require the auditor to "get out of the audit room" and interact with those responsible for internal control from day to day. They also provide the auditor with the opportunity to learn about the everyday activities of the company, which may not be reflected in any document that the auditor reviews."
page 27: **Question 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?"
QMS/EMS Comment:

- **QMS/EMS**: ISO 9001 and ISO 14001 internal auditors could act as guides for the SOX auditors in performing walkthroughs. Also, the work performed by quality and environmental auditors may contain valuable information for SOX auditors.
- ISO 9001 was designed for business processes, where an end-to-end walkthrough may be used and process driven auditing can be comprehensive for both Operations and Financial organizations.

Comment # 7: page A1-9: "Assessing company-level controls to sufficiently address risks of misstatement. A smaller and less-complex company might rely more frequently on monitoring controls performed by senior management to detect misstatements in certain assertions"
QMS/EMS Comment:

- **QMS**: ISO 9001, Clauses 8.2.3 and 8.2.4: require monitoring & measurement of processes and product. Clause 8.4 requires analysis of the data gathered. This often results in the identification of risks to the organization's objectives. These results can be used by external auditors.
- **EMS**: ISO 14001, Clause 4.5.1 requires monitoring and measurement, on a regular basis, of the key characteristics of its operations that can have a significant environmental impact and Clause 4.5.2 requires evaluation of compliance. These results can be used by external auditors.

Comment # 8: **pages A1-11 & A1-12**: "Company level controls include: Controls to monitor results of operations."
QMS/EMS Comment:

- **QMS**: ISO 9001, Clauses 8.2.3 and 8.2.4 require monitoring and measurement of processes and product. ISO 9001, Clause 4.2.4 requires

that records be legible, readily identifiable and retrievable and that a documented procedure be established to define controls needed for identification, storage, protection, retrieval, retention time and disposition of records. These results can be used by external auditors.
- **EMS**: ISO 14001, Clause 4.5.1 requires monitoring and measurement, on a regular basis, of the key characteristics of its operations that can have a significant environmental impact and Clause 4.5.2 requires evaluation of compliance. These results can be used by external auditors.

Comment # 9: **page A1-12**: "As part of evaluating the control environment, the auditor should assess – Whether management's philosophy and operating style promotes effective internal control over financial reporting."
QMS/EMS Comment: This is typically called "Tone at the Top."
- **QMS**: ISO 9001, Clause 5.1, Management Commitment, requires top management to communicate to the organization the importance of meeting customer as well as statutory and regulatory requirements, establishing the quality policy, ensuring that quality objectives are established, conducting management reviews and ensuring the availability of resources. These results can be used by external auditors.

Comment # 10: **page A1-12**: "As part of evaluating the control environment, the auditor should assess –Whether management and employees are assigned appropriate authority and responsibility to facilitate effective internal control over financial reporting."
QMS/EMS Comment:
- ISO 9001, Clause 5.5.1 and ISO 14001, Clause 4.4.1 require that top management define responsibilities and authorities and that they communicate them within the organization. These results can be used by external auditors.

Comment # 11: **page A1-17**: "The auditor should follow the process flow of actual transactions using the same documents and information technology that company personnel use."
page A1-20: "Testing Design Effectiveness: Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation."
page A1-20: "Testing Operating Effectiveness: Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, walkthroughs, and re-performance of the control."
QMS/EMS Comment:
- The work of ISO 9001 and ISO 14001 auditors provides valuable information for the SOX auditors. The QMS/EMS internal auditors could act as guides during a SOX audit.

3.0 Comments on "Considering and Using the Work of Others in an Audit"

Comment # 12: **page A2-3**: "1. For these purposes, the work of others includes work performed by internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee." **QMS/EMS Comment:** "company personnel" includes quality and environmental system auditors, IT auditors, and business process owners.

Comment # 13: **page A2-3**: "3. The auditor should obtain an understanding of work performed by others sufficient to identify relevant activities."
QMS/EMS Comment: The QMS/EMS has documented procedures and a record trail to define the functions of QMS/EMS auditors, their work papers and reports.

- **QMS**: ISO 9001, Clause 8.2.2, Internal audit, and **EMS**: ISO 14001, Clause 4.5.5, Internal audit, provide the auditable framework. This framework is used world-wide by third-party certification bodies or Registrars.

Comment #14: page A2-5 "10. To use the work of others to reduce the nature, timing, or extent of the work the auditor would have otherwise performed, the auditor should –b. Evaluate the competence and objectivity of the individuals who performed the work;"
QMS/EMS Comment: In the U.S., the competence of internal quality auditors can be certified by RABQSA or ASQ.

Comment #15: page A2-5 "13. Evaluating the Competence and Objectivity of Others. The auditor should evaluate the competence and objectivity of the individuals performing tests of controls, accounts, or disclosures to determine the extent to which the auditor may use their work."
QMS/EMS Comment: In the U.S., the competence of internal quality auditors can be certified by RABQSA or ASQ.

Comment #16: page A2-7 "15. b. The organizational status of the persons responsible for the work of others, including – • Whether the responsible persons report to a person of sufficient status to ensure sufficient testing coverage and adequate consideration of, and action on, the findings and recommendations of the persons performing the testing."
QMS/EMS Comment: In many companies, the internal quality and environmental audit organizations are designed to be free of bias based on the organizational structure.

4.0 Summary and Conclusions

In response to the request from the PCAOB for comments we have established a role for quality and environmental management and auditors in support of an organization's compliance to SOX. In addition, because of top management and the Board of Director interest in compliance, our comments will provide them with a better understanding of quality and environmental management systems capabilities.

The American Society for Quality is the largest quality organization in the world. The observations and recommendations in this letter are meant to have broad application in the public and private sectors throughout the world. Quality and environmental management systems provide valuable inputs to an organization's financial structure that help maintain its competitiveness in the global economy. The ASQ SOX Team will be pleased to provide further details on the comments in this letter.

Respectfully submitted,

Burton S. Liebesman

Dr. Burton S. Liebesman, Ph.D.
Chairman-Elect
ASQ Electronics and Communications Division

February 23, 2007

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February 26, 2007

Via Electronic Mail
The Honorable Christopher Cox, Chairman
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Attn: Nancy M. Morris, Secretary
100 F Street, NE Washington, DC 20549
Electronic Address: rule-comments@sec.gov

The Honorable Mark W. Olson, Chairman
Attn: Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803
Electronic Address: comments@pcaobus.org

Re: SEC File Number S-7-24-06; Management's Report on Internal Control Over Financial Reporting (71 Fed. Reg. 77,635); PCAOB Release No. 2006-007; Proposed Auditing Standard

The American Stock Exchange ("Amex," or the "Exchange") appreciates the opportunity to comment on the Proposed Rule for Management's Report on Internal Control over Financial Reporting. We commend the Commission and the Public Company Accounting Oversight Board ("PCAOB") for this undertaking aimed at tailoring regulation implementing Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX"). In the period since SOX was enacted, there has been widespread recognition that the impact of regulation in terms of compliance burden and increased cost is proportionally much greater for smaller companies. Because rulemaking by the Commission and the PCAOB is closely linked in its impact on public companies, the Exchange offers its comments in light of proposed rules issued by both bodies.

The Amex is the only national exchange with a primary focus on smaller companies. We have a strong corporate interest in seeing these companies succeed on a U.S. exchange. We have previously testified before Congress and the Commission on the need for modification of Section 404 to achieve badly needed regulatory clarity and reform. The Sarbanes-Oxley legislation and the rules associated with it were established in 2002 to improve corporate governance and internal controls after a wave of accounting scandals that tarnished the image of corporate America. There is real value in having legislation that protects the investing public from corporate malfeasance. The new regulations, however, made no distinction between a fifty billion-dollar large-cap company and a 75 million dollar small-cap company. The failure to recognize those differences has made it extremely difficult for smaller companies to compete and grow in this current regulatory environment. In addition to problems faced by domestic companies, the lack of differentiation also places Amex and other U.S. exchanges at a steep competitive disadvantage not only in seeking listings of foreign based companies based in countries with markets to which SOX does not apply, but also in seeking listings of U.S. companies concerned about the additional costs and regulatory burden in the U.S. relative to competing non-U.S. exchanges. Foreign exchanges have used the SOX compliance burden as a key message in competing against U.S. markets for new listings.

The Exchange has firsthand experience with the impact of SOX on smaller public companies. Even though some of the smallest public companies are still exempt from the full requirements of complying with Section 404 due to their status as non-accelerated filers, more than a dozen companies have voluntarily delisted from the Exchange over the past year. While all exchanges experience delistings when companies fail to maintain exchange listing standards, the companies in this particular group have voluntarily delisted, often citing the expenses associated with SOX compliance as a significant reason for leaving the Exchange for the private equity market, pink sheets, or listing on a non-U.S. exchange. Obviously, this also largely removes them from SEC regulatory oversight. While the voluntary delistings are troubling, of even greater concern is the number of companies that may have been considering listing on a domestic exchange, but instead may be choosing non-U.S. capital markets where SOX does not apply. This situation has potentially serious implications for U.S. capital markets' ability to maintain their global leadership in increasingly competitive global markets. The Amex believes in a having a strong regulatory environment, but one that allows competition and innovation to thrive.

Amex Response to SEC and PCAOB proposals

Our response to the new proposed guidelines will focus on the impact that they will have on the types of companies that list on our exchange as well as the mid-cap companies that previously favored raising capital in the U.S. capital markets but may have pursued alternate solutions in lieu of incurring the high costs of implementation and ongoing compliance with the requirements of SOX Section 404. We have stated previously that the provisions of Section 404 as well as the PCAOB's AS2 were unduly onerous for smaller companies. Among the potential solutions proposed in the past are the following:

- Exempting small companies ($75 million or less in market capitalization) from the requirements of SOX 404

- Eliminating the duplicate audit requirements of AS2 whereby the external auditors are required to report on management's Internal Control over Financial Reporting (ICFR) as well as opining separately on the overall effectiveness of ICFR

- Applying the requirements of 404 on an alternating cycle rather than on an annual basis

- Scaling down the requirements of the legislation for smaller companies to reflect the different control environment that they maintain compared with their larger counterparts

- In lieu of modifying the prevailing legislation and auditing guidance, providing specific guidelines, checklists and examples to aid companies in implementing the requirements, thus eliminating the guesswork and expansive scope that many companies experienced in designing their management assessment process.

Using the potential solutions listed above as a backdrop, we examined both the SEC's proposals and those of the PCAOB("Rulemaking Docket 021: Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements") to determine the degree to which they address the concerns that generated the proposed solutions listed above.

- The SEC's proposal in Release 33-8762 does not provide an exemption for small companies. The only concession made by the Commission was to extend the compliance date for management assessment of ICFR for non-accelerated filers '…*until it files an annual report for its first fiscal year ending on or after December 15, 2007."* The first external auditor attestation of ICFR would be required for fiscal years ending on or after December 15, 2008. Since this is merely an extension and not a waiver, it is unlikely to have any significant impact on the decisions by companies to proceed with a public offering of their securities. In the PCAOB's Rulemaking Docket 021 there was no mention of a small company exemption.

- Both the SEC and the PCAOB have made progress with respect to the elimination of the duplicate audit requirement. In a separate proposal, the Commission is seeking public comment on an amendment to acknowledge that the auditor will now opine only on the effectiveness of ICFR, thereby eliminating the opinion on **management's** assessment. Likewise, the PCAOB's proposed new standard would eliminate the requirement for the auditor to report on **management's** assessment. Neither proposal would eliminate management's responsibility for conducting an annual assessment of ICFR. The SEC guidance is intended to provide flexibility, but is lacking specific guidance and examples, while the PCAOB revised standard is very prescriptive, containing specific bullet point standards by which auditors will be directed to measure and appraise management's ICFR process. The ambiguity between the SEC and PCAOB approaches must be addressed and reconciled. The SEC and the PCAOB must work together to harmonize the SEC's management guidance and the PCAOB's revisions to the audit standard. To better assist management in constructing and evaluating ICFR, the SEC guidance should provide more information in the form of examples and more specific information that management can utilize in its process of development and evaluation of ICFR.

- Neither proposal addresses an alternating cycle for ongoing compliance. An alternating cycle would remove the "all or none" gauntlet that faces smaller companies and could effectively establish a process that could still be sustainable in the "off cycle" years with a reduction in scope and formality.

- Scalability was addressed by both the SEC and the PCAOB in their proposals, albeit from two different perspectives. The SEC recommends that management focus on employing a top-down, risk-based approach. While the SEC's proposal indicated that management is still required to use a framework such as COSO in evaluating ICFR, it stressed the fact that management's objective should be to identify only those controls (including entity level controls) necessary to adequately address the risk of material misstatement in the financial statements. The SEC also made clear that management and the auditor may have different testing approaches, but still stipulated that management's evaluation of deficiencies should be based on both quantitative and qualitative factors. Unfortunately, the SEC proposal does not provide a definition of "risk-based," nor does it provide examples of a risk based approach for management to use in the development of their ICFR evaluative process. The lack of additional information and guidance could well result in a continuation of the current problem of spending an excessive amount of time and financial resources attempting to take a prudent, conservative approach to unspecific guidelines in order to "fill in the blanks." The PCAOB proposal is primarily focused on the auditor's role and provides materiality guidelines as well as reinforcing the concept of a risk-based approach. The proposal also links the measures of materiality for the ICFR audit with the financial statement audit. It offers principles to help scale the audit to smaller and less complex companies.

- The SEC's proposal stops short of providing a more specific roadmap for companies to follow. It is a principles-based approach that stresses the use of management's judgment in making its assessment of ICFR. We believe that the Commission should provide more specific guidelines and examples for identification and documentation of controls, the scope to be applied to the program of testing and the remediation of control weaknesses. In the past, companies have struggled to implement a process that is compliant while achieving a streamlined, efficient approach. Specific guidelines would ensure that management's program is tailored to the size and complexity of the company. The PCAOB has provided general guidelines to auditors which, when followed should enable them to tailor their approach to each individual client. These should result in a streamlined approach and ultimately yield cost savings.

The SEC and the PCAOB are to be commended for their efforts to address the widespread concerns arising from implementing SOX Section 404. The proposals represent a step in the right direction. However, as currently delineated, they risk falling short of being significant enough to reverse the trends that are presently developing in the U.S. capital markets in terms of companies seeking to avoid having to comply with SOX by accessing capital through private equity or non-U.S. capital markets. We would encourage the Commission and the PCAOB to re-evaluate these proposals in light of public comments received and provide a more dramatic change in requirements as well as more comprehensive guidance that includes examples for management to use in constructing and assessing their ICFR regime. We believe that the most significant change that could be implemented would be the elimination of the external audit of internal control and place the focus upon the opinion on management's assessment. This would reduce audit costs across the board without relieving management of its obligation to maintain, document and evaluate the effectiveness of its internal control environment.

Sincerely,

Neal Wolkoff

Neal L. Wolkoff
Chairman and CEO

February 26, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 021
Release No. 2006-007 (December 19, 2006)

Dear Sir or Madame:

America's Community Bankers[1] is pleased to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, ("Revised Standard") that would supersede the PCAOB's Auditing Standard No. 2 ("AS2").

ACB Position

ACB strongly supports the PCAOB's proposed Revised Standard for the audit of internal control over financial reporting ("ICFR"). The proposed Revised Standard is a significant step in the right direction to help reduce the costs and burdens of the implementation of Section 404 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). However, ACB strongly recommends that the PCAOB accept, in satisfaction of written representations from management in the Revised Standard, the reports filed by bank management in accordance with Section 36 of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") and Part 363 of the Federal Deposit Insurance Corporation ("FDIC") regulations.[2] ACB also believes that the PCAOB's inspection process should be revised contemporaneously with the proposed Revised Standard.

Background

ACB is pleased that the proposed Revised Standard addresses many of our members' concerns with the audit of ICFR that were raised at the two PCAOB and Securities and Exchange Commission ("SEC") roundtables, comment letters filed in connection with the roundtables, and meetings of the PCAOB's Standing Advisory Group. The proposed Revised Standard achieves the PCAOB's goal of simplifying and clarifying the auditing standard for ICFR. In particular,

[1] America's Community Bankers is the national trade association committed to shaping the future of banking by being the innovative industry leader strengthening the competitive position of community banks. To learn more about ACB, visit www.AmericasCommunityBankers.com.
[2] 12 U.S.C. § 1831m and 12 C.F.R. Part 363.

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ACB strongly supports provisions in the Revised Standard that permit the use of auditor judgment, emphasize an audit of the most important controls to financial reporting, permit reliance on the work of others and the work from prior audits, and require scaling the audit to fit the size and complexity of smaller companies. ACB believes that the proposed Revised Standard will improve the audit of ICFR

PCAOB Inspection Process

ACB is concerned that unless the PCAOB's inspection process is contemporaneously revised with the Revised Standard, auditors concerned with PCAOB sanctions and statutory and civil liability will continue to conduct redundant audits that require the same level of detail and testing as audits conducted under AS2. Recent PCAOB inspection reports have criticized auditors for not being diligent in their responsibilities for detecting fraud, failing to perform adequate audits, and prepare appropriate documentation.

We believe it is important for the PCAOB to revise its inspection process and provide auditors with assurance and certainty that they will not be subject to sanctions or penalized for using judgment in conducting and scaling an audit under the Revised Standard. ACB is concerned that even with the Revised Standard and a revised inspection process, because of statutory and civil liability concerns, auditors may not significantly change their audit or reduce their engagement fees.

Obtaining Written Representations

Paragraph 84 of the Revised Standard requires an auditor to obtain written representations from management regarding management's responsibility for establishing and maintaining effective ICFR and management's evaluation and assessment of ICFR as of a certain date. ACB recommends that the PCAOB recognize bank management's reports as required by Section 36 of the FDICIA and Part 363 of the FDIC rules as meeting the requirements of paragraph 84 in the Revised Standard.

Many of the representations required by paragraph 84 are similar to the representations required from bank management under FDICIA and FDIC regulations. Management of all insured banks is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting. Management of insured banks with over $500 million in assets is required annually to prepare a report signed by the chief executive officer and chief accounting or chief financial officer that states management's responsibilities for preparing the institutions' annual financial statements; establishing and maintaining an adequate internal control structure; and maintaining procedures for financial reporting and compliance with designated safety and soundness regulations. In addition, management of banks with over $1 billion in assets must include in the report an assessment by management of the effectiveness of the internal control structure and procedures for financial reporting as of the end of the fiscal year. Management's report is required to be included in the annual report it files with its primary federal regulator and the FDIC.

In addition, ACB believes that the representations made in a bank management's report concerning the bank's compliance with designated safety and soundness regulations during the year could provide auditors with a strong indicator that banks making this statement to their regulator have an effective regulatory compliance function rather than a material weakness in ICFR. Inclusion of the foregoing recommendations in the Revised Standard will help to reduce the audit burden for community banks.

Additional Provisions

Testing

ACB suggests that the Revised Standard include additional direction for testing key controls. Testing internal controls remain a source of concern for management and auditors. Too much testing, particularly of controls that do not affect the integrity of a company's financial statements, has been overly burdensome and costly without benefit. We support the Revised Standard's focus on the most important controls as they relate to risk assessment, but we believe that the Revised Standard should provide further direction as to the amount and frequency of testing key controls.

For example, we suggest that key controls be risk-rated so that the significance and the frequency of the control should be taken into account when determining the nature, timing and extent of the tests to be performed. Furthermore the methodologies for testing controls vary between auditors. The Revised Standard should provide a standardized but flexible approach to testing. By standardizing the testing process, confusion is minimized and a more efficient process can be implemented for management and auditors.

Although the proposed Revised Standard provides that an auditor can reduce the nature, timing and extent of testing based on knowledge of past audits, we believe that the Revised Standard should permit rotation of the audit. The Revised Standard gives the auditor flexibility based on knowledge of previous audits, but we are not convinced that auditors will reduce testing because of concerns with PCAOB sanctions and liability. Therefore, ACB believes that companies that have demonstrated effective internal controls and have had no significant deficiencies or material weaknesses for a designated number of consecutive annual audits should be eligible for rotation and reduced testing. Lower level transactional and routine controls could be tested in full periodically with controls that directly affect or impact financial statements tested every year. We believe that rotations of testing internal controls should be included in the Revised Standard so that auditors will have a safe harbor and there will be a meaningful reduction in testing internal controls and associated audit costs.

Definitions

Although ACB appreciates the PCAOB's efforts in the Revised Standard to revise the definitions of "significant deficiency" and "material weakness," the new definitions are still ambiguous and confusing to our members. We believe it is an improvement to replace "more than remote" with a less stringent "reasonable possibility" within the definitions of both material weakness and significant deficiency. We are doubtful, however, that the revisions will alter the difficulty of evaluating the most important deficiencies that may lead to a material misstatement.

ACB recommends that the Revised Standard require auditors to consider both quantitative and qualitative factors in assessing materiality for identifying deficiencies in ICFR. As an initial step, quantitative factors should be evaluated and based on a percentage of revenues or net income. This quantitative assessment should only be the basis for a preliminary assumption of materiality and should be considered in conjunction with a full analysis of qualitative considerations. The quantitative factor should be a guide that can be overridden by qualitative considerations. We believe that the addition of a quantitative factor will help clarify the revised auditing standards definitions.

Revised Auditor Opinion

ACB supports the provision of the proposed Revised Standard that would require the auditor to express an opinion directly on the effectiveness of ICFR and eliminate the auditor's opinion on management's assessment of ICFR. Eliminating this opinion should help to eliminate duplication in the ICFR process and reduce the expense of the engagement.

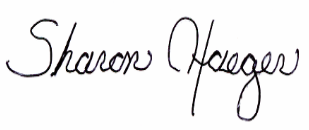
Section 36 of the FDICIA and Part 363 of the FDIC's rules require the external auditor of a bank to attest to the internal controls. Section 404 also requires an attestation and not an opinion on the effectiveness of ICFR. An attestation and an audit are completely different engagements and require significant differences in time and liability standards which affect the cost of an engagement. When appropriately conducted, the banking agencies have found attestation engagements to be effective. We see no reason for the SEC and PCAOB to go beyond the clear language of the statute and require an opinion audit of ICFR.

Extension for Non-Accelerated Filers

ACB believes that non-accelerated filers should be granted an additional extension from compliance with Section 404(b) of Sarbanes-Oxley. Although the SEC has the sole authority to amend its rules for non-accelerated filers' compliance with Section 404, we would like to raise our member's concerns on this issue with the PCAOB. Section 404(b) requires auditors to attest to the effectiveness of ICFR in a company's annual report filed with the SEC. ACB believes that the SEC should follow the advice of the SEC's Advisory Committee on Smaller Public Companies and not require microcap and smallcap companies to comply with Section 404 "unless and until" there is suitable framework for the implementation of Section 404. We will not know if the Revised Standard will be a suitable framework for smaller public companies until it is carefully considered in light of public comments, finalized and approved by the SEC, and tested by auditors in the field. Non-accelerated filers should not be required to comply with Section 404(b) and expend limited resources until all of the foregoing has been completed.

ACB appreciates the opportunity to comment on the PCAOB's proposed Revised Standard. If you require additional information please contact Patricia Milon at (202) 857-3121 or pmilon@acbankers.org or the undersigned at (202) 857-3186 or shaeger@acbankers.org.

Sincerely,



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February 26, 2007

File No. S7-24-06: Management's Report on Internal Control over Financial Reporting
PCAOB Docket Matter No. 021

Here are my comments on the proposed "guidance" and rule changes. In brief:

- The implementation of §404 by the Commission, the PCAOB, the accounting profession, and issuers resulted in *de facto* regulatory requirements far beyond the requirements of the text of the statute.
- §404 was in keeping with the basic philosophy of U.S. regulation: disclosure. §404 should be interpreted as a disclosure requirement of the current state of the issuer's internal controls, not as a dictate for any particular level of controls or control verification.
- The resulting implementations of §404 have generally assessed control effectiveness in black-and-white terms: either effective ineffective. This provides little useful information to investors.
- The proposed SEC guidance does little to fix the regulatory train wreck that occurred in the implementation of §404, and indeed only compounds the problem with its vague "guidance" that lack clear examples of a realistic safe harbor.
- Rather than a binary black-and-white standard, the assessment should disclose the level of the quality of controls. For example, internal controls could be graded according to different frameworks, similar to credit ratings. Issuers would then

choose whether it is cost effective to spend the resources to earn a AAA internal control rating, or whether a single A is good enough.

- The proposed new auditing standard is a step forward, but does not fix the original mistake in the implementation of §404: a binary assessment of effectiveness rather than real disclosure of the current level of internal controls.

Background

The SEC, PCAOB, and Congress have been inundated with howls of protest over the implementation of §404 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). The "overly conservative" (in the SEC's phrase) implementation has resulted in a massive increase in auditing costs for public companies in the United States. Many feel that the time and expense of the exercise will not do much to decrease the probability of another Enron or WorldCom level fraud. No wonder, then, that many firms have chosen to deregister their securities and exit the public capital markets of the United States.

How did this regulatory train wreck happen?

In the wake of Enron and WorldCom, Congress passed Sarbanes-Oxley. Among other things, the act created the Public Company Accounting Oversight Board (PCAOB), increased penalties for financial fraud, tightened standards for corporate governance, increased requirements for auditor independence, and increased the SEC budget. In particular, Title IV, Enhanced Financial Disclosures, called for more disclosure of transactions involving management and principal stockholders, disclosure of the existence of an audit committee financial expert, and disclosure of a management assessment of internal controls.

The Commission and the new PCAOB duly passed a number of rules to implement Sarbanes-Oxley, and issuers set about to comply. Alas, the rules for §404 generally called for a binary assessment of whether or not controls were "effective." This was the key mistake. Internal financial controls are basically a risk management exercise. How much money should the company spend to set up procedures to prevent materially bad things from happening? What should be the cutoff probability that something "material" could happen? And how big is "material", anyway? Which controls are "key"? A lot of the contentious issues come from these judgment questions about how much risk is acceptable.

It is downright silly to think of risk management in black-and-white terms. One can always argue that a particular cut-off level for an acceptable risk is too lax or overly conservative. It comes down in the end to a matter of judgment. (Indeed, I notice that the word "judgment" appears to be used 31 times in the SEC's proposing release.)

It is usually impossible to remove all risk. Even if it were technically possible, it would be so expensive as to be impractical. For example, one could protect a single vending machine by installing a Fort Knox-like security system with cameras, sensors, and armed guards. But the cost of doing so would be more then the revenue from the vending machine. Individuals, businesses, and governments every day make risk management decisions in which they accept some risk because the costs of additional risk reduction are not worth the benefits.

The auditors, recently chastened by the public execution of Arthur Andersen, generally required expensive procedures to document and test internal controls before they would attest to management's evaluation that the controls were "effective." And who can blame them? If they required an overabundance of paperwork to cover their backsides, they were just doing their job. On the other hand, if they only required the socially optimal amount of paperwork (the point at which the total costs to society equaled the benefits), there would still be some risk, however small. If that tiny bit of risk blew up in a particular situation, then the auditor involved would be in deep trouble. Given these professional incentives, the auditors did the natural thing and performed an "overly conservative" -- and overly expensive – implementation of §404.

Issuers were caught between a rock and a hard place. Even if it made no economic sense to do what the auditors demanded, issuers were forced to comply or else they would get a "failing" grade from the auditors. No issuer could dare let "ineffective" grades go uncorrected, even when it made no economic sense, because of the potential legal liability if something happened and their "ineffective" controls were blamed.

Issuers were thus stuck with doing whatever the risk-averse auditors said to do, resulting in massive compliance costs. The general consensus is that the costs exceed the benefits. The Financial Executives Institute survey found that 85.1% of surveyed firms believed that the costs of 404 compliance exceeded the benefits.[1] The survey also found that the average large company (market capitalization over $700 million) spends over $5 million per year on §404 compliance.[2] This implies that the total amount spent on Section 404 compliance is more than the total budgets of the SEC and PCAOB combined.

What should be done about it?

§404 was basically a call for better disclosure. Its placement in Title IV, *Enhanced Financial Disclosures*, was no accident. Note that this title was not named *Enhanced Auditing Requirements* or *Enhanced Control Requirements*. Title IV fits in with the long tradition of U.S. financial regulation to promote disclosure and transparency in the markets.

[1] FEI Survey on Sarbanes Oxley § 404 Implementation March 2006. http://www2.fei.org/files/spacer.cfm?file_id=2104

It is useful to recall the actual wording of the law:

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.

(a) RULES REQUIRED- The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall--

> (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
>
> (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Note that §404 calls for "an assessment … of the effectiveness … " It does not call for specific controls or procedures. Congress was basically calling for more information, just as it was with the other requirements of Title IV. However, the black-and-white disclosures that have resulted from the implementation provide investors with little information. If the controls have been deemed "effective," the 10-Ks just contain standard boilerplate that the controls are "effective." If "material weaknesses" have been found, then there is a tiny bit more information about the nature of the weakness.

As a professor, I do assessments of my students frequently. Most of the time, the assessments are more than just pass/fail. Instead, they range from A to F. In financial services, credit rating agencies also assess the risk of various debt offerings. These evaluations provide important information that permits investors to make intelligent investment decisions.

There are over 10,000 public companies in the United States. It does not make sense for all of them to have the same types of internal controls, or adopt the same framework for assessment of those controls.

One possible evaluation would be for there to be different acceptable frameworks for assessing the effectiveness of controls. These different frameworks would have different definitions for items such as "key control," "material," "significant," "reasonable possibility," and "effective." They would require different levels of documentation, different levels of testing, and permit different levels of reliance upon previous years' audits. These different frameworks could be graded as AAA, AA, A, etc. just like credit ratings.

Instead of merely opining that controls were "effective," management could state that its controls were effective under a particular standard that was one of a menu of acceptable standards. Just as investors decide whether a single A rated bond is good enough for their portfolios, they could decide whether a firm with single A rate controls is good enough as well.

Management already has the correct financial incentives for most internal financial controls. If the controls break down, the financial impact on the company directly affects management. Managements should have the flexibility to choose which level of controls and which levels of controls assessment are most cost effective for their companies.

The only area in which top management does not have the correct incentives is one in which top management itself is involved in a fraud such as in Enron and WorldCom. This implies that the emphasis of the 404 audit should be on those top-level controls that would serve as a deterrent to fraud by top management. To this extent, the emphasis in the PCAOB's new auditing standard on a top-down approach is a step forward.

In terms of scalability, the proposed auditing standard is still somewhat vague. Given the understandably risk averse nature of the auditors, it is not likely that they will suitably scale down their requirements for smaller firms. By allowing a number of different acceptable frameworks, the responsibility will be on management rather than the auditors to select the appropriate framework. This reduces risk for the auditors, and also will lead to a more cost effective level of expenditures on §404 compliance.

Congress left it up to the SEC and the PCAOB to use professional judgment in writing the rules for §404 implementation. I call upon the SEC and PCAOB to use this discretion to fix the basic flaw in the original implementation of §404, the black-and-white definition of "effectiveness," and to come up with a common sense menu of acceptable assessment frameworks that will implement §404 in an efficient manner.

Respectfully submitted,

James J. Angel, Ph.D., CFA

Association for Financial Professionals®

February 21, 2007

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Re:	**SEC**	**File Number S7-24-06**
	PCAOB	**Rulemaking Docket Matter No. 021**

The Association for Financial Professionals (AFP) appreciates the opportunity to comment on the Securities and Exchange Commission's (SEC) *Interpretive Guidance for Management regarding its Evaluation of Internal Control over Financial Reporting* and the Public Company Accounting Oversight Board's (PCAOB) *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements (AS 5).* AFP represents 15,000 finance and treasury professionals employed by over 5,000 corporations and other organizations.

Secure, transparent and efficient capital markets is a goal shared by AFP members and regulators. AFP members are concerned that current regulations have become a barrier to efficient capital markets. Increased oversight of the capital markets was necessary as a response to the corporate scandals from the early part of the 21st Century and AFP appreciates much of the work done by the SEC and the PCAOB in implementing the Sarbanes-Oxley Act (SOX). However, our concern is that regulations are being interpreted and implemented in a way that imposes excessive cost on companies and serves as a barrier that locks out companies from the capital markets. The increasing complexity of many accounting standards, combined with the concerns about Sarbanes-Oxley compliance and expectations by investors, is causing many corporations to employ suboptimal financial and risk management strategies.

Corporations and their shareholders have been responsible for the administrative and financial burden of SOX 404. As a consequence, AFP members have expressed a keen interest in the modification of SOX 404 internal control regulations. We have previously filed comments (dated 5/1/2006 in response to file #4-511 and 9/14/2006 in response to S7-11-06) with the SEC and the PCAOB expressing our views and suggestions.

AFP offers the following comments on the recent SEC and PCAOB proposals:

Improve the Alignment Between the SEC Document and the PCAOB Document
The SEC's proposed guidance and the PCAOB's audit proposal (AS 5) are presented in significantly different formats. The SEC guidance is a conceptual document while the PCAOB AS 5 proposal is a technical paper. Corporate management seeks guidance in resolving issues related to SOX 404 compliance work which also includes resolving issues with their auditor. There should be a greater

alignment between the two documents in order to resolve any interpretation differences between company and auditor.

Increase the Clarity of the SEC Document and make it More Direct and Specific
The SEC proposed guidance attempts to address several issues that exist with SOX 404 and how management can more effectively and efficiently comply. However, the proposal in its present form lacks clarity. The SEC should specifically identify what the difficulties are and what the SEC will require of corporate management in the future.

As the draft is currently written, only those who have been significantly engaged in the SOX 404 work of the SEC over the last two years will understand what the document suggests on guidance. The SEC's proposal is a response to the issues presented by the various participants at the SEC's roundtable discussions. Unfortunately, the SEC's proposed guidance does not go far enough in explaining the issues.

The bigger concern is related to the expectations from auditors during the corporate annual audit. Management may be able to understand and interpret the proposed SEC guidance, but without clearer guidance, compliance will still be subject to the interpretation by the auditor. The current language is not strong enough to use as supporting or authoritative evidence to present to the auditor during the audit. Because of the lack of direction in the SEC document, management will remain subject to the auditor and will be required to rely on the PCAOB document (proposed AS 5) for specific guidance when communicating with the auditor.

AFP recommends improving the draft document in one of two possible ways. First, the SEC staff should rework the document and include direct and explicit explanations of what is and is not required. Second, the SEC could include some type of appendix or addendum with specific guidelines to follow. For example, the appendix could include flow charts that illustrate when evidence gathered satisfies Internal Control Financial Reporting (ICFR).

Reconsider Testing By Exception for Years After a Clean 404 Report
It should not be necessary for companies that have completed and provided a clean SOX 404 report to repeat the entire process each financial reporting year. Once a company attains a clean 404 report, the next three-to-four-year reporting cycle should not require another 404 report except to report on any significant changes during the year. Further, the document should explain what events would require a report on changes. Examples of changes might include corporate reorganizations, mergers, purchases and downsizing or unusual staff turnover which impact corporate controls on financial reporting. To require a full SOX 404 compliance report every year for a company that has not experienced material changes in its internal controls does not increase transparency, and unnecessarily increases costs.

We do not support the concept of a complete exemption from ICFR. A company should still be obligated to comply with ICFR at some scaled level if the company intends to participate in the capital markets. A periodic inspection and reporting process is not the same as requesting an exemption from 404 reporting. An annual SOX 404 reporting cycle is not necessary for a company that is practicing good corporate governance. However, a company that fails a compliance threshold should be obligated to perform another annual audit of internal control until there is reasonable assurance that the company's controls are adequate.

Policy and Practical Issues of Management and Auditor Within the SEC Draft
The SEC proposal details examples of where identification of risk and certain controls over financial reporting should be sufficient within a corporation. However, without more explicit guidance it is highly unlikely that the external auditor performing the evaluation of internal controls would consider these controls adequate. We are concerned that the auditor will continue to rely heavily on the concept of "separation of duties" and the "documentation" mentality.

For example, the SEC draft addresses *Identifying Financial Reporting Risks.* The SEC report presents an example of a small company with less complex business processes in which the company "operates on a centralized basis and with little change in the risks or processes, management's daily involvement with the business may provide it with adequate knowledge to appropriately identify financial reporting risks."

In the current environment, it is likely that an auditor complying with AS 2 or proposed AS 5 will require additional controls, which are fully documented in order to protect the audit firm from any PCAOB inspection problems even though the company "operates on a centralized basis and with little change in the risks or processes, with management's daily involvement."

Further, the SEC proposal states that "for purposes of the evaluation of ICFR, the controls are not adequate when their design is such that there is a reasonable possibility that a misstatement in the related financial reporting element could result in a material misstatement of the financial statements will not be prevented or detected on a timely basis."

Such a statement is confusing and causes both auditor and management to require excessive controls and documentation. The statement could simply state that <u>controls are adequate if they have been designed to reasonably detect a material misstatement in the financial statements on a timely basis.</u>

Establish an Informal Committee to Define Controls that Adequately Addresses Financial Reporting Risks
The SEC and PCAOB should form a joint committee which includes corporate representatives, including finance and treasury professionals, to better define a *"Control that Adequately Addresses Financial Reporting Risks."* Regulatory documents promote the concept of a top-down, risk-based approach to internal controls. However, at this time there have been no high level discussions to develop guidance which will add clarity and definition to that concept.

SEC Commissioners have made public statements about how they have seen an unrealistic number of 'key' corporate controls identified by auditors when making a determination of the extent of required documentation and testing. Both the SEC document and the PCAOB proposals stress the importance of focusing on the key corporate controls. There is no discussion or information from a practical view of what are 'key' controls. Guidelines on the definition of key controls should be developed by the SEC, PCAOB and corporate representatives.

While it would be impossible to cover all possible corporate structures, examples based on a common conceptual understanding would be useful. The theoretical discussions will continue to result in divergent interpretations.

While the draft documents discuss the issue of materiality, added clarification is needed to improve the conceptual understanding between company, auditor and regulator. This committee could also provide added clarification on the definition of "materiality" which represents another area of divergence between management and auditor.

Specific Comments on PCAOB AS 5 Draft

Overall, we view the PCAOB document as helpful, and AFP endorses the provisions of AS 5. However, we strongly urge the PCAOB to make compliance with this revised document, mandatory for the audit firms. AFP is concerned that excessive internal control testing procedures and practices put in place during the last two years by the audit firms may be continued, unless compliance with AS 5 is made mandatory.

The requirements to remove the evaluation of management's process and the "stand alone guideline" are good revisions. These changes will prevent additional costs from being incurred by companies.

The "walkthrough" is an effective way for an auditor to gain knowledge and understanding of the company and its controls. We agree with the proposed standard that the walkthrough should only be for significant processes and not for each major class of transactions. We also agree with the proposed standard that the auditor should be able to use others for direct assistance with the walkthrough. However, it is important to stress that the auditor is to perform this task, not the client.

PCAOB Perpetuation of Excessive Auditor Costs Through the Inspection Process

When reviewing publicly available PCAOB inspection reports, it appears that the inspectors may be performing excessive searches for auditor deficiencies and may be exacerbating the high and unreasonable costs to companies.

An auditor that is fearful of missing something in the audit of the company because of the PCAOB is going to spend time, energy and resources performing unnecessary audit procedures. Furthermore, the high degree of criticism expressed by the PCAOB Inspection Team for failure to document everything results in wasteful and duplicative work. The PCAOB should foster an environment that translates into reasonable testing and documentation within reasonable costs.

The Issue of Auditor Liability Needs to be Addressed

On September 18, 2006, the auditing profession held a roundtable meeting in Chicago. The topic was the *Future Viability of the Audit Profession.* The meeting focused on the challenges facing the largest audit firms after the Andersen and Enron collapse and the risks associated with auditing the largest global companies.

The auditors who participated at the roundtable discussed the risks and fear of working with <u>any</u> company that might represent a risk to the audit firm. The result is that companies in need of an audit are finding it more difficult to retain these services. Smaller, newer companies are having a particularly hard time working with audit firms.

A serious problem is the inability of the largest audit firms to obtain malpractice insurance. With a lack of insurance coverage, audit firms have no other choice but to self-insure against claims.

In light of these problems, auditors are going to great lengths to investigate and to insulate themselves against the risks of any potential corporate misrepresentation. The result is excessive audit work and inordinate audit documentation. Auditors perform whatever work is necessary to be protected against the risk of litigation. This means that some percentage of the audit work and the costs associated with the audit are not for the purpose of assuring the fair presentation of the financial statements, but are to document and insulate the auditor against potential litigation. As a result, corporations are paying significantly higher fees to auditors and other outside consultants in order to participate in the capital markets. For some companies, economics has made it more practical to delay going public or to finance the company through alternative sources.

Some reports have indicated that many companies are increasingly looking overseas to obtain needed capital. It is worth noting that the European Union has been discussing the introduction of liability caps for auditors. Some EU states already have liability caps in place. If the EU does introduce some type of cap on auditor liability, it will further encourage U.S. companies and foreign companies to search outside of the U.S. for capital.

Comment on Accounting Standards

Complex U.S. accounting standards are also contributing to the difficulty in complying with SOX 404. Corporate management is often criticized and flagged by their auditors and the SEC for deficiencies that are, in part, due to complex and unclear accounting standards.

Robert Herz, Chairman of the Financial Accounting Standards Board (FASB) has made public how complex the standards are and has stated his intent to simplify standards when possible. At the same time an increasing number of FASB standards are being prepared which require fair value presentations that rely more on professional opinion and judgment and less on actual transaction-based documentation.

Summary

As we stated at the outset, "secure, transparent and efficient capital markets is a goal shared by AFP members and regulators." There must be a regulatory system that protects the investor and the public and allows companies to operate efficiently and effectively. Unfortunately, the SEC, PCAOB and auditors are not currently acting in cooperation to facilitate efficient capital markets, but rather as separate and distinct pieces of the process.

Regulators, standard setters and auditors appear to have forgotten that they are all an integral part of the entire process. The independent reviews by the auditor and the regulatory oversight and authority of the SEC is part of the total system. By working together we can reduce material misrepresentations and improve financial reporting. More accurate reporting allows investors to make better decisions and generally increases the efficiency and transparency of our capital markets.

AFP and its membership appreciate the opportunity to comment on these matters before the SEC. If you have any questions, please contact John Rieger, AFP Director of Accounting and Reporting at jrieger@afponline.org 301-961-8844.

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26 February 2007

Dear Ms Morris and Mr Seymour,

Securities and Exchange Commission Release on Management's Report on Internal Control over Financial Reporting
File Number S7-24-06

Public Company Accounting Oversight Board Proposed Auditing Standard on An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals
PCAOB Rulemaking Docket Matter No. 021

ACCA (the Association of Chartered Certified Accountants) is the largest and fastest-growing international accountancy body with 296,000 students and 115,000 members in 170 countries. ACCA works to achieve and promote the highest professional, ethical and governance standards and advance the public interest.

ACCA is pleased to comment on:

the Securities and Exchange Commission (SEC) Release Nos. 33-8762 and 34-5476 on Management's Report on Internal Control over Financial Reporting (the SEC's proposals); and

the Public Company Accounting Oversight Board (PCAOB) Rulemaking Docket Matter No. 021 of 19 December 2006 – Proposed Auditing Standard on An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals (the PCAOB's proposed standard).

We are submitting this single response to both the SEC release and the PCAOB proposed standard as the subject matter 'internal control over financial reporting' is the same in each case. Our comments are confined to the corporate governance and risk management aspects of the documents: we are not commenting on detailed technical auditing aspects of the proposals.

ACCA supports the aims of both proposed documents. We understand this, in both cases, to be ensuring both management and auditors focus on those matters which are most important to assessing the effectiveness of internal control over financial reporting and so allowing the requirements to be simplified and unnecessary procedures eliminated. We particularly welcome the PCAOB's decision to introduce a new audit standard rather than revise the existing one. We also welcome the thrust of the significant changes between the existing standard and the new one.

Last September we submitted our comments to the SEC in respect of its concept release on rule 404. We said we were concerned that, in practice, the internal control evaluation process has become dominated by PCAOB Auditing Standard No2 and the way the audit standard has been applied. We argued this has caused two problems:

1. control evaluation has become over focussed on documenting and evidencing key controls at the expense of a proper evaluation of the control environment.

2. the process has become more expensive than was necessary.

The control environment (as articulated in COSO and other frameworks) is the foundation of all other aspects of control, it was weakness in the control environments at Enron and WorldCom that were their undoing and which brought about the need for the Sarbanes-Oxley Act. Because the control environment includes people factors such as culture and ethics, much of its assessment has to be subjective. It is therefore something that cannot reasonably be comprehensively and totally documented. Nor can such subjective assessment be satisfactorily verified solely by traditional audit methods.

There is a danger with the existing practice that the over reliance on documentation could mean that fundamental weaknesses in the control environment are missed. Further, anecdotal evidence suggests that some companies which have found it necessary to document thousands of controls are experiencing an adverse reaction from staff who resent burdensome controls: this weakens the control environment.

We recommended that if guidance on assessing internal control is to be issued, it should be brief and keep to high level principles to avoid any risk of it becoming another set of rules. We recommended that such principle-based guidance should emphasise the importance of assessing the control environment and recognise that certain aspects of the control environment, such as culture and ethics, cannot be fully assessed by objective means alone and require subjective, but structured and rigorous, assessment by management. The following considerations are particularly relevant:

- The purpose of internal control is to enable the organisation to operate effectively and have reasonable assurance that significant risks to achieving objectives are identified and managed.

- It follows that internal control should be owned by managers and staff throughout the organisation at all levels rather than by internal or external auditors.

- Too much focus on documentation of, and compliance with, procedures can have unintended consequences and potentially create a culture which is either risk averse and/or inclined to circumvent written rules.

- A structured and facilitated 'self-assessment' approach should be used as part of the evaluation process. Such an approach can be particularly effective in providing assurance on the control environment. It works best when initiated as a top down approach involving managers and staff in constructive face to face communication; it can also lead to improved team working, improved control culture and better operational effectiveness.

Finally we suggested that the PCAOB Auditing Standard No2 should be realigned to become consistent with any revised SEC guidance thereby allowing both management and external auditors to apply reasoned judgement. It should be the SEC guidance, rather than any PCAOB auditing standard, which determines the approach that management follows in order to comply with s404; we are not convinced that this has been so, to date.

Although we support the aims of both new documents we are concerned that these aims may not be achieved in practice. Our concerns centre on:

- Inconsistencies in approach and terminology between the two proposed documents. These include:
    - differences in definition; e.g. The SEC's definition of 'Material Weakness' (page 13) is: A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's internal control over financial reporting. The PCAOB defines 'Material Weakness' (paragraph A8) as: A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.
    - the fact that the proposed auditing standard no longer requires an opinion on management's process for assessing internal control;

  and
    - The PCAOB correctly emphasising the importance of the control environment whereas the SEC seems to down grade its fundamental performance.
- The SEC interpretative guidance being written in a style which may be more suited to the external audit profession and may not be easily understood by managers. Arguably, the SEC rule takes an external audit rather than a management approach.
- An apparent downgrading in the SEC proposal of the fundamental importance of the control environment. Page 26 of the SEC document, says controls such as the control environment may not, by themselves, be effective at preventing or detecting misstatement. While, strictly, this may be true, it is also true to say that ALL the significant cases of significant deliberate misreporting of financial accounts have been a result of failure of the tone at the top, that is a failure in the control environment. The proposed rule could be interpreted as saying it is not essential for management to consider entity level controls of this nature.

- The PCAOB decision to remove the requirement to evaluate management's evaluation process yet retain a requirement to audit internal control seems perverse. In our view the wrong opinion has been dropped. It makes sense for the auditors to base their work on what management is doing. The separate auditor opinion on internal control is likely to mean duplication of effort and may lead to management performing more work than otherwise necessary to satisfy audit requirements. It also means two quite separate costly and time consuming processes will be required to achieve was is essentially the same purpose.

Questions asked by the SEC
We comment below on some of the questions posed by the SEC:

- Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process? Does the proposed guidance allow for management to conduct an efficient and effective evaluation? If not, why not?

- *As we have commented above, we consider the proposed rule to be in a style more suited to external auditors than management. Also, as commented above, we consider that the proposed rule takes fundamentally the wrong approach to the control environment. In spite of the great need for guidance in this area, none is given in how to assess the control environment or any of its vitally relevant components such as culture, tone at the top or processes to prevent management override of controls. Moreover the guidance could be interpreted as meaning that management need not consider the control environment at all as the control environment can not be relied upon to prevent misstatement. While in absolute terms this is true, an effective control environment is the best defence against misstatement and, as COSO says, is the foundation of all other elements of control.*

- Are there particular areas within the proposed interpretive guidance where further clarification is needed? If yes, what clarification is necessary?

- *Yes, as stated above, clarification is required on assessing the control environment and how this relates to assessing other components of control.*

- Considering the PCAOB's proposed new 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, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to resolve the incompatibility?

- *Yes, as described in our answer to your first question. By contrast the PCAOB correctly emphasises the control environment and amongst other things requires auditors to 'assess whether sound integrity and ethical values, particularly of top management, are developed and understood'.*

- Are there any definitions included in the proposed interpretive guidance that are confusing or inappropriate and how would you change the definitions so identified?

- *As noted in our general concerns above, there are also inconsistencies in definitions between the two documents.*

Questions asked by the PCAOB

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

- *It should help to ensure focus on the most important 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?

- *Provisionally yes, however we are concerned there is a lack of suitable audit procedures and experience to evaluate properly the control environment including 'whether sound integrity and ethical values, particularly of top management, are developed and understood'. In practice this may mean that a proper assessment is not carried out.*

- 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?

- *Up to a point. However risk assessment could be better addressed if the auditor opinion was on management's assessment rather than on internal control.*

- 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?

- *No*

- 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?

- *In our opinion little or no clarity will be provided by replacement of terms such as "more than remote likelihood" with the term "reasonable possibility"*

- 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?

- *As stated above, we suggest the wrong opinion has been dropped.*

We would be pleased to discuss any aspect of this letter you may wish to raise with us.

Yours faithfully

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February 23, 2007

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Re: PCAOB Rule Making Docket Matter No. 021

The Assurant organization extends its gratitude to the PCAOB for undertaking the task of eliminating unnecessary requirements of the existing standard on Auditing Internal Controls over Financial Reporting. Assurant believes it has incurred substantial costs associated with these unnecessary requirements and with little or no corresponding benefit received.

Assurant believes a new standard would create a more manageable integrated audit process which should ultimately result in lower costs to our organization without sacrificing quality results. We further believe that some changes could be made to the proposed standard that would enable it to be even more effective.

1. Rotational Testing – under the proposed standard, rotational testing is not allowed. We support an approach to testing that would allow the auditor to rely on the procedures that were performed and the knowledge gained in prior years, refreshing the testing every few years to insure nothing has changed and that controls continue to be effective. Since walkthroughs will be done annually, it should be very apparent when changes have been made in a process that necessitate updated testing. For those processes that have not changed, rotational testing should be an acceptable practice.

2. Principal Evidence - We support providing more definition and examples for the term "principal evidence". We believe there is a lack of definition that promotes an environment that leads to meeting a given desired numerical coverage by the external auditor, rather than an environment where the auditor can gain greater leverage from the work of others in meeting the principal evidence goal. Companies have invested huge sums in testing key controls and companies should be able to gain substantial benefit in reduced audit hours by having auditors use the work of the companies in meeting their principal evidence requirement.

3. Benchmarking - benchmarking is another area where we request more guidance. With good change management controls in place, re-benchmarking should not be needed; the proposed guidance suggests a company is not required to retest after benchmarking

unless the company has made changes to the process/control being tested. This seems to defeat having good change management controls which should have been tested and shown to provide adequate controls in and of themselves.

Thank you for considering these changes to the proposed standard. Please feel free to contact me if you have questions regarding our suggested changes.

Sincerely,

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February 26, 2007

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Re: 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*

Dear Members and Staff of the Public Company Accounting Oversight Board:

BDO Seidman, LLP welcomes this opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") proposals: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would supersede Auditing Standard No. 2 ("AS 2"), and related other proposals.

BDO supports the efforts of the PCAOB to increase efficiencies in the implementation of an audit of internal control over financial reporting ("ICFR") while maintaining its effectiveness. We recognize that a methodology that integrates the audits of the financial statements and ICFR and balances benefits and costs is essential for the successful implementation of ICFR audits. The current proposals, while introducing new guidance in some areas, in many ways serve to clarify and consolidate previously issued guidance into one standard, which we believe should assist in implementation.

While we support the principles based approach provided for in the proposed standard, we also believe that an increase in the number of examples presented and clarification of some of the more complex issues will help ensure consistent application. For example, we suggest that the proposed standard retain examples about how to evaluate the significance of internal control deficiencies in various situations and examples of controls designed to address fraud.

During the initial implementation of AS 2, the effort expended to implement the standard vastly exceeded expectations. This was due to a number of factors, including a tight implementation time frame. As a result, the learning curve was steep for both management and auditors. As auditors and registrants have gained experience over the past two years in performing ICFR audits, and are better able to implement a top-down, risk-based approach, efficiencies are being realized.

Now in the third year of implementation, we believe that ICFR audits have become further integrated with the financial statement audit, and that auditors generally are now taking a risk-based audit approach to the integrated audit, except where limited by specific provisions within AS 2.

While we generally support the proposed standard and other related proposals, we have provided suggestions in response to the specific questions below that we believe would improve implementation. Further, we have added additional commentary, at the end of this letter, on other matters that we believe merit attention.

Focusing the Audit on the Matters Most Important to Internal Control

- Directing the Auditor's Attention Towards the Most Important Controls

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

   The top-down approach is an essential element impacting overall audit efficiency. The description of the top-down approach, where the auditor first looks at the financial statement level and company-level controls in place, and then moves sequentially down to significant accounts and disclosures, relevant assertions, and significant procedures, could be enhanced by the inclusion of the table that is presented in the PCAOB's May 16, 2005, Staff Q&A 38. While the approach is described in the text of the proposed standard, an illustration of the sequence of steps, including examples of the timing and nature of procedures appropriate at each step in the process, would promote efficiency in implementation.

   We also believe that it would be helpful to include more detailed discussion of the different types of company-level controls, and how some company-level controls have a closer relationship than others to specific financial reporting assertions and related control activities and thereby have a greater impact on the top-down approach. Also refer to our response below to question four.

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 addresses the auditor's consideration of fraud as part of the evaluation of the control environment in the implementation of the top-down approach (paragraph 20) and also as a factor to consider in identifying significant accounts and disclosures and in selecting controls to test (paragraphs 26 and 45). Footnote references to AU section 316, *Consideration of Fraud in a Financial Statement Audit,* are provided for additional guidance. However, we recommend that in addition to including footnote references, important concepts also should be emphasized and stated in the standard; for example, it may be useful to list the fraud risk factors that relate to (1) fraudulent financial reporting, and (2) misappropriation of assets and how the auditor's response to the assessment of the risk of material misstatement due to fraud is influenced by such risk factors.

Paragraph 20 of the proposed standard includes matters the auditor should assess as part of the evaluation of the control environment, including "whether the company takes actions to reduce or mitigate the incentives and pressures on management that would provide a reason to misstate the company's financial statements." We suggest that this matter be clarified by providing examples of the types of company actions the auditor should assess.

We also believe that fraud considerations should be emphasized throughout the proposed standard, starting with risk assessment, rather than as a separate section. Specifically, we suggest including fraud considerations earlier in the standard, starting with the discussion on identification of company-level controls that starts at paragraph 17, in order to better integrate the auditor's consideration of fraud, consistent with the provisions of AU section 316, *Consideration of Fraud in a Financial Statement Audit.*

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

We believe that the top-down approach is essential to identifying the most important controls, first at the company-level and then at the transaction level. Based on our experience in implementing the top-down approach within the integrated audit, this approach is necessary to focus engagement teams during planning and throughout the audit on the most important controls, those that mitigate the risk of material misstatement. The assessment of the control environment and the controls that operate at that level have a pervasive effect on controls that operate at the transaction level and, as a result, any assessment of controls operating at that lower level cannot be performed effectively without an understanding of those higher level controls.

For example, when company-level controls such as monitoring controls are operating effectively, with the appropriate degree of precision, testing at the lower level can ordinarily be reduced. However, if company-level controls are not operating effectively, this will generally result in more rigorous testing at the lower level.

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?**

AS 2, paragraph 54, states that, "Testing company-level controls alone is not sufficient for the purpose of expressing an opinion on the effectiveness of a company's internal control over financial reporting." This provision of AS 2 prohibited reliance on company-level controls alone to address the risk of material misstatement, under the presumption that it would be difficult for controls that operated at such a high level to operate at a level of precision necessary to prevent or detect material misstatements to individual relevant assertions. Under AS 2, the effectiveness of company-level controls impacts the nature, timing and extent of work performed at the more detailed level, but some additional testing at the lower level is always required.

The proposed standard now omits this provision, and instead paragraph 43 states, "…the auditor should recognize that company-level controls vary in precision. Some company-level controls are designed to operate at the process, transaction, or application level and might adequately prevent or detect, on a timely basis, misstatements to one or more relevant assertions." This provision effectively eliminates the absolute prohibition of the use of company-level controls alone to address the risk of material misstatements to individual relevant assertions. However, we believe that many company-level controls only indirectly relate to relevant assertions and often do not operate at a sufficient level of precision to address the risk of material misstatement at the individual relevant assertion level.

To better communicate how company-level controls could operate at an acceptable level of precision, further guidance and examples should be presented, including examples about the effectiveness of company-level controls in adequately addressing the risk of fraud. Additional examples that demonstrate when company-level controls would be expected to operate at a level of precision to adequately prevent or detect material misstatements on a timely basis at the individual assertion level, contrasted with those company-level controls that would not operate at such a level, should be presented to emphasize the characteristics of the controls and circumstances that lead to one conclusion versus the other.

Without these examples, we believe that some auditors may not take appropriate credit for tests of certain company-level controls that are operating effectively. Conversely, there is also a risk of over-reliance on other company-level controls that, even if operating effectively, would have little direct bearing on accurate reporting of relevant assertions.

- Emphasizing the Importance of Risk Assessment

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?

The proposed standard appropriately recognizes that there is a relationship between risk and evidence to be obtained when it states, "As the risk associated with the control being tested decreases, the evidence that the auditor needs to obtain also decreases." (See paragraph 51.)

However, this guidance does not provide examples or further amplification to demonstrate the application of this concept, specifically, how risk impacts the nature or extent of evidence to be obtained. We believe that to fully explain this concept, the standard should add guidance, such as, "for example, in areas of low risk, where relevant company-level controls are strong and operating effectively, the nature of tests of controls may consist of inquiry and observation and/or a walkthrough, or a lower sample size, whereas in areas of higher risk, the nature and extent of tests would generally be more extensive." A similar explanation to illustrate the *quality* of evidence to be obtained in areas of differing risk, such as work done by others versus the auditor's own work, should be added to fully illustrate this point.

With respect to the extent of testing, we believe expanded discussion regarding the consideration of risk in use of sampling to test the effectiveness of controls would be beneficial. For example, further clarification would be useful where the auditor does not plan to place reliance on controls for financial statement audit purposes and how this impacts the definition of the population to be tested and related sample sizes. This could occur when the auditor is retained late in the year, or where there have been significant and pervasive changes in internal controls late in the year. Clarification about how these situations and the auditor's risk assessment in general affect the extent of testing required to determine whether controls are effective at year-end will assist auditors in testing more efficiently.

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

   We believe that in areas of low risk, where company-level controls are operating effectively, testing in the prior year resulted in no exceptions, and the control has not changed from the prior year, walkthroughs would be sufficient to test the design and operating effectiveness of some of the more routine controls. However, we would expect that the same controls would generally not be evaluated in this manner for multiple consecutive years.

   Further, we are concerned with the provision that permits using the work of others to perform walkthroughs. We believe that walkthroughs are an important audit procedure in planning an integrated audit and assessing the risk of material misstatement. They assist auditors in the identification of control deficiencies, either from missing controls or design deficiencies, as well as evaluating the competence of the persons performing the controls and gathering information about what could go wrong. While we understand that the proposed standard envisions that work performed by others in this area would be under the direct supervision of the auditor, we believe that additional guidance should be provided to ensure that auditors do not over-rely on others to perform this important task, particularly in areas other than those with low risk.

- Revising the Definitions of Significant Deficiency and Material Weakness

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?**

   While we believe that the proposed definition of a significant deficiency is improved and more realistic than the former definition, we believe that additional guidance is necessary to help auditors appropriately apply judgment and to avoid inconsistencies in practice.

   To facilitate consistency in the evaluation of identified control deficiencies, as stated earlier, we recommend that examples of each type of deficiency, such as those included in Appendix D to AS 2, be retained (and modified as necessary to fit the revised definitions of a significant deficiency and material weakness contained in the proposed standard). Additionally, specific examples that are applicable to smaller companies would be useful, specifically examples related to segregation of duties issues and the risk of management override.

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?**

The evaluation of the severity of deficiencies in ICFR is a subjective process taking into account the following factors –

- whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies.

These subjective factors require auditors (and company management) to exercise professional judgment based on their knowledge and experience. In situations where auditors do not have a sufficient history with a company, this judgment becomes more complex. It can be extremely difficult to conclude that a material error could occur when one has not occurred, particularly in judgmental areas. Conclusions in this area require evaluations about a person's technical competence and consistency in maintaining that level of competence. Absent an error, it is often extremely difficult to conclude that a material error could occur.

To assist auditors in making these determinations, examples that illustrate certain fact patterns, that in one circumstance would result in a material weakness but in another would not, would be beneficial. Areas where additional guidance in the evaluation of deficiencies would be most helpful include deficiencies in the control environment (especially assessing the risk of management override, fraud risk, and audit committee effectiveness), deficiencies in client expertise in financial accounting and reporting, (particularly with respect to complex and infrequent matters), and deficiencies in segregation of duties.

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 do not believe that the proposed changes in the definitions will have a significant impact on the amount of effort auditors expend in identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statements, although these changes may help in communication between auditors and management. However, we do believe that the elimination of examples in applying the definitions could significantly increase the amount of effort to analyze deficiencies.

- Revising the Strong Indicators of a Material Weakness

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?

We believe that the standard should allow the auditor to conclude that no deficiency exists when one or more of the strong indicators are present. This flexibility in approach permits the auditor to exercise appropriate judgment based on the facts and circumstances of each situation without forcing a conclusion that a deficiency exists when one may not.

The use of judgment is preferable to a fixed conclusion that cannot contemplate the entirety of differing circumstances that may require consideration. However, we recognize that the application of judgment may cause inconsistencies in the evaluation of deficiencies. To address this concern, we suggest that examples be provided to illustrate circumstances that could result in the conclusion that no deficiency exists when one of the strong indicators provided in the proposed standard is present.

- Clarifying the Role of Materiality and Interim Materiality in the Audit

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

We do not believe further clarification is necessary to avoid unnecessary testing; however, we do believe further clarification to the scope should be considered to reduce the risk of insufficient testing. In particular, we are concerned that material areas may be inappropriately excluded from the scope of the audit.

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 reference to interim financial statements in the definitions of significant deficiency and material weakness should be retained, since external financial reporting encompasses both quarterly and annual reporting. We believe identified deficiencies should be evaluated against both interim and annual financial results.

However, we are concerned that there will still be confusion about what this definition means as it relates to scoping an engagement (selecting areas for audit or designing procedures). The reason for this is as follows: Paragraph 2 of the proposed standard would require the auditor to perform the audit to obtain reasonable assurance about whether material weaknesses exist. A material weakness is defined in the context of either the annual or interim financial statements. Therefore, auditors may deduce from this that they need to design their tests to look for weaknesses that could generate misstatements that would be material to interim financial statements. This would be tantamount to using an interim materiality for planning purposes.

In addition, in circumstances where a material weakness has been identified, because the definition of a material weakness is included in the report, this could suggest to users of the report that the auditor has planned and performed the audit to identify weaknesses that are material to interim periods. We are concerned that the audit report would therefore be misleading to investors, since the audit has not been planned or performed to identify material weaknesses based on interim materiality.

To avoid this confusion, we recommend the proposed standard clarify that the auditor is required to test only those controls which if not operating effectively could result in a material misstatement to the annual financial statements.

Eliminating Unnecessary Procedures

- Removing the Requirement to Evaluate Management's Process

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

With the removal of the requirement to report on management's assessment, we believe there should no longer be any confusion as to the extent to which the auditor needs to evaluate management's work. While auditors still need to evaluate management's work in areas on which the auditor intends to rely, any "unnecessary" work in this area should now be eliminated.

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

We believe that an audit of ICFR can be effective without performing an evaluation of the quality of management's process. However, in order to use the work of others, auditors would still need to perform this evaluation in those areas where there is an intention to rely on management's work. In addition, management's assessment process often overlaps with and is part of management's monitoring controls, and some evaluation of the assessment process could be necessary in order to test the effectiveness of those controls. We believe it would be useful to provide additional clarification with respect to each of these points in the final standard.

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 one opinion, only on the effectiveness of internal control, clearly provides investors with the necessary information about the scope of the audit and the opinion on the effectiveness of ICFR.

- Permitting Consideration of Knowledge Obtained During Previous Audits

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

We support permitting the auditor to consider knowledge gained in prior years related to individual controls in determining risk, and therefore impacting the nature, timing, and extent of testing in the current year. The approach outlined in the proposed standard directs the auditor to consider three risk factors (the nature, timing, and extent of procedures performed in prior years' audits; the results of that testing; and any changes in the control or its related process since the last audit) when determining the risk related to a given control in subsequent years' audits. We believe this is appropriate and consistent with concepts addressed in the May 16, 2005 guidance.

We suggest, however, including additional language that provides direction to auditors when information obtained in prior years may be irrelevant as a result of changes at the entity or the environment in which it operates.

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?

We believe that in the following circumstances a walkthrough may provide sufficient evidence of operating effectiveness.

- The control is an automated control or was tested for operating effectiveness in a prior year (as part of a financial statement or an ICFR audit, either by the current or predecessor auditor) and found to be effective;
- There is an assessed low inherent risk, including consideration of the complexity of the control and the degree of judgment or subjectivity involved in performing the control;
- There have been no significant changes in the volume or nature of transactions for which the control operates;
- There is no history of errors in the relevant assertion to which the control relates;
- It has been established that relevant company-level controls are operating effectively; and
- There is no identified risk of fraud related to the control

Further, we would not envision that the same controls would be evaluated via walkthrough every year; so that at least some low risk controls are tested more extensively for operating effectiveness each year.

-Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage

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 proposed standard's focus on the risk of material misstatement to the financial statements, in determining the scope of testing in a multi-location engagement, appropriately focuses audit attention on those locations or business units with the greatest degree of risk, and we believe this focus will contribute to efficiencies in the performance of these audits. While auditors will still need to obtain enough evidence to support the opinion, the elimination of the "large portion" requirement appropriately permits the auditor flexibility in scoping an engagement based on risk and materiality, in the same manner used for the audits of financial statements.

- Removing Barriers to Using the Work of Others

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?

The concept of an integrated audit contemplates the performance of one risk assessment process, one scoping analysis, and one assessment of the effectiveness of ICFR. To facilitate this integrated approach in an efficient manner, we believe that a single framework for using the work of others is appropriate. We are concerned however, that the introduction of specific provisions in the proposed auditing standard, *Considering and Using the Work of Others in an Audit,* that permit reliance on the work of others, other than internal audit, could compromise audit integrity in some cases. When assessing the competence of internal auditors, under AU sec. 322, external auditors consider the professional experience, educational level, and quality of work of the internal auditors, among other factors. While these factors are similar to those presented in the proposed standard, the factors included in AU sec. 322 are considered in the context of competence in internal auditing matters and not in any other context. The proposed standard is not specific about the nature of the competencies. This may lead auditors to believe that if a corporate employee is competent in performing the daily tasks, this person could perform substantive audit procedures, when in fact the employee may have no experience in auditing.

Additionally, the auditor ordinarily considers the following matters in an assessment of the internal audit function: organizational status within the entity, application of professional standards, audit plan, access to records, and whether there have been any limitations on the scope of their activities. Further, internal audit departments are often in a unique position organizationally (often reporting directly to the Board of Directors or the audit committee), and generally comply with professional standards developed for the professional practice of internal auditing by The Institute of Internal Auditors and the General Accounting Office, all of which contribute to the competence and objectivity of internal auditors.

The proposed standard on using the work of others does not contain these necessary considerations for using the work of others. As such, we are concerned that audit effectiveness may be reduced through the inappropriate use of the work of others in performing substantive tests in relation to a financial statement audit.

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?

We believe that the proposed standard captures the correct scope of activities that should be considered as relevant activities; however, we suggest providing additional guidance about (1) how and when the auditor would be expected to obtain this understanding as part of the integrated audit, and (2) the expected form of documentation that would be necessary to evidence completion of this presumptively mandatory requirement to search for relevant activities.

With respect to documentation, we are concerned with the possible unintended consequences relative to the interaction between the documentation requirements in the proposed standard and the Board's Auditing Standard No. 3, *Audit Documentation*, as a result of the extensive use of the words "should" and "must" in the proposed standard. The use of these terms, for other than a performance requirement, has the potential to drive a level of documentation that would not add to the effectiveness of the audit. Therefore, we recommend that the Board reconsider the use of the words "should" and "must" to ensure that disproportionate auditor effort is not unnecessarily devoted to documentation.

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

Obtaining this understanding is important to the auditor's assessment of risk, and as such we believe that this requirement will improve audit quality.

22. Is the principal evidence provision that was in AS 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?

We believe that the concept of principal evidence, that is, that the auditor's own work should provide the principal evidence for the auditor's opinion, does not change whether or not the principal evidence concept is reflected in the standard. The audit opinion is the responsibility of the auditor alone and, since this responsibility is not a shared one; the judgment about the sufficiency of evidence to support the opinion can only be made by the auditor. Therefore, while we agree that there is no need to define "principal evidence," we believe that the standard should clearly state that the auditor is solely responsible for the audit, so the auditor should perform sufficient work to support the opinion.

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?**

With the increased emphasis on using the work of others, it is important that the framework for evaluating the competence and objectivity of persons performing testing be clear and unambiguous. We believe that the proposed standard is unclear in a number of respects:

- With respect to competence, the standard should clearly state that when the auditor is assessing competence, this assessment relates to competence with respect to auditing principles and internal control testing procedures. Competence in areas other than these is irrelevant. This clarification was not necessary in AU sec. 322, since that standard dealt with the auditor's consideration of the internal audit function only. Please see our response to question 19 for further discussion.
- With respect to the smaller company environment, additional guidance would be useful about how reliance on the work of others may be accomplished. The smaller company environment is unique in that areas of concern such as segregation of duties and the risk of management override may hinder efforts to use the work of others.
- We also believe that the discussion of risk and its impact on the extent of the use of the work of others, included in paragraph 11 of the proposed standard, should be expanded to include concepts similar to those in paragraphs 21 and 22 of AU sec. 322:

> Paragraph 21 provides that when the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, the auditor should perform sufficient procedures to fulfill his or her responsibility to obtain sufficient, competent evidential matter to support the auditor's report. Consideration of the use of internal auditors' work in these circumstances cannot alone reduce audit risk to an acceptable level to

eliminate the necessity for the auditor to perform tests of those assertions directly.

Paragraph 22 provides that for assertions related to less material amounts, where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is low, and after consideration of certain other factors, such that audit risk has been reduced to an acceptable level, direct testing of the assertions by the auditor may not be necessary.

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

Please see our response to question 19 above.

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 it is appropriate to consider the company's policies addressing compensation arrangements for individuals performing tests of controls as a factor in concluding on objectivity. However, we do not believe that any person on the company's payroll is automatically rendered not objective.

- Recalibrating the Walkthrough Requirements

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

We believe that this approach may reduce the number of walkthroughs performed in certain circumstances where a company has a lot of less significant or low risk sub-processes. We do not believe audit quality is impaired by this change as the proposed standard appropriately considers that differing transactions within a significant process may have different associated inherent risks and may affect the types of controls necessary to adequately address the risks. The proposed standard also discusses the concept of probing inquiries to ensure the auditor gains a sufficient understanding of the process and is able to identify important points at which a necessary control is missing or not designed effectively.

We also believe that the use of probing inquiries may be appropriate instead of a walkthrough for some other processes in addition to the period-end financial reporting process described in the standard. For example, in a process where there are only a few transactions (which are material) that flow through the process, we believe that probing inquiries may in some instances be more efficient than a walkthrough. We recommend that rather than giving one example, such as the period-end financial reporting process, that the proposed standard provide factors auditors should consider when evaluating whether walkthroughs or the use of probing inquiries provide sufficient evidence about how transactions are recorded.

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?

Using the work of others as direct assistance in the performance of walkthroughs *may* be appropriate in areas that the auditor considers to be low risk. However, we would expect to use others in this role on a rotational basis to introduce unpredictability into the audit approach.

- Scaling the Audit for Smaller Companies

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?

An audit of ICFR for smaller public companies presents unique challenges that require auditors to consider each company's unique facts and circumstances in developing an audit approach. Smaller public companies, by their nature, are less complex and have control structures that are often less formal than their larger counterparts. We believe that the proposed standard appropriately recognizes these differences as it requires auditors to consider a company's size and complexity when planning audit procedures.

While we agree that this evaluation is appropriate, we believe that the consideration of the size and complexity of a company may at times be apparent, based solely on its mere size, so that there should be no need for documentation regarding this evaluation in such circumstances. As such, we believe that the requirement that states, "The auditor should document how the size and complexity of the company affected the audit," may drive a documentation requirement that may not be appropriate in all instances and therefore result in inefficiencies.

In this regard, it is unclear what documentation would be required to evidence consideration of these factors. It is not clear whether it would be necessary to document this consideration for each engagement within the engagement workpapers, or whether this could be accomplished solely through a firm's audit methodology and training that would emphasize these items.

Further, we believe that there are sometimes differences in how an ICFR audit is integrated with a financial statement audit for smaller public companies that should be addressed in the proposed standard. For example, it might make sense in some situations, such as where the client lacks appropriate segregation of duties and/or lacks appropriate accounting knowledge and expertise such that reliance on controls in the financial statement audit is not contemplated, that efficiencies may be gained by concentrating ICFR testing at year end rather than throughout the year. This would allow for smaller sample sizes based on the smaller population being tested.

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

We have no comments on this question.

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?

We believe that it would be useful to include additional guidance with respect to testing controls that are based on management's daily interaction, including how to determine these controls are effective when there is minimal written documentation evidencing the operation of the control.

When only less formal documentation is available, the proposed standard allows inquiry and observation to support operating effectiveness. We suggest that this lower level of evidence be permitted only in circumstances where this approach is supported by the risk assessment. This approach recognizes that the lower the auditor's assessment of risk of material misstatement, the more likely that inquiry and observation would be appropriate tests of the operating effectiveness of controls.

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

We have no comments on this question.

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?

While we agree that market capitalization and revenue thresholds are useful indicators of a company's size for setting regulatory reporting requirements, we do not believe that these thresholds are necessarily the only relevant factors for purposes of planning and performing an audit of ICFR.

There is no bright line that distinguishes a smaller company from a larger one. Therefore, we believe that the determination about the size and complexity of a company should be left to auditor judgment based on criteria set forth in the proposed standard and as set forth in the Internal Control over Financial Reporting – Guidance for Smaller Public Companies, published by the Committee of Sponsoring Organizations.

Proposed Rule 3525 – Audit Committee Pre-approval of Services Related to Internal Control

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?

We believe that the scope of services to be provided should be discussed with and approved by the Audit Committee. The proposed standard states that in circumstances where the auditor concludes it will be necessary to disclaim an opinion, no additional work should be performed after such determination is made. We believe that the standard should require the auditor to discuss this situation with the Audit Committee and require the Audit Committee to determine whether or not any additional testing of controls should be performed.

Effective Date

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?

We believe that the sooner the new standard is adopted, the more audit firms will be able to take advantage its benefits. We believe that auditors should be permitted to use the provisions of the final standard to support any opinion dated after the release of the standard, but the standard should not be mandated for audits of companies that have a year-end within 6 months of the date the standard is released.

Additional Comments for the Board's Consideration

- Relevant Assertions

Paragraph 31 of the proposed standard on auditing internal control directs auditors to identify relevant assertions by determining the "likely sources of those potential misstatements in each significant account that would cause the financial statements to be materially misstated." This contrasts with AICPA Statement on Auditing Standards ("SAS") No. 106, which defines a relevant assertion as having a "meaningful bearing" on whether an account is fairly stated. Using the AICPA definition, all assertions, other than those that are truly not applicable would be considered to have a "meaningful bearing," even though they may be lower risk.

There seems to be a difference in focus between these two definitions such that a relevant assertion under SAS 106 would not necessarily be a relevant assertion under the proposed standard. For example, if the fixed asset financial statement account is considered a significant account, under SAS 106, the relevant assertions would ordinarily include: existence or occurrence, completeness, valuation or allocation, rights and obligations, and presentation and disclosure. However, these same assertions may not necessarily be considered relevant assertions under the proposed standard, since relevant assertions are based on the likely source of potential misstatement.

We understand that the Board has not adopted SAS 106. However, we are concerned about the confusion that may arise from different meanings for the same term. If this difference in focus is the intention of the Board, we believe this distinction should be made more clearly, and examples that demonstrate how this consideration should be made would be helpful.

- Foreign Private Issuers

The Securities and Exchange Commission has provided guidance to management about how to plan and conduct its evaluation process for foreign private issuers (based on their primary financial statements) in addition to how to evaluate control deficiencies (in relation to both the amounts reported in the primary financial statements and amounts reported in the U.S. GAAP reconciliation). We suggest that the Board provide equivalent auditing guidance to reduce the likelihood of auditors and management reaching different decisions about scoping and the severity of deficiencies in these circumstances.

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We appreciate your consideration of our comments and suggestions and we would be pleased to discuss these with you at your convenience. Please direct any questions to Wayne Kolins, National Director of Assurance at 212-885-8595 (wkolins@bdo.com)

Very truly yours,

/s/ BDO Seidman, LLP

BDO Seidman, LLP

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RE: SEC File Number S7-24-06
PCAOB Rulemaking Docket Matter Number 021

Dear Chairman Cox and Chairman Olson:

On behalf of its members, the Biotechnology Industry Organization ("BIO") is pleased to provide comments on the proposed rulemaking by the Securities and Exchange Commission ("SEC") and the Public Company Accounting Oversight Board ("PCAOB") to clarify, reform and amend the guidance to public companies and their auditors on implementation of Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX" or "Sarbanes-Oxley").

BIO represents over 1,100 members, including over 850 private and public biotechnology companies of all sizes, as well as academic centers, state affiliates and related organizations. Together, BIO members are advancing the vision of using biotechnology to improve health, feed a growing population and develop more efficient manufacturing processes and sustainable energy sources.

Dramatic advances in these fields require substantial investment, and biotechnology companies are heavily dependent on well-functioning capital markets. We are therefore committed to working with both the SEC and the PCAOB toward the development of a regulatory framework that enhances the strength, depth and integrity of these markets. In that spirit, we offer the following comments on the SEC's proposed interpretive guidance and the PCAOB's draft Auditing Standard No. 5.

BIO applauds both the SEC and PCAOB for acknowledging that implementation of Section 404 should be scaled to the size of the company and proportionate to the complexity of underlying corporate structures. Regrettably, implementation to date of the simple policy objective of Section 404 demonstrates the risks inherent when the burden of compliance far exceeds any benefit to the company, the capital markets or to the stated public policy objective. The critical test for these reform proposals will not be the words written in the final approved rules package, but how these reform proposals are implemented by auditors and enforced by the SEC and the PCAOB. **Going forward, BIO strongly urges both agencies to undertake a series of steps to monitor how well the objectives of "scalability" and "proportionality" are being achieved.**

BIO member companies are engaged in the development of new products that are at the cutting edge of innovation in the health care, energy and agricultural fields. In health care, the development of new therapies to treat disease is a high risk, capital intensive, and long lead-time process that requires strong capital markets to support the necessary research and development. However, a regulatory regime that is inflexible or one in which costs exceed benefits means that resources that could otherwise go to pursuing new cures for disease are instead dedicated to overly burdensome compliance costs. This ultimately weakens and diminishes the very markets and companies that are the engines of American economic growth and innovation.

1. **While BIO commends the efforts of the PCAOB to include revenues to define smaller companies, the SEC should recognize product revenue as a strong indicator of complexity, and the PCAOB should direct auditors to consider it as an important factor in scaling audits for smaller companies.**

One of the key elements of "scalability" is the basis on which the company is being judged. As described above, biotechnology companies frequently are in the position of having little or no revenues for an extended period of time, even while publicly owned. During this period of time, these biotech companies have large research and development expenses as well as overhead, and are generally straightforward from an accounting and internal controls standpoint. However, due to investor sentiments, biotech companies may have high market capitalizations during this same period.

BIO recommends that the SEC and PCAOB follow the spirit of the recommendation of the SEC's Advisory Committee on Smaller Public Companies: "The concept we are trying to convey in providing relief for small cap companies with less than $10 million in annual product revenues is that full Section 404 compliance is not appropriate for uncomplicated business organizations with much potential but simple current operations from an accounting standpoint." While the Advisory Committee's recommendation was for exemptive relief, we urge that the SEC and PCAOB nonetheless implement the intent of the Advisory Committee: that companies with little or no product revenues should have scaled, more appropriate implementation.

Product revenue, rather than market capitalization, is a far better metric for organizational complexity and the challenges that management could face with respect to internal controls for financial reporting. Product revenues suggest that the organization may face revenue recognition, inventory management, and product manufacturing issues that would not be the case for an emerging biotech firm that remains in the research and development phase, but nevertheless has a several hundred million dollar market cap.

In our September 12, 2006 comment letter to the SEC on Release No. 34-54133 and Release No. 33-8731, BIO, along with several other trade groups representing biotechnology, healthcare technology, information and communications technology, electronics and semiconductor industries, strongly supported the recommendation of the SEC's Small Business Advisory Committee that a more appropriate test for inclusion in this smaller company category should be based upon a "revenue filter," or product revenues. In that letter, we noted:

> This approach reflects corporate reality in that product revenues drive the complexity of corporate structures and the corresponding need for increased internal controls to protect against financial fraud. Scaling Section 404, requirements, in part, on product revenues is critical to smaller companies in our industries. Biotech and other innovative start-up companies generally have very low revenues compared to their market capitalizations. For example, it is not uncommon for an early stage public biotech company with a market capitalization of $700 million to have product revenues of $1 million or less.

Indeed the Advisory Committee itself suggests that while it would "defer to the SEC as to how the term "product revenue" should be defined... We would assume that the SEC would define the term similarly to the way it provides for the disclosure of product and services revenue in Section 5-03 in SEC Regulation S-X, 17 CFR 210.5-03, but exclude license fees, and research and development payments, milestone payments, and other payments received from an unrelated third party before product sales have commenced under the terms of a collaborative contractual agreement to develop a product."[1] BIO supports the recommendation of the Advisory Committee.

[1] See page 46, Footnote 106 – Final Report of the Advisory Committee on Smaller Public Companies to the Securities and Exchange Commission (April 23, 2006).

The introduction to the PCAOB's proposed Auditing Standard No. 5, in discussing factors to identify smaller companies appears to emphasize market capitalization as a threshold factor in choosing to use the scaled down approach, while the proposed audit standard itself mentions in a note both market capitalization and revenues to define "smaller companies."[2] BIO commends this effort to include revenues as a test for scalability of an internal controls audit, with a specific level of revenues. However, this should be drawn out and not simply made part of a note. Furthermore, depending on the application of these two standards, a combination of the two may still unfortunately penalize companies in the implementation of the audit. BIO urges that the test should be market capitalization OR product revenues, not both.

Applying a market capitalization or revenue standard will alleviate concerns with the potential conflict of interest relating to the incentives of the auditor who is charged with evaluating the "size and complexity of a company in planning and performing the audit" and also being the company providing the work.[3] In pursuing its incentive to maximize profits, an auditor has an economic incentive to determine a company too large and too complex, thus requiring an extensive audit mandating additional hours of billing, etc. While we are aware previous guidance required two Independent Auditor opinions, we believe that retaining the opinion on internal controls without an objective bright line test will not significantly decrease audit fees.

In addition, some – like SEC Chief Accountant Conrad Hewitt as well as principals of the big accounting firms - have suggested auditors currently face unlimited exposure to legal liability and thus should receive some sort of limitation or cap on such liability.[4] While we make no policy judgment on that issue at this time, the mere consideration does suggest an auditor has great incentive to be overly ambitious with its internal control opinion in an effort to protect itself from such liability and the costs associated with litigation.

Combined, these two incentives provide auditors powerful reasons to require excessively detailed internal controls. Such actions may benefit and protect the auditor, but do not necessarily serve the purpose of this proposal or the marketplace. Neither do such actions coincide with Congressional intent. The Senate Committee's report on Section 404 is clear: "the Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees."[5]

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[2] P. A1-7-Standard indicates that companies with a market capitalization of approximately $700 million or less, with reported annual revenues of approximately $250 million or less, "should be considered smaller companies."

[3] See page 28 of the proposal. Proposal-2006-00 http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf.

[4] See Taub, Stephen. CFO.com "SEC's Hewitt: Indemnify the Big Four," CFO.com, Stephen Taub 26 January 2007; and www.pwc.com, "Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks" November, 2006.

[5] S. Rep. No. 107-205, at 31 (2002).

For these reasons, BIO strongly believes that the goal of making implementation of Section 404 appropriate to the size and complexity of individual companies would be best served by implementing a standard specifically referencing a threshold for product revenues (or at least total revenues) in the discussion of smaller companies.

2. BIO commends efforts to draw out materiality standards by both SEC and PCAOB, but there needs to be significant improvements in implementation to reduce inconsistency in application.

One of the continuing concerns about implementation of Section 404 to date has been the multiple and vague standards to which management is held in determining that a company has sufficient internal controls on its financial reporting. BIO commends the SEC and PCAOB for their efforts to address the definition of "materiality" to make it both more reasonable and more consistent.

In particular, BIO congratulates the PCAOB for recognizing that it's earlier standard - that the an internal control deficiency had more than a "remote likelihood" of causing a misstatement of the financial statement – was vague, confusing and resulted in unnecessary costs and audit burdens, especially for small companies. BIO is pleased and encouraged that both the SEC proposal and the PCAOB proposal now use the same standard of materiality: " A material weakness is a deficiency, or combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's ICFR."[6]

However, even this important reform may not go sufficiently far to provide certainty and consistency in its application.

First, while BIO respects that both auditors and corporate managers require flexibility in making determinations as to what is or isn't material, we remain concerned that there is still a great deal of inconsistency in its application. For example, we have heard concerns from member companies, who after changing auditors, experience new interpretations of what is the definition of a material weakness. Even within the context of a principals-based approach to auditing, some clear guidance on this point would be useful.

Second, we would also note that PCAOB guidance itself can be confusing because the same definitions are not uniformly used throughout in guiding auditors in what they should be looking for. The PCAOB uses the term "materiality" as it currently applies to a public company's annual financial statements, but also uses other terms such as "control deficiency" and "significant deficiency." Further on, the PCAOB uses the phrase "deficiency or combination of deficiencies" without any either previously stated modifiers of "control" or "significant."

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[6] See page 13 of the proposal. Release 33-8762 http://sec.gov/rules/proposed/2006/33-876d2.pdf

If, as stated in the proposal that the "auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness"[7] why are other standards used elsewhere in the guidance?

The ultimate concern with regard to vague or multiple standards is that the auditors will come in and determine those standards for our companies. This could result in a continuation of the lack of uniformity and create standards that are far too burdensome and far too costly. We view this as a significant risk to capital formation and the ability of the management of our companies to execute their respective duties.

3. Auditors should be required to use the work of others such as management monitoring and testing that is done in accordance with SEC guidance.

BIO has urged the SEC and PCAOB that any reforms to Sarbanes-Oxley be risk-based. This orientation is critical for ensuring the appropriate level of both management and auditor oversight to internal controls processes. BIO commends both SEC and PCAOB's mindfulness of this principle in developing their proposals.

BIO supports the SEC's guidance that management may use evidence from on-going monitoring and its own direct testing of controls, particularly in lower-risk areas.[8] Specifically, the SEC's interpretive guidance describes that "a small company with less complex business processes that operate on a centralized basis and with little change in the risks or processes, management's daily involvement with the business may provide it with adequate knowledge to appropriately identify reporting risks."[9] Indeed, for the vast majority of BIO's companies, which are engaged in project-oriented research over long time horizons funded generally by a combination of venture capital plus public investment, the complexity tends to be relatively low.

However, BIO is concerned that there are inconsistencies between the SEC proposed guidance and the PCAOB proposals. Confusion or conflicts between the two rules create uncertainty with corporate management as to which is the appropriate standard to follow.

For example, efficiencies created by the SEC guidance to management could potentially be offset by the PCAOB's proposed auditing standard "Considering and Using the Work of Others in an Audit." To guard against this result, we believe the

[7] See page A1-27 of Appendix 1 of the proposal. Proposal-2006-00- http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf.

[8] See page 36 of the proposal. Release 33-8762 http://sec.gov/rules/proposed/2006/33-876d2.pdf.

[9] See page 24 of the proposal. Release 33-8762, http://sec.gov/rules/proposed/2006/33-876d2.pdf

PCAOB should revise this proposed standard to make it clear to auditors that they may rely on management monitoring and testing done in accordance with SEC guidance.[10]

In addition, the PCAOB proposal, while ostensibly allowing auditors to use the work of others, (e.g., corporate management) in making evaluations of internal controls, requires that the auditor first take into account the "objectivity of the individuals who performed the work."[11]

Reconciling this type of inconsistency is particularly important to ensure that the primary goal of these new proposals is met. BIO urges PCAOB to make explicit that management testing that is in conformity with the SEC guidance may be relied upon by auditors in evaluating a company's internal controls. Furthermore, BIO urges that a risk-based approach is not just described in preambles, but actually implemented.

4. BIO urges both the SEC and the PCAOB to continue to work cooperatively to eliminate these seeming disparities, and is pleased that both organizations have worked together to address the many problems that BIO and other organizations have raised regarding the implementation of Section 404 of SOX.

The SEC proposal provides that "an evaluation that complies with the interpretive guidance is one way to satisfy [its] rules."[12] However, to the extent that there is conflict between two regulatory interpretations, it is unclear where that resolution is fully met. While one may construe that the resolution will necessarily occur at the firm's audit committee, nevertheless such a committee may have difficulty resolving two equally valid views – those of management and those of its auditor – based on two separate regulatory interpretations. In short, if there is a conflict between the SEC guidance and PCAOB rules, how does that conflict get resolved?

The execution and coordination of policy implementation between the SEC and PCAOB is critically important to achieve the stated objectives and resolve conflicts inherent in the two proposals.

There is substantial interplay between the two proposals that are the subject of this comment letter. The SEC proposal provides broad and general guidance, and embodies a principle-based approach to compliance with Section 404 of SOX, while the PCAOB proposal is far more specific and detailed. However, in some cases, the PCAOB proposal, through its implementation by auditors, may in some cases conflict with the policy intentions outlined by both agencies. For example, one of the objectives of these

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[10] See A2-10, A2-15 of Appendix 2 of the proposal. Proposal-2006-00- http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf.

[11] See A2-10, A2-15 of Appendix 2 of the proposal. Proposal-2006-00- http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf.

[12] See page 1 of the proposal. Release 33-8762 http://sec.gov/rules/proposed/2006/33-876d2.pdf

proposals is to reduce the unnecessary compliance burden, it is unclear how PCAOB will address overly conservative applications of its new Auditing Standard No. 5 (when implemented) which create undue costs for management. The PCAOB should examine both the inadequate and the unduly aggressive applications of its standard and discourage both in its examination of auditors.

BIO urges both the SEC and the PCAOB to continue to work cooperatively to eliminate these seeming disparities, and is pleased that both organizations have worked together to address the many problems that BIO and other organizations have raised regarding the implementation of Section 404 of SOX. **However, should it be necessary to ensure policy consistency and reduced compliance burdens, BIO encourages the SEC to use, if necessary, its authority to amend PCAOB rules under Section 107(b)(5) of Sarbanes-Oxley.**

Cost/Benefit Analysis

In our aforementioned September 12, 2006 letter, BIO urged that any reforms reflect a rational cost/benefit balance. Unfortunately, there is little formal discussion of costs and benefits in either the SEC or PCAOB's proposal. Given the disproportionately high cost of Section 404 compliance for smaller companies, it is critical that both proposals review modifications under the light of costs and benefits.

BIO urges the SEC to utilize its Office of Chief Economist to provide sound economic analysis of the costs and benefits of the SEC's guidance the implementation of that guidance under AS5. Neither the SEC nor the PCAOB has subjected their proposals to a rigorous cost/benefit analysis performed by an economist. While we applaud the intent of both proposals, we would note that the SEC's cost/benefit analysis[13] is wholly qualitative and is lacking in any quantitative analysis. The PCAOB proposal lacks any attempt to measure the costs and benefits associated with its rules. Pure economics should not be a driver of auditing standards and practices, but to wholly ignore the economic consequences of adopting certain rules is equally inappropriate and may help explain how many observers believe that certain auditing rules and regulations are divorced from reality.

A true and meaningful cost/benefit analysis going forward may assist both agencies in determining further reforms that may be necessary to reduce unnecessary compliance costs, particularly for smaller companies with limited product or other revenues. BIO strongly urges the SEC to utilize its Office of Chief Economist to perform, on an ongoing basis, quantitative analysis of the costs associated with its proposed guidance and measure those costs against the incremental public policy benefits qualitatively spelled out in the release.

[13] See page 54-59 of the proposal. Release 33-8762 http://sec.gov/rules/proposed/2006/33-876d2.pdf.

Additional Deferrals for Non-Accelerated Filers

BIO commends the SEC for its action regarding the extension of deadlines for both filing the management's assessment and the auditor attestation to fiscal years for non-accelerated filers that was taken on December 15, 2006. Many BIO member companies fall into this category of company, and the regulatory burdens of Section 404 have hit these companies perhaps most acutely. Accordingly, as the SEC and PCAOB seek to make adjustments to the implementation of Sarbanes-Oxley, it is fully appropriate that the implementation timeline for these emerging companies should be delayed while new standards are set and procedures established.

CONCLUSION

BIO strongly urges the SEC and the PCAOB to move expeditiously to finalize these rules with any changes necessary to improve or clarify the proposals. BIO welcomes the recognition by both agencies that previous implementation of Section 404 of Sarbanes-Oxley was rigid, overly burdensome and inappropriate for smaller companies. The net effect of the previous implementation was not to reduce corporate fraud or improve the accuracy of financial statements but, in fact, to deter companies from seeking financing from public markets, weaken the US competitiveness in a global economy and drive scarce corporate resources away from job creation, growth and investment and into compliance and audit fees.

We hope that the stated desire to adopt more flexible, scaled and proportionate rules for the audit of internal controls succeeds in achieving its aims. Continued attention by both agencies to the success of these proposals will be integral to making that determination and to understanding what further steps should be taken to make sure that our capital markets and public companies operate with the integrity and efficiency required by truly global economy.

Sincerely,

Alan F. Eisenberg
Executive Vice President
Emerging Companies & Business Development

Iain Macdonald
Group Vice President & Group Controller

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25 February 2007

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

RE: Rulemaking Docket Matter No. 021

Dear Sir or Madam,

BP plc appreciates the opportunity to comment on PCAOB Release No. 2006-007 "An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements."

We believe that the issuance of the proposed guidance will improve communication between public companies and their auditors and increase the efficiency of integrated audits. Comments on specific sections of the proposed guidance are provided below.

We encourage the use of walkthroughs to evaluate the design and operating effectiveness of lower risk controls, particularly controls around routine, recurring transactions that do not involve the application of complex accounting policies.

The standard should allow an auditor to conclude that no deficiency exists when one of the strong indicators is present as long as there is reasonable support behind the conclusion as this approach will allow auditors to exercise judgement and base their conclusion on the specific facts and circumstances of the client.

The proposed removal of the requirement for an auditor evaluation of management's process will provide additional clarity without compromising the integrity of the audit, since this opinion is not considered to add value to the process. The removal of this language will not result in a drastic reduction of unnecessary audit work; however, it will reduce the likelihood of misinterpretation of the guidance. This change will also focus the auditor's attention on the design and operating effectiveness of internal control over financial reporting, which is the most critical control related element of an integrated audit.

Under Accounting Standard No. 2, auditors were placed at a disadvantage as the standard required each year's audit to "stand on its own"; therefore, auditors could not properly utilize the experience gained from past work, which could dissuade auditors from employing a risk-based approach. The removal of this language as proposed by the new standard is viewed as a key change that will increase the audit efficiency.

The proposed revisions to the guidance related to the auditor's use of the work of others are considered to be positive changes. The principal evidence provision contained in Auditing Standard No. 2 implies that the work performed by non-auditors is not reliable, and that guidance could actually deter auditors from relying on high-quality work in certain situations. The proposed update will allow auditors to use judgement to determine when it is appropriate to rely on the work of others.

Since the proposed standard is considered to be an improvement to the audit guidance, we would encourage the PCAOB to issue the new standard as soon as practical. The release of this guidance is not expected to negatively impact the current year audit.

We appreciate your consideration of our comments on the proposed PCAOB Auditing Standard.

Sincerely,

Iain Macdonald
Group Vice President &
Group Controller

BROWN-FORMAN

ANDY KIM
Director

JANE MORREAU
VICE PRESIDENT,
CONTROLLER

February 26, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Re: Proposed Interpretive Guidance, Rules and Auditing Standard Related to Management's Report on Internal Control Over Financial Reporting, PCAOB Rulemaking Docket Matter No. 021

Dear Ms. Morris and the Public Company Accounting Oversight Board:

Our company is very pleased that the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) have closely monitored the effects of Sarbanes Oxley (SOX) Section 404 and the Auditing Standard No. 2 (AS2) over the last two annual reporting cycles. We agree with your assessment that the audit of internal controls over financial reporting has produced significant benefits but that benefit has come at a significant cost. We are encouraged by the initial draft of the proposed new standard.

Our company responded to the SEC *Concept Release Concerning Management's Reports on Internal Control over Financial Reporting* on September 18, 2006. Our letter included a number of recommendations aimed at improving the efficiency of complying with SOX 404. We are encouraged the SEC and the PCAOB have addressed many of the issues discussed in our previous letter through the PCAOB's proposed Auditing Standard No. 5 (AS5), *An Audit of Internal Controls Over Financial Reporting That Is Integrated with An Audit of Financial Statements* and the SEC's proposed interpretive guidance and rules related to management's report on internal control over financial reporting as set forth in Release No. 33-8762. However, there are two points that we believe have not yet been adequately addressed but that should be in keeping with the spirit and reasoning of the newly proposed Auditing Standard. In particular, we strongly encourage the SEC and the PCAOB to:

- Consider abandoning multiple classifications of deficiencies in favor of focusing on material weaknesses, leaving to management the discretion as to how to communicate lesser deficiencies to its audit committee , outside auditors and shareholders; and
- Clarify the definition of what constitutes strong entity-wide controls and articulate how such strong entity-wide controls may lessen the transactional testing requirements.

Reassess the Need for Three Deficiency Classifications

We believe that the SEC and the PCAOB need to reassess the necessity of having three classifications of deficiencies. Shareholders should be informed of material weaknesses, but knowledge of minor control deficiencies or those that are the consequence of unintentional, human error does not benefit investors. We recommend focusing only on material weaknesses, and allowing the company to determine how lesser deficiencies are communicated to its audit committee, outside auditors and shareholders. With this approach, we would recommend that a company continue to track and communicate all deficiencies to its outside auditor so that issues can be assessed and aggregated as needed.

More Guidance Needed on Entity-Wide Controls

Although much focus has been placed on the need for strong entity-wide controls, the majority of the work required to assess internal controls for SOX 404 purposes involves documentation and testing of detailed, transactional based controls. This approach, in our experience, results in excessive documentation and testing without providing much additional assurance that controls are effective.

Currently, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework provides some examples of entity wide controls, but determining which controls directly impact “financial reporting” is challenging in the absence of clear guidance. Additionally, the control environment components are often difficult to assess. For example, COSO states that the critical factors in a company’s control environment are driven by the people and the individual attributes of the company including integrity, ethical values, and competence. But, how do we further measure these attributes, and against what standard? No real guidance is provided. COSO states that the entire financial statement process should be monitored. Again, no real guidance has been provided in terms of the degree of monitoring required, and level of detail that shall be marked.

We applaud the SEC’s and the PCAOB’s recognition that external auditors can rely on some of the work of other companies when testing the control environment. However, to make SOX 404 more effective and efficient, we believe a better definition or standard of what entity wide controls should be tested would be highly beneficial. If a clearer definition or standard existed for measuring the effectiveness of the control environment, we believe a company with strong entity-wide controls should undergo less detailed transaction control testing (for SOX 404 purposes) and less substantive work (in connection with the Financial Statement audit) should be performed by our auditor. We believe this is consistent with the spirit of the proposed new Auditing Standard.

Furthermore, we strongly urge the SEC and the PCAOB to continue to identify ways to improve the “integrated audit” approach to minimize the overall work performed. We hope that you will consider our recommendations to continue to improve the process.

We would like to commend the SEC and the PCAOB for their continued efforts to improve the effectiveness of SOX 404. We hope our suggestions, along with others you receive, will assist in improving and refining the standard.

Please feel free to contact us if you would look to discuss our suggestions. We are pleased to participate in this process to moderate these standards.

Sincerely,

Jane Morreau
Vice President and Controller

Andy Kim
Director Internal Auditor

Business Roundtable

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February 28, 2007

VIA FACSIMILIE

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
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

Dear Public Company Accounting Oversight Board:

This letter is submitted on behalf of Business Roundtable, an association of chief executive officers of leading U.S. companies with over $4.5 trillion in annual revenues and more than 10 million employees. Member companies comprise nearly a third of the total value of the U.S. stock market and represent nearly a third of all corporate income taxes paid to the federal government. Roundtable companies give more than $7 billion a year in combined charitable contributions, representing nearly 60 percent of total corporate giving. They are technology innovation leaders, with $86 billion in annual research and development spending – nearly half of the total private R&D spending in the U.S.

Business Roundtable strongly supported the enactment of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), as well as the efforts of the Public Company Accounting Oversight Board (the "Board") to implement Section 404 of Sarbanes-Oxley. We support the Board's proposed new internal control standard (the "Proposal") to supersede Auditing Standard No. 2 ("AS2"). In particular, we support those elements of the Proposal that are designed to focus on matters most significant to internal controls and that enhance the use of a top-down approach. We believe these aspects of the Proposal should make the internal controls audit process more efficient and effective for auditors and public companies.

We also support the important revisions that have been proposed to the process for walkthroughs, the ability to rely on the work of others, and the ability to rely on procedures conducted in prior year audits. These changes, which we have encouraged the Board to undertake, also should significantly aid in streamlining the internal control audit process. *See Letter from Business Roundtable to PCAOB (May 5, 2006); Letter from Business Roundtable to PCAOB (Nov. 26, 2003)* (copy attached).

While AS2 and the Proposal serve a purpose distinct from the recently proposed U.S. Securities and Exchange Commission ("SEC") guidance on internal control evaluations, the interplay between these authorities is critical. Consequently, we encourage the Board to work with the SEC in adopting the Board's final revision to AS2 so as to eliminate any inconsistent elements. For example, both the SEC guidance and the Proposal offer views as to indicators of material weaknesses. Specifically, the Proposal states that an ineffective internal audit function and risk assessment process are each strong indicators of a material weakness. The SEC guidance does not list these as examples of issues the SEC views to be strong indicators of material weakness. To avoid unnecessary confusion between management and auditors in assessing whether a control deficiency constitutes a material weakness, the examples of material weakness indicators should be harmonized in the SEC guidance and the Board's final internal control standard.

We also commend the Board for focusing on some of the important definitions in AS2 in its proposal. In particular, the proposed replacement of the term "more than inconsequential" with the term "significant" in the definition of "significant deficiency" provides a more appropriate threshold for evaluating deficiencies. We believe this clarification will reduce the effort devoted to deficiencies that do not present a reasonable possibility of a misstatement.

Nevertheless, we believe that some of the other definitional changes proposed by the Board may not achieve their desired effect. Specifically, the Board proposes to replace the reference to "more than a remote likelihood" in the definitions of "material weakness" and "significant deficiency," with "reasonable possibility." We are concerned that this may not be sufficient to focus attention on those matters that are most likely to impact the financial statements. In this regard, the Board issued guidance in 2005 indicating that the "more than remote likelihood" standard is intended to mean the "reasonable possibility" of a material misstatement (in the case of a material weakness) or a misstatement (in the case of a significant deficiency). Notwithstanding this guidance, in practice, the threshold at which material weaknesses are identified has still been applied in a very restrictive manner. Thus, we believe that consideration should be given to whether a higher threshold than "reasonable possibility," such as "more likely than not," would more appropriately focus the auditor's attention on the matters that are most likely to impact the financial statements.

Finally, in order for these proposed changes to succeed in making the internal controls process more efficient and effective, auditors must be assured that they will be incorporated into the Board's inspection process. Without assurance that the Board's inspection process will take into account the new auditing standard immediately upon its adoption, auditors will be less inclined to change their procedures. Accordingly, we urge the Board to incorporate into its final standard assurance that the inspection process will align with the new audit standard.

We appreciate the opportunity to present our views on this subject. We want to express our continued support for the underlying premise of Section 404 – effective internal controls. The suggestions we have outlined are designed to enhance the efficiency and effectiveness of the Section 404 process, while still preserving the benefits Congress intended.

Please do not hesitate to contact Thomas Lehner, Director of Public Policy at Business Roundtable at (202) 872-1260 if we can provide further information.

Sincerely,

Michele Cahn Peters

Ms. Michele L. Cahn Peters
Vice President-External Affairs
Xerox Corporation
Chair, Corporate Governance Coordinating Committee
Business Roundtable

Attachments

cc: Mr. Mark Olson, Chairman, PCAOB
Ms. Kayla J. Gillan, Member
Mr. Daniel L. Goelzer, Member
Mr. Bill Gradison, Member
Mr. Chales D. Niemeier, Member

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Patricia Hanahan Engman
Executive Director

BY EMAIL

November 26, 2003

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

Re: ***PCAOB Rulemaking Docket Matter No. 008 (Proposed Auditing Standard – An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements)***

Ladies and Gentlemen:

The following comments are submitted on behalf of the Business Roundtable, an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues. The Business Roundtable strongly supported enactment of the Sarbanes-Oxley Act of 2002 (the "S-O Act"), and we support the efforts of the Public Company Accounting Oversight Board (the "Board") to implement the S-O Act. We appreciate the opportunity to provide you with our views on the Board's recent proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (the "Proposed Standard").

Scope of the Proposed Standard

Under Section 404 of the S-O Act ("Section 404"), management is required to prepare an internal control report that, among other things, is to include an assessment of the effectiveness of the internal control over financial reporting for the issuer. Section 404 separately requires a registered public accounting firm to "attest to, and report on, the assessment made by management of the issuer." Although the statute envisions a discrete responsibility for the auditor under Section 404 – attesting to, and reporting on, management's internal control assessment – the Proposed Standard appears to expand the scope of the auditor's responsibility beyond that contemplated under Section 404. By proposing at the outset that the auditor's attestation required under Section 404 be characterized as "an integrated audit of the financial statements and internal control over financial reporting," we believe that the Proposed Standard proceeds from an incorrect premise.

To fulfill Congress's mandate under Section 404, an auditor clearly needs to perform sufficient attest procedures to reach a conclusion regarding management's own assessment and evaluation of the issuer's internal control over financial reporting. These attest procedures need to be robust and aligned with the scope of the auditor's responsibility under Section 404. However, by proposing that the auditor conduct an audit of the internal control over financial reporting, the Proposed Standard embraces a level of testing that is more extensive than that contemplated under the statute. If Congress had intended the auditor to conduct a full-blown audit of an issuer's internal control over financial reporting, it would have expressed such intent by using the term "audit" rather than "attest," and it would have made clear that the scope of such "audit" extended to the entirety of the issuer's internal control over financial reporting and not just management's assessment of this function. Accordingly, we urge the Board to revisit the scope of the Proposed Standard.

In addition to our concerns around the scope of the standard, we believe that the standard as currently drafted, does not permit an auditor enough latitude to exercise its judgment with respect to what is an appropriate level of testing for the specific company. In companies that have strong control environments, routine transactional processing should only require a minimal amount of detailed testing of the controls. Further, the amount of detailed testing should vary by not only the type of transaction stream, but also by the auditor's judgment as to the risk of a material weakness or significant deficiency based on the control environment, including external factors. For example, the payroll cycle would have regular checks by employees and tax regulators, and therefore, an auditor might deem most of the risk to come from unauthorized people being paid and focus detailed testing on that area. In addition, we believe that auditors should be permitted to vary the level of testing from year to year based upon whether there have been changes in the documented controls.

Finally, we believe that a standard that more appropriately focuses on the significant issues around business risk, fraud prevention and detection would better serve the needs of investors rather than the very prescriptive detailed testing approach in the Proposed Standard.

Using the Work of Management and Others

The Proposed Standard sets forth several principles that limit the ability of the auditor to rely on the work of management and others in conducting the required attestation. Specifically, the Board proposes to prohibit reliance on the work of management and others when the internal controls at issue relate to the prevention or detection of fraud that is reasonably likely to have a material effect on the issuer's financial statements and to restrict reliance where the internal controls relate to non-routine transactions. Reliance is essentially only unfettered where the controls relate to routine processing. In addition, the proposal requires that the auditor's own work, on an overall basis, form the basis for the required attestation.

These proposed restrictions may have been suitable if the proposal were being adopted as a stand-alone effort to enhance internal control over financial reporting, but it is not. The S-O Act and the rules adopted by the U.S. Securities and Exchange Commission (the "SEC") to implement Section 404 already bolster the internal control over financial reporting function. Under Section 404, management is required to design and evaluate the effectiveness of the internal control over financial reporting, to prepare an annual report evaluating this function, and to certify as to the effectiveness of these internal controls. Our members and their financial and accounting teams take these new obligations very seriously. The proposed restrictions on the auditor's ability to rely on the work of management and others give insufficient credit to the significant steps that issuers are taking to comply with the Section 404 requirements.

Rather, the Proposed Standard would require auditors to develop and obtain separate and extensive evidence about whether the internal controls are effective. Consistent with the statutory requirement that the auditor attest to management's evaluation of these controls, the auditor should be able to exercise its judgment in deciding whether to rely on management's or others work with respect to the entire range of internal controls, not simply controls for routine processes. This approach will eliminate duplicative, unnecessary testing that would increase issuers' costs significantly with only questionable benefit, if any, for investors.

The final standard also should reflect attestation procedures that allow auditors to place greater reliance on testing performed by internal auditors. The internal audit function is set up to serve as a separate check on the financial reporting process in addition to the work performed by the external auditor. Yet, the Proposed Standard subjects the work performed by internal audit to the same proposed guidelines for reliance to which others within an issuer organization would be subjected. The final standard should allow an auditor to place greater reliance on work performed by internal audit where the outside auditor views the internal auditor to be sufficiently independent and competent.

Accordingly, the final standard should allow the auditor greater flexibility in determining whether to place reliance on the work performed by management and others within the issuer, including, in particular, the internal audit function.

Evaluation of the Effectiveness of the Audit Committee

The Proposed Standard provides that the auditor should evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting as part of its attestation requirements. The Board proposes that this evaluation should include, among other things, review of the audit committee's independence from management, compliance with applicable listing standards, and the level of involvement and interaction with the auditor (including the committee's role in appointing, retaining and compensating the independent auditor).

We believe that this proposed requirement is particularly inappropriate given the audit committee's direct responsibility for the appointment, compensation, retention and oversight of the registered public accounting firm under Section 301 of the S-O Act and implementing SEC and securities markets rules and listing standards. By creating a dual evaluation standard for the auditor and audit committee, the proposal would establish a clear conflict of interest. Moreover, the audit committee has responsibilities that go well beyond those in which it interacts with the external auditor, and the auditor does not have any particular expertise with respect to such issues as the independence of individual audit committee members from management. Accordingly, we believe that this aspect of the proposal is ill-conceived, and we urge the Board to eliminate it.

Definitional Issues

We have additional concerns about certain of the definitional aspects of the Proposed Standard. First, the Board proposes a "more than remote likelihood" standard to evaluate whether a deficiency rises to the level of a "significant deficiency" and whether a significant deficiency rises to the level of a "material weakness." This proposed standard creates an unreasonably low threshold for placing a purported deficiency into the "significant deficiency" category and for placing a purported "significant deficiency" into the "material weakness" category. We believe the current standard for determining whether the control component reduces to "a relatively low level" the risk of misstatement is more appropriate for each of these definitions, and we urge the Board to adopt this standard.

Second, the definition of "significant deficiency" also includes the concept that the deficiency at issue must be one that results in an inability to prevent or detect fraud that results in a misstatement that is more than "inconsequential in amount." It is unclear what this phrase is intended to mean; more than "inconsequential in amount" could mean relatively de minimis amounts to any given issuer. This construction could lead to the reporting of deficiencies that are by no means material, simply because they represent a perceived, consequential dollar amount. We therefore also urge the Board to replace this vague construction with a "materiality" concept, which has a more familiar and developed meaning under the securities laws.

* * *

We appreciate your consideration of these comments, and we would be happy to discuss these matters further or to meet with you if it would be helpful.

Sincerely,

David L. Shedlarz
Executive Vice President & CFO
Pfizer Inc.
Chairman-Principle Financial Officers Subcommittee
Corporate Governance Coordinating Committee
Business Roundtable

cc: William J. McDonough, Chairman
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
William Gradison, Member
Charles D. Niemeier, Member

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May 5, 2006

VIA FACSIMILIE

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

Re: Internal Control Roundtable

Dear Public Company Accounting Oversight Board:

This letter is submitted on behalf of Business Roundtable, an association of chief executive officers of leading corporations with over $4.5 trillion in annual revenues and more than 10 million employees. Business Roundtable strongly supported the enactment of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), as well as the efforts of the Securities and Exchange Commission (SEC) to implement Sarbanes-Oxley.

We are all in agreement that, in the wake of Enron, Worldcom and several other high-profile corporate scandals, Congress needed to act to restore the integrity of financial reporting. One of the critical measures Congress enacted as part of Sarbanes-Oxley was Section 404, relating to internal controls. The Roundtable companies have embraced Sarbanes-Oxley, including Section 404, and the revised listing standards, and have used the opportunity to improve their corporate governance and their internal controls over financial reporting. The result has been -- as Congress intended -- improved investor confidence in our capital markets.

Now that we have gone through another cycle of the Section 404 process, it is a good opportunity to address implementation issues. Thus, we applaud the SEC for convening the roundtable on May 10, 2006 to reflect on the Section 404 implementation process for the second year in a row. In implementing Section 404 and its related rules, including, in particular, the PCAOB's Auditing Standard No. 2, it continues to be clear that the benefits of Section 404 do not always outweigh the burdens. In this letter, we would like to outline some of the challenges that Section 404 continues to present and offer some suggestions to the SEC and PCAOB with respect to Auditing Standard No. 2.

To be clear, we want to express our continued support for the underlying premise of Section 404 -- effective internal controls over financial reporting. However, as we indicated at the 2005 Section 404 Roundtable, there are steps that the SEC and the PCAOB can take to make the Section 404 process more effective and efficient, while still preserving the benefits Congress intended.

We appreciate the constructive statements in the guidance documents provided last summer by the SEC and the PCAOB, but we believe that more needs to be done to streamline the Section 404 process (see Commission Statement on Implementation of

Internal Control Reporting Requirements, May 16, 2005; Staff Statement on Management's Report on Internal Control over Financial Reporting, May 16, 2005; and PCAOB Release No. 2005-009, Policy Statement Regarding Implementation of Auditing Standard No. 2, An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, May 16, 2005). We are concerned that, against the tremendously detailed backdrop of the text of Auditing Standard No. 2 itself, the guidance offered in these releases last summer has not been sufficiently embraced. Accordingly, we think an actual amendment of Auditing Standard No. 2 is necessary to bring about effective and efficient implementation to diminish the Section 404 process. Among the topics to be addressed, which we noted in our statement filed on April 7, 2005, are:

- *A Change in Tone*: Encourage the auditor to exercise greater professional judgment in the internal control process.

- *The Definition of Significant Deficiency*: The definition in Auditing Standard No. 2 should be modified to reflect a reasonable assurance standard under which public companies and their auditors will focus on concerns that actually may impact financial reporting and thus are of concern to the investing public.

- *Limit Walkthroughs*: Propose that the independent auditor may use its professional judgment to conduct walkthroughs for only a random sampling, rather than all, of the major classes of transactions in any given audit year.

- *Reliance by Auditors on Work of Others*: Clarify that the independent auditor is encouraged to exercise its professional judgment and rely on the work of others, particularly a company's internal audit function, as principal evidence where the independent auditor has considered and reasonably tested the competence, objectivity and independence of those on whom it seeks to rely.

We appreciate the opportunity to present our views on this subject. The suggestions we have outlined are designed to enhance the efficiency of the Section 404 process and Auditing Standard No. 2, while retaining the most important benefit – effective internal controls.

Sincerely,

David Fannin
General Counsel, Office Depot, Inc.
Chairman, Coordinating Committee,
Corporate Governance Task Force Business Roundtable

cc: Mr. Bill Gradison, Acting Chairman, PCAOB

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FEB 26 2007

CalPERS
75 Years

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February 26, 2007

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

RE: Rulemaking Docket Matter No. 021- An Audit of internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, Considering and Using the Work of Others In An Audit

Dear Mr. Seymour:

I am writing you on behalf of the California Public Employees' Retirement System (CalPERS). CalPERS is the largest US Public Pension Fund with total assets of $231.1 billion and more than 1.5 million members. CalPERS is pleased to provide the Board with comment regarding its proposed audit standard on internal controls and financial statement reporting which would supersede Auditing Standard No. 2.

CalPERS supports both section 404 of the Sarbanes-Oxley Act of 2002 and the Public Company Accounting Oversight Board's efforts to enforce adherence to its requirements through issuing this proposed auditing standard which would integrate the audit of internal control over financial reporting with an audit of financial statements. CalPERS submits this comment letter to assist the PCAOB with understanding the interest a large institutional investor has in the proposed standard.

In the fall of 2006, CalPERS provided the SEC some recommendations to ensure adherence by all public companies with the requirements of Section 404. We believe Section 404 of the Sarbanes-Oxley Act of 2002 contributes to the establishment of certainty necessary for investors to maintain confidence in the integrity of a public company's financial statements. CalPERS believes the PCAOB proposed standard is integral for ensuring the integrity of a public company's financial statements. We support the PCAOB with this proposed standard and agree with:

- Emphasizing the importance of risk assessment - emphasizing a top-down, risk-based approach. We strongly agree that auditors should apply the appropriate focus on controls to prevent and detect fraud. We agree with the Board that auditors should evaluate the risk of management override and mitigating actions and determine whether a material weakness exists.

- Clarifying the definitions of significant deficiency and material weakness. We believe this will assist in eliminating any inconsistencies of evaluation and application among audit firms.

- Clarifying the role of materiality by illustrating that the auditor should plan and perform the audit of internal control using the same materiality measures used in the audit of the annual financial statements.

- Permitting consideration of knowledge obtained during previous audits since the auditor will be emphasizing a top-down, risk-based approach adjusting the nature, timing and extent of testing in subsequent years commensurate with the risk.

- Allowing the independent auditor to rely more on the work of others, particularly after the initial audit of internal controls has been completed.

- Adopting proposed Rule 3525 which requires Audit Committee pre-approval of services related to internal control. Just as CalPERS strongly supported the provisions in the proposed rule requiring additional emphasis on the Audit Committee to ensure the independence of the external auditor regarding tax services; CalPERS fervently supports:

    - Describing in writing to the Audit Committee the scope of the proposed service on internal control;
    - Discussing with the Audit Committee the potential effects of the proposed service on internal control on the firm's independence; and
    - Documenting the substance of the firm's discussion with the Audit Committee.

CalPERS believes that having greater transparency in the decisions made by the Audit Committee permits greater investor oversight as well as improves confidence in the capital markets.

Internal Controls are designed and owned by management of a company. We continue to support SEC rules implementing Section 404 of the Act requiring management to evaluate the effectiveness of internal controls. CalPERS does not believe the auditor evaluating management's annual evaluation process is redundant of the opinion on internal control itself or that it contributes to the complexity of the standard and confusion regarding the scope of the auditor's work. Rather, this evaluation of management's review ensures the integrity of a robust review by management and assists the auditor in determining the "tone at the top." Additionally, in our fall 2006 letter to the SEC, we supported the annual certification of processes directly related to the risk of a material weakness and of processes that contribute to the restatement of financial statements.

We encourage the PCAOB not to include dollar limits on the size of a company. This conflicts with a principle based approach and could lead to a tiered approach. We believe one standard is needed for all companies.

CalPERS is prepared to provide assistance to the PCAOB at its request. Please contact Dennis Johnson, Senior Portfolio Manager–Corporate Governance at (916) 795-2731 if there are questions or if we can be of further assistance.

Sincerely,

Russell Read

Russell Read
Chief Investment Officer

Cc: Fred Buenrostro, Chief Executive Officer, CalPERS
Anne Stausboll, Assistant Executive Officer, CalPERS
Christy Wood, Senior Investment Officer, CalPERS
Peter Mixon, General Counsel, CalPERS
Dennis Johnson, Senior Portfolio Manager, CalPERS

From: h.j.campbell@comcast.net [mailto:h.j.campbell@comcast.net]
Sent: Monday, February 26, 2007 10:27 PM
To: Comments; Comments
Subject: Docket 21

My comments are prompted by the following text in the release: “the proposals are designed primarily to - … Eliminate unnecessary procedures by, among other things, removing the requirement to evaluate management's process; permitting consideration of knowledge obtained during previous audits; refocusing the multi-location testing requirements on risk rather than coverage; removing barriers to using the work of others; and recalibrating the walkthrough requirement.

1) I have observed attempts by public companies to have their audit firms rely on the work of internal audit to be cumbersome and problematic. This occurs when the audit firm insists on the internal audit department scribing the audit program, instead of the external auditing firm drafting the audit program based on controls identified by the company, for which the auditing firm has performed a walk-through and found to be designed adequately. When the internal audit department scripts the test plans, the final products often is obtained only after a number of iterations back and forth between internal audit and the external auditing firm.

2) Under the previous guidance it was my understanding that management could not rely on any work performed by the external auditors. This seemed logical since the independent auditors were opining on management’s assessment and if management’s assessment was based in part on any work performed by the independent auditing firm, the external auditors would be opining on their own work. With the proposed rule amendments, without an opinion on the effectiveness of management’s assessment, would, it follow, in principle, that there are instances when management can rely on the work of the external auditor to give it comfort in certain areas regarding the effectiveness of the company’s ICFR? One area that comes to mind is for the external auditors to test some IT controls so that, in the worse case, remediation of any deficiencies can take place early enough and be retested by both the company and the auditing firm and in the best case, the controls be found effective without testing by management.

I look forward to the publication of the Board’s views regarding my comments,

Respectfully,

Hugh J. Campbell Jr., CPA

CANADIAN BANKERS ASSOCIATION

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March 1, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090
USA

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

Dear Sir/Madam:

Re: SEC Subject File S7-24-06
Re: PCAOB Rulemaking Docket Matter No. 021

The Canadian Bankers Association ("CBA") welcomes the opportunity to provide comments on:

i) the paper released by the SEC on December 20, 2006 entitled, "Management's Report on Internal Control over Financial Reporting"; and

ii) the proposed auditing standard issued by the PCAOB on December 19, 2006 entitled, "An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals".

The CBA is a professional industry association that provides information, advocacy, education and operational support services to its members, the 54 chartered banks of Canada, which include domestic banks, foreign banks and branches of foreign banks. The CBA's mission is to be a leading contributor in the development of public policy on issues that affect the financial services sector. A number of CBA members are foreign private issuers and are subject to the requirements of SOX 404, as well as equivalent draft requirements of the Canadian Securities Administrators ("CSA").

We have chosen to provide our comments on the above-noted documents together. Overall, we are pleased that both the SEC and the PCAOB have concluded that a single methodology that meets the needs of every company is not practical. The emphasis on a principles-based approach, specific enough to provide direction but not so prescriptive as to preclude the use of professional judgment in its application, is consistent with suggestions provided by the CBA to the SEC in response to previous proposals issued during 2006.

For the provisions of the *Sarbanes Oxley Act* to be sustainable, management and their auditors need to work together to ensure that the most effective and efficient audit is carried out with appropriate reliance being placed on the work performed by others. The CBA is pleased that the SEC has provided management with useful, practical guidance to assist with increasing the efficiency of the certification process.

We have noted however that inconsistencies between the SEC and PCAOB proposals exist in some areas, some of which are discussed below. These inconsistencies could lead to differences in the approaches taken by management and the auditors, which in turn could hinder the auditors' ability to rely on the work of others. The CBA believes it is important that the new guidance for management and auditors be aligned and consistent in order to gain the necessary efficiencies. Both the SEC and PCAOB proposals will assist management in increasing efficiency of the certification process and reducing costs.

Suggestions for Consideration

The following are our comments on specific provisions within the proposals:

1. Applicability of Policy Revisions

The adoption of changes suggested by the SEC and PCAOB will, without question, result in improved efficiency and effectiveness of internal control evaluations by both management and auditors. As a result, financial reporting stakeholders, including shareholders, auditors and management, will be anxious for early adoption of such changes. We are confident the SEC and PCAOB will do their best to issue this guidance as soon as possible.

Many filers do not have December 31 year-ends, including many of Canada's chartered banks. Nevertheless, there will still be time for management and auditors to incorporate changes in their strategy following the release of the guidance. We request management and auditors be given the option of complying with the new guidance for all fiscal periods ending after its release date, including any remaining fiscal periods that may be ending in 2007.

2. Rotational Testing

The CBA concurs with both the SEC's and PCAOB's emphasis on the use of a risk-based approach to determine the nature, extent and timing of testing of controls. Many useful factors are cited by the SEC and PCAOB for consideration in any properly conducted risk assessment. Of particular note is the PCAOB's support for the use of information obtained from prior years as one such factor. We concur with the PCAOB's view in this regard.

However, the proposed standard allows the auditor the flexibility to reduce testing in subsequent years but does not permit rotational testing. In our view, a true risk-based approach should allow for rotational testing and we believe this form of testing is ideally suited to medium and low risk situations.

3. IT Application Controls

The PCAOB's view on allowing a benchmarking or baselining strategy for automated application controls in subsequent years' audits is based on the auditor verifying and obtaining evidence that the control has not changed since the baseline was established. In our view, any efficiency benefits gained from allowing benchmarking are diminished by the burden of proof required to confirm each individual control has not changed. In principle, the testing of the change management process as part of the general information technology controls should be considered sufficient for reliance on the controls over changes made to applications within its scope.

4. Walkthroughs

The CBA is encouraged by the PCAOB enhancing the opportunities for auditors to rely on the work of others. For walkthroughs, the PCAOB has introduced the direct assistance of others as permissible but unfortunately fell short of permitting full reliance without some element of re-performance or direct participation by the auditors. We believe, under certain conditions and subject to the auditor's professional judgment, the work of others for a walkthrough can be fully relied upon. Such conditions would include a common understanding of the objectives of the walkthrough, agreement with the scope to be covered, agreement as to the means by which the walkthrough will be documented as well as competence and objectivity in the individual performing the walkthrough.

Conclusion

We ask that you consider these comments in the final guidance. The CBA and its members look forward to reviewing the principles-based guidance that will ultimately emerge from the results of these releases and commend the SEC and the PCAOB for their positive response to stakeholders' previous feedback.

Please do not hesitate to contact us if you wish to discuss these comments further.

Sincerely,

Cardinal Health
7000 Cardinal Place
Dublin, Ohio 43017
614.757.7000 main

CardinalHealth

www.cardinalhealth.com

February 26, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 021 (PCAOB Release No. 2006-007)

Dear Sir or Madam,

Cardinal Health, Inc. ("Cardinal Health") is pleased to comment on the PCAOB's proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (the "Proposed PCAOB Standard"). Overall, Cardinal Health believes that the Proposed PCOAB Standards provide helpful guidance in a number of areas, particularly in the use of a top down, risk-based approach to designing and conducting an audit of management's assessment of internal control over financial reporting.

However, after reviewing the Proposed PCAOB Standard, we feel that a few areas could benefit from some expansion or further clarification:

Impact of a Centralized Control Environment on Scoping

With more and more companies taking advantage of shared services models and fully-integrated enterprise resource planning systems, it would be beneficial to provide specific guidance to the auditors on considerations around the scoping process and the extent of detailed control testing required for companies operating in a shared services environment and with fully-integrated enterprise resource planning systems.

Rotational Testing

The Proposed PCAOB Standard mentions that the knowledge gained from prior year's audits should be considered as a factor in the auditor's risk assessment when determining the scope and nature of testing to be performed. The Proposed PCAOB Standard also specifically states that it is not proposing to permit the practice of "rotational" testing, a practice in which the auditor relies on procedures that were performed in prior years for large sections of internal control, refreshing the testing every few years to ensure that nothing has changed and that controls continue to be effective.

It would be beneficial for the guidance to provide some clarification as to why this would not be considered an acceptable approach for lower-risk areas, particularly when one of the main themes of the Proposed PCAOB Standard is to provide the auditor with the flexibility to decide to reduce testing in some areas based on prior knowledge and its affect on the auditor's assessment of risk.

Definition of "Company-Level Controls"

The Proposed PCAOB Standard describes "company-level controls" in paragraph 18 to include a wide variety of control activities, ranging from consideration of the control environment to the controls over the period-end financial reporting process. Given the broad scope of the definition of entity-level controls, there may be some confusion as to exactly what types of procedures are encompassed by entity-level controls.

It may be beneficial to consider refining the definition of entity-level controls to include two categories: those controls that are more general and pervasive but may not detect specific financial reporting risk (e.g. control environment), and those controls that are detailed enough to detect specific financial reporting risk (e.g. controls over the period-end financial reporting process).

In addition, we believe it would be less confusing if the terminology in the Proposed PCAOB Standard ("Company-Level Controls") and the Proposed SEC Ruling ("Entity-Level Controls") are identical.

Test of Controls in an Audit of Financial Statement

Paragraph B7 of the Proposed PCAOB Standard instructs the auditor to evaluate the results of tests of controls when assessing control risk, and that "consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

In addition to the above, it may be beneficial to provide the auditors with guidance in situations where the tests of internal controls prove the control environment to be more effective than previously thought, rather than only indicating those situations in which the auditor should consider expanding the testing of controls.

Using the Work of Others

In paragraph 7 of the proposed auditing standard, *"Considering and Using the Work of Others in an Audit,"* it states the auditor may use the work of others when assessing risk. Further guidance would be helpful to clarify whether the auditor may use the work of others for the purposes of planning. For example, the auditor may use qualitative/quantitative risk assessments and results from management's test of operating effectiveness to further refine the appropriate level of work required to express an opinion on internal control over financial reporting.

In addition, it would be beneficial to provide guidance on whether or not the auditor would be able to rely on walkthroughs performed by management, particularly for lower risk/routine controls.

We believe the concept of reliance on the work of others potentially represents the single biggest efficiency opportunity within the Proposed PCAOB Standards. We believe that clear guidance supplemented by examples of typical areas and approaches seen in practice will go the furthest to achieve the intended objective of avoiding excessive testing by auditors.

<u>Scoping for General IT Controls</u>

Both the Proposed PCAOB Standard and the Proposed SEC Ruling discuss the use of a top-down, risk-based approach to identifying and evaluating management's key controls; however, there is no specific mention of how this approach would apply to the identification and evaluation of General IT Controls ("ITGC").

Companies have generally taken an "all or nothing" approach in determining the scope of ITGC testing. If an application has been identified as being in-scope (because key financial controls either reside on the application or are executed around information produced by that application), then the complete scope of ITGC has historically been examined for that application with little consideration of the risk associated with the individual components of ITGC.

The Institute of Internal Auditors ("IIA") has released guidance entitled the *"Guide to the Assessment of IT General Controls Scope based on Risk"* (GAIT) that is meant to help facilitate the cost-effective scoping of ITGC assessments by helping organizations identify key ITGCs where a failure might indirectly result in a material error in a financial statement. GAIT is driven by four primary principles:

1. The identification of risks and related controls in ITGC processes (e.g., in change management, deployment, access security, and operations) should be a continuation of the top-down and risk-based approach used to identify significant accounts, risks to those accounts, and key controls in the business processes.

2. The ITGC process risks that need to be identified are those that affect critical IT functionality in financially significant applications and related data.

3. The ITGC process risks that need to be identified exist in processes and at various IT layers: application program code, databases, operating systems, and networks.

4. Risks in ITGC processes are mitigated by the achievement of IT control objectives, not individual controls.

It would be beneficial for the Proposed PCAOB Standard to provide some clarity on how a top-down, risk-based approach for scoping should be applied to ITGC, perhaps by incorporating some of the principles included in GAIT as described above.

Sincerely,

Eric Slusser
EVP, Chief Accounting Officer & Controller

CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors, & the Markets

Cynthia M. Fornelli, Executive Director

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February 16, 2007

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

RE: PCAOB Rulemaking Docket Matter No. 21 – *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

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is a newly formed group created by the public company auditing profession to help foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. The CAQ consists of approximately 800 member firms that audit or are interested in auditing public companies. We welcome the opportunity to share our views on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals* (December 19, 2006).

The CAQ supports the PCAOB's proposed auditing standard on internal control over financial reporting and the related proposals. Overall, we believe that these proposals will facilitate continued progress in upholding the investor protections that are so fundamental to the success of the Sarbanes-Oxley Act (the Act) and the market vitality that has been the result of its passage in a manner that better balances costs with benefits. These changes also will serve to improve the effectiveness and efficiency of the processes related to the internal control reporting provisions of the Act.

Since its passage, the Act has served to enhance the integrity of our capital markets and restore investor confidence. It has done so in part by recognizing that effective internal controls are the bedrock of reliable financial reporting. As the PCAOB contemplates issuance of the new standards and related proposals, we strongly believe that change should flow primarily from the desire to reinforce the significant benefits of Section 404 of the Act and the audit of internal control over financial reporting rather than a drive to cut costs.

Investors are the lifeblood of our capital markets system, and that system can not thrive without investors' steady, unwavering belief that legislative and regulatory safeguards are designed for their protection. We believe that the PCAOB's proposals support our mutual and deep commitment to investors and the markets.

We expect the proposed changes, along with the proposals by the Securities and Exchange Commission (SEC), will result in a reduction of total Section 404 efforts, due to various specific, positive changes in the proposals. These would include the ability of an auditor to (a) determine audit coverage based upon risk, without any pre-established quantitative coverage requirement, relative to an issuer's operations; (b) adjust, under certain conditions, the nature, timing and extent of testing of particular controls, based in part on cumulative experience gained in prior audits; and (c) increase the use of the work of others, if certain conditions are met.

We believe that the scope of these reductions in effort, and their relative balance between management effort and auditor effort, will likely vary significantly based on facts and circumstances for each particular company. Factors that will impact these reductions include: (a) the degree to which management undertakes a thoughtful, comprehensive effort to rationalize the controls that it includes in its assessment; (b) the state and quality of an issuer's control structure, as well as the degree of centralization and complexity of its operations, and the risks inherent in its business model; and (c) the quality and commitment management demonstrates in its assessment process, including the quality of its documentation, its tone at the top, and the consideration it gives to various activities it performs, in order to maximize the degree to which these could be used by the auditor.

Because of these and other factors, it is not possible to set the expectation of a specific or across-the-board reduction that the proposals by the PCAOB and the SEC will cause in Section 404-related costs for all companies. Although the effect of the new guidance will vary from company to company, the maximum opportunities for efficiencies and cost-effectiveness in Section 404 implementation can be obtained when management and auditors work together to conduct their assessments in a complementary manner, and when the auditor can make effective use of other's work. We also believe that the benefits from the SEC and PCAOB proposals will be greatest to companies that have not yet initially implemented the requirements of Section 404, such as non-accelerated filers and new public companies. We also expect that the cost of complying with Section 404 can decline as companies and members of the auditing profession become more familiar with the legal and regulatory requirements.

We support the PCAOB's increased emphasis and flexibility on the auditor's use of professional judgment, and its decision to apply a single model of auditor reporting on internal control over financial reporting, that is scalable to companies of varying size *and* complexity.

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We also applaud the PCAOB's project to develop guidance and education for auditors of smaller public companies that is supported by many of the member firms of the CAQ. This project will facilitate scalability of the proposed standard in an effective and efficient manner for audits of these smaller public companies.

The CAQ also supports the PCAOB's plan to require that auditors obtain evidence regarding the operating effectiveness of controls to determine whether the controls in place actually work as intended. Requiring auditors to apply a risk-based approach to testing controls and annual tests of key controls supports the reliability of the audit.

The CAQ appreciates the PCAOB's emphasis on more flexibility in determining the extent to which the work of others may be used by the auditor. However, we believe that changes in the proposed standard on internal control over financial reporting in this area, coupled with the existing standard *"The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"* (AU sec. 322), can achieve the Board's objective of effective and efficient implementation of Section 404. Accordingly, we do not support the Board's proposed standard that would supersede AU sec. 322, as it is unnecessary to achieve the Board's objectives in this area, and may reduce audit effectiveness through the inappropriate use of the work of others.

However, if the Board determines that it is necessary to have a separate standard for considering and using the work of others in an audit that supersedes AU sec. 322, we believe that the Board should incorporate the paragraphs of AU sec. 322 identified in the appendix to this letter, which are missing from the proposed standard, as we consider these to be fundamental to reliance on the work of others, to help ensure both effective and efficient use of the work of others in execution of all aspects of an integrated audit.

A more detailed discussion of our perspective is included in the appendix to this letter, and many of the public company auditing firms that are members of the CAQ will submit their own comment letters.

We appreciate the PCAOB's efforts to improve integrated audits and implementation of the provisions of Section 404, and look forward to working with all market constituents to identify enhancements that improve efficiency without diluting investor protections. We believe that these changes should be implemented as soon as practicable in 2007, allowing for sufficient time for auditors to conduct training and develop methodologies for complying with the final standard and guidance. In this regard, we encourage the Board's accelerated consideration of these proposals, so that the revisions can impact audits for the current year ending December 31, 2007.

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Office of the Secretary
Public Company Accounting Oversight Board
February 16, 2007
Page 4

We appreciate the opportunity to comment on the PCAOB's proposals and would welcome the opportunity to meet with you to clarify any of our comments.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc: PCAOB
Mark W. Olson, Chairman
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
Willis D. Gradison, Member
Charles D. Niemeier, Member
Thomas Ray, Chief Auditor and Director of Professional Standards

SEC
Chairman Christopher Cox
Commissioner Paul S. Atkins
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Commissioner Annette L. Nazareth
Commissioner Kathleen L. Casey
Conrad Hewitt, Chief Accountant
Zoe-Vonna Palmrose, Deputy Chief Accountant for Professional Practice
John W. White, Director of Division of Corporation Finance

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Appendix

The Center for Audit Quality recognizes that there were various requests for comments within the PCAOB's Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals.* However, we would like to state that we have limited our comments to the significant matters noted below on behalf of our member firms. Please refer to the individual public company auditing firm letters for additional comments.

We are very supportive of the direction of the proposed standards, particularly their increased emphasis on appropriate exercise of auditor judgment. However, we offer the following comments intended to improve them to meet the overall goal of making implementation of Section 404 more effective and efficient.

Considering and Using the Work of Others in an Audit

We believe that the changes in the proposed standard on internal control over financial reporting (ICFR) coupled with the existing standard *"The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"* (AU sec. 322) can achieve the Board's objective of effective and efficient implementation of Section 404. Accordingly, we do not support the Board's proposed standard that would supersede AU sec. 322, as it is unnecessary to achieve the Board's objectives in this area, and may reduce audit effectiveness through the inappropriate use of the work of others.

Conversely, if the Board concludes that a new standard is necessary, one very important principle in AU sec. 322 that has not been included in the proposed standard relates to the auditor's ability to use the work of others, where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, and the notion that in these circumstances, the auditor's evidence should not be derived solely from the work of others. We have noted the relevant specific paragraphs from AU sec. 322 below and recommend that the Board add this very important concept to the proposed standard.

> **.21** For assertions related to material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, the auditor should perform sufficient procedures to fulfill the responsibilities described in paragraphs .18 and .19. In determining these procedures, the auditor gives consideration to the results of work (either tests of controls or substantive tests) performed by internal auditors on those particular assertions. However, for such assertions, the consideration of internal auditors' work cannot alone reduce audit risk to an acceptable level to eliminate the necessity to perform tests of those assertions directly by the auditor. Assertions about the

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> valuation of assets and liabilities involving significant accounting estimates, and about the existence and disclosure of related-party transactions, contingencies, uncertainties, and subsequent events, are examples of assertions that might have a high risk of material misstatement or involve a high degree of subjectivity in the evaluation of audit evidence.
>
> **.22** On the other hand, for certain assertions related to less material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is low, the auditor may decide, after considering the circumstances and the results of work (either tests of controls or substantive tests) performed by internal auditors on those particular assertions, that audit risk has been reduced to an acceptable level and that testing of the assertions directly by the auditor may not be necessary. Assertions about the existence of cash, prepaid assets, and fixed-asset additions are examples of assertions that might have a low risk of material misstatement or involve a low degree of subjectivity in the evaluation of audit evidence.

In addition, recognizing that the "principal evidence" concept previously included in *PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements"* has been eliminated, the auditor still must be in a position to positively state in the opinion that he or she has audited the financial statements and management's assessment of ICFR. The ability of the auditor to state such an opinion implies that he or she has obtained principal evidence. As noted in paragraph 9 in the proposed standard on considering and using the work of others in an audit, judgments about the sufficiency of evidence obtained, assessments of risk, the materiality of misstatements, and evaluations of test results must be those of the auditor. We believe that replacing AU sec. 322 with the proposed standard likely will lead to confusion regarding the auditor's implied obligation to obtain principal evidence in support of his or her opinion.

Paragraphs 3 through 6 of the proposed standard describe the auditor's responsibility to determine whether there are activities performed by others that can be used in connection with the audit. We believe that these paragraphs likely will lead to unnecessary effort expended searching for activities significantly removed from those of internal auditors and similar groups described in AU sec. 322 that, upon consideration, will not be useable because of issues related to competence and objectivity or are not tests that provide audit evidence as described in the proposed standard. Accordingly, we see no benefit to adding these paragraphs. If the Board decides to adopt the proposed standard, then we recommend that the discussion of competence and objectivity precede the consideration of relevant activities in order to more appropriately reflect the thought process of the auditor in considering the work of others. In addition, the Board should describe the extent of documentation it would consider appropriate when conducting the activities required in paragraphs 3 through 6.

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Consideration of Fraud and Company-Level Controls

We believe it is important that when an auditor assesses risk when planning the audit, the interaction between the assessed risk of fraud for certain assertions be addressed when scoping the audit of ICFR. We recommend that this notion be clearly articulated in the proposed standard. For example, we believe the Board should better articulate this notion in the interaction between the risk that the control might not be effective as described in paragraph 51 and whether the control is intended to address significant fraud risk.

Another example is that the Board's proposed standard lacks clarity with regard to the consideration of the precision of company-level controls as it relates to the risk of fraud. In other words, we believe that the concept regarding company-level controls cited in paragraph 43 of the proposed standard should be reiterated earlier in the standard – around paragraph 17, the section on Identifying Company-Level Controls – to better address the auditors' consideration of fraud and to better integrate fraud considerations consistent with the concepts in AU sec. 316 "*Consideration of Fraud in a Financial Statement Audit*."

Considering the Effect of Company-Level Controls

The evaluation of company-level controls is an important part of a top-down, risk-based approach and should occur early in the audit. However, we are concerned that, at times, such controls may not operate in a manner that would identify possible breakdowns in lower-level controls. For example, company-level controls may not be designed at a level of precision that would sufficiently address the risk that material misstatements to a relevant financial statement assertion will be prevented or detected.

We believe that the final standard should acknowledge that in many circumstances company-level controls only indirectly relate to relevant assertions (e.g., those controls that primarily operate within the control environment) and do not operate in a manner that would be sufficient to address the risk of material misstatement to specific accounts and disclosures in the financial statements. In addition, we would welcome examples that illustrate the linkage between company-level controls and relevant assertions and the benefit that could be derived from them in determining the nature, timing, and extent of testing of lower-level controls.

Multi-location Scoping Decisions

We are supportive of the Board's refocus of the multi-location testing requirements on risk rather than coverage and likewise are supportive of the deletion of "large portion" from the proposed standard on ICFR. However, we believe that the auditor should not lose sight of the need to obtain sufficient audit evidence to support the auditor's opinion. Accordingly, we suggest that guidance be added to paragraph B13 acknowledging that the responsibility for the opinion expressed in the auditor's report rests solely with the auditor.

Strong Indicators of Material Weaknesses

We have observed that the description of strong indicators of material weaknesses in the Board's proposed standard on ICFR differs from the SEC's proposed management guidance. As indicated in our letter to the SEC on its proposed management guidance, we believe that the SEC should conform its description to the PCAOB's description of such factors. Conforming the two documents will help to reduce potential confusion, inconsistencies, and possible inefficiencies that may occur as a result of differing evaluations by management and auditors of the same control deficiency. Please refer to our comment letter to the SEC on the proposed management guidance on ICFR.

Documentation

We note that there may be possible unintended consequences relative to the interaction between the requirements of the proposed standard on ICFR and the Board's Auditing Standard No. 3 "*Audit Documentation,*" as a result of the use of the words "should" and "must" throughout the proposed standard. For example, paragraph 51 of the proposed standard under the *Relationship of Risk to the Evidence to be Obtained* includes a requirement that "[f]or each control selected for testing, the auditor **should** [emphasis added] assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result." Compliance with this requirement could generate a level of documentation relating to the auditor's assessment of risk as it pertains to documentation required, that may not necessarily add to the level of effectiveness of the audit. Therefore, we recommend that the Board reconsider the use of the words "should" and "must" throughout the proposed standard to ensure that disproportionate auditor effort is not unnecessarily devoted to documenting consideration of items that ordinarily would be incorporated into the auditor's overall methodology.

Precedent of Mandatory Efficiency Requirements

We support the objective of conducting an efficient as well as effective audit, but we are concerned about the precedent established with the inclusion in an auditing standard of presumptively mandatory performance requirements relating to efficiencies. We are concerned that this is inconsistent with the nature of professional standards, and that it may detract from the overarching objective of performing high quality audits – audits that ultimately help protect investors.

Donald H. Chapin, CPA
53 Water's Edge
Rye, NY 10580

February 12, 2007

PCAOB Rulemaking Docket Matter No. 021

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

The internal control standard, AS No. 2, was the Board's first substantive standard. The Board recognized that internal control was an essential underpinning for the effectiveness of all other standards, and that AS No. 2 should address control deficiencies that allowed major frauds.

I am disappointed that the proposals both weaken the effectiveness of AS No. 2 and fail to remedy a major shortcoming in how it addressed those control deficiencies.

This is what I believe happened:

> Company executives and investment bankers brought intense political pressure on the SEC to reduce regulation and its attendant costs. The SEC unduly influenced the deliberations of an independent Board. And, the Board listened to the expressed concerns of companies without hearing much from investor groups and defenders of the public interest. There was a rush to do something. The accounting firms, who have a strong influence on the Board, appear to have been satisfied by the liability limiting reduction of specific requirements, more reliance on judgment, and no expansion of their duty to detect fraud.

While a number of cost reductions are appropriate, the Board appears to have overdone it, and has not done it in ways that would protect investors from major frauds.

Each of the following underlined deficiencies in the Board's proposals is accompanied by commentary in *italics*.

1. The chance of success of the Board's many good cost saving proposals depends, in part, on improving the "old" general standards of auditing.

> In one form or another, the first two improvements suggested below have long been advocated by those concerned with the public interest. Some aspects of the third have been considered by the SAG:

(a) Auditors should be made professionally responsible to investors, stockholders and creditors, and some additional specific rules to further reduce pro-management bias should be adopted.

(b) Auditors' responsibility for the detection of fraud should be strengthened, with sufficient guidance to accomplish this obligation.

(c) Auditors' technical training and proficiency requirements should meet today's demands, with guidance on how to develop and manage the required skills.

The good judgments required by the Board's proposals, and acquiring all the necessary facts to support them, make the above mentioned improvements in the general standards even more necessary than they were for SAS No. 2.

2. <u>In making risk assessments more emphasis should be placed on identifying weaknesses in the control environment.</u>

This is essential for the success of the "top-down, risk based" approach. The proposed required assessments should be expanded to include all the principles of the control environment addressed in a recent COSO report. The proposed assessment process is founded on observable signs and does not, as it should, require follow-up inquires and additional observations or tests of the implementation of any of those control principles that have the potential to contribute to a material weakness in internal control. At this very top level of internal control, auditors should be encouraged to look for significant weaknesses

Weaknesses in the control environment have pervasive effects on all other risk assessments. They have a direct effect on the strength of other company level controls, and increase audit risk at all lower levels of control. Contrary to some views, I believe that limited effectiveness of individual control principles that have a reasonable possibility of contributing to a material weakness, if identified, can help focus the audit on particular areas of control weakness. Sometimes, they can help in identifying specific problematic accounts and disclosures.

3. <u>The proposed standards fail to emphasize that fraud, especially management led fraud, is a far greater control risk than pure error.</u>

Failure to adopt a fraud risk priority is hard to justify in view of the fact that fraud was the major reason for the passage of Sarbanes Oxley and the creation of PCAOB.

Errors in the choice and application of accounting standards do result in material misstatements, but reduction of that risk is helped considerably by the audits of *financial statements. A very good proposal with specific requirements that should help to reduce fraud and also help identify misapplication of accounting standards is the proposal for walkthrough of the period-end financial reporting process.*

But, strangely and discussed later, another proposal reduces the effectiveness of walkthroughs of operations that have the dual purpose of identifying systematic causes of error as well as fraud. The Board's proposal also fails to identify the inherent weaknesses in IT systems that can be used by management to override controls, and IT systems are an integral part of the period-end financial reporting process.

Other types of error ordinarily deserve relatively low priority in both audits because it is probable that they cannot be of such size as to constitute a material error. The major exception to this generalization occurs when company level controls are weak, thus opening the possibility of a great number of small errors.

I think the benefit of close coordination of both audits should be emphasized more than it has, and guidance that would assist that coordination should be issued

The Board should use this opportunity to set more definitive priorities in ways that will both help to make justifiable reductions in audit costs and provide better protection to investors and stockholders from the disastrous losses of major financial statement fraud.

4. <u>The "top-down, risk based" model is deficient in its failure to correct the major shortcoming of AS No. 2, namely its failure to require an effective evaluation of the ethics and integrity of senior management.</u>

There is convincing evidence that senior management commits a very high percentage of the frauds that damage investors and stockholders, and that auditors, in large measure, are failing to detect those frauds.

Investors and stockholders need auditors to apply an anti- fraud standard that will deter management led frauds as well as detect them, including the new types of fraud that are not now addressed and may not be addressed by PCAOB until long after the damage has been done.

To accomplish that, auditors should be required to look for fraud by applying a chain of required processes that start with procedures to appraise senior management's ethics and integrity.

I have made a comprehensive remedial suggestion to the Board. It requires that the partner primarily responsible for the audit make a truly informed decision, based on a careful evaluation of the ethics and integrity of senior management, as *to whether or not management fraud is reasonably possible. Then, working closely with audit committee and with its agreement and help, it requires inquires whose results would indicate whether of not to conduct more extensive forensic auditing procedures.*

The details of this suggestion were previously sent to the SEC as well as the PCAOB.

Individual audit partners will certainly have liability if they fail to apply the designated processes and fraud is not detected as a result. As I understand it, under the way existing law is being interpreted, auditing firms will probably be exposed to additional liability. But, there is good argument that the firms should not have such liability if they were not complicit in the failure of the responsible individual partners to apply the required processes.

Costs of execution of the required anti-fraud processes can be justified by the very substantial reduction of overall audit risk that will permit substantial reductions in other auditing procedures. The benefits of the required processes to investors and the markets are immeasurably great.

The procedures of AU 316 (Consideration of Fraud in a Financial Statement Audit) cannot stop management led fraud. AU 316 requires "discussion among engagement personnel regarding the risk of material misstatement due to fraud", but it does not focus on senior management ethics and integrity. It does not have requirements, as my suggestion has, for specific evaluation processes, decision making, investigative processes and, when indicated, forensic procedures. The need for requirements when it comes to fraud is indicated by recent PCAOB inspections. They found that auditors are not always implementing fraud standards when they should, especially the procedures described in AU 316.

5. The proposals do not include needed improvements in the audit risk standard (AU 312)

The AICPA has already adopted changes in this and in a number of other risk related standards in response to recommendations by the former Public Oversight Board's Panel on Audit Effectiveness. Its new standards mention the need for processes to evaluate risk. I have not had a chance to study their more recently issued implementation guidance, so that I do not know how they suggest applying this requirement.

Taken as a whole the Board's proposals seem to reduce required processes, rather than increase their use to help guide auditor risk assessments. The AICPA guidance should be considered by The Board.

Some time ago, that the Board's staff discussed the audit risk standard (AU 312) with the SAG, but no changes have been proposed. And, there is not much in the existing standard about how to make control risk assessments. I can think of questions that might deserve some coverage, e.g. how higher level control evaluations affect lower ones as the auditor works from top to bottom; and whether, or to what extent, attention should be paid to low risk assessments at the bottom in the face of high risk at the top.

Risk assessment itself is a risky process, especially when there is limited guidance on how to make these judgments.

6. <u>Decreased emphasis on the nature and extent of AS No. 2 walkthroughs increases the likelihood of undetected material weaknesses and successful management fraud.</u>

The impact of the proposed changes goes far beyond what might be thought from just reading the release that accompanies the new proposed standard. They will change what might be considered an audit of transaction flows into a limited review. They will put the auditor more out of touch with what is actually going on, and do not put sufficient emphasis on situations that might accommodate fraud, including controls override.

This is one of the most worthwhile parts of AS No. 2, and was written that way because auditors were not finding major fraud and were not looking for it. Managements will object to attempts to go beyond the confines of what is written in this proposal. This is a good example of proposed changes where reliance on auditor judgment to do the right things is unjustifiably risky.

7. <u>Increased reliance on auditor judgment in lieu of specific requirements in the standards should be coupled with additional evidential requirements and partner level involvement in important judgments</u>

I do not fully understand what the proposal says about evidence and the use of judgment.

It seems to me that evidential requirements for judgments should be similar to those for the audit of financial statements, such as: (a) Auditors should consider all relevant evidential matter, and their judgments should be based on evidence that appears to contradict the company's control evaluation as well as that which supports it, and (b) The evidence for whatever judgment is made should be at least persuasive.

Partners should determine what judgments are important, be aware of the evidence for them, and make them. Critical judgments should require concurrence by the partner responsible for the audit and the "concurring partner".

But, even if additional evidential requirements coupled with participation by responsible partners were imposed, if auditors act as they have in the past when AICPA standards were in effect, the " principles based" approach applied to this inherently more subjective audit of internal control could contribute to audit failure. The general standards, the audit risk standard and the other standards mentioned in this critique need to be strengthened. Back then, important financial statement audit problems were not always identified by the auditors; and, if they were identified, auditor discussions with management frequently led to waiving "borderline" adjustments and disclosures.

8. Defining materiality for internal control as the same as materiality for financial statements may serve to continue auditor failures to identify material weaknesses before misstatements occur.

Materiality for internals control should be determined based in part on what the effects of weaknesses on future financial statements may be, and should always give consideration to weaknesses in company level controls that do not yet relate directly to any particular accounts or disclosures.

It should be stated explicitly that identified significant risks of material misstatement that have continuing control implications should always be reported as material weaknesses in internal control, whether or not transactions or adjustments have been identified that could be the result of those risks.

9. Proposed changes relating to significant weaknesses appear to be problematic; and taken together, they may unnecessarily increase the number of restatements

(a) A proposed change to stop auditors from searching for significant weaknesses may cause auditors to seek to identify only such control deficiencies that in themselves rise to the level of a material weakness, rather than significant deficiencies that taken together might constitute a material weakness.

(b) Defining "significant" as less than material, yet important enough to merit attention by those responsible for oversight of the company's financial reporting, may limit the deficiencies that are reported in writing to the audit committee, and a result in failure to remedy them on a timely basis

(c) Failure to designate a "strong indicator" of a material weakness as at least a significant deficiency should require the auditor to carry the burden of proof that it is not a significant weakness, e.g. have convincing, rather than persuasive, evidence that it is not.

(d) The proposal that reported significant weaknesses, uncorrected over a reasonable period of time, may indicate a material deficiency in the control environment is a good concept. But determining whether or not they should be considered as components of a material weakness at later date is overly dependent on good judgment at a time of stress when the basis for the initial reasoning and evidence for it may not be clearly remembered. As written, the proposal will not force the discussion with management and the audit committee as to whether the weaknesses are truly significant back to the time when they were first identified. This, and the consequent possible delay in remediation, tends to allow some truly significant weaknesses to continue longer than necessary, and thus unnecessarily contribute to restatements.

10. The proposals' advice for "scaling" the audit of smaller companies turns the inherent control risks of smaller companies into a control benefit, by stressing the benefits, more than the risks of greater management involvement in the control environment, the monitoring function, etc.

There is persuasive evidence that smaller companies are more likely to be subject to fraud.

Management must have a high level of ethics and integrity to play a positive role in turning the inherent risks of a smaller company into a controls benefit.

11. The proposal that the auditor needs only to understand management's control evaluation process, rather than evaluate that process, will increase audit risk unless the company's evaluation is a systematic, adequately tested and well documented evaluation.

If the SEC requires that companies use COSO's Guidance for Smaller Public Companies, as amended to include the anticipated improvement in its monitoring component, the suggested approach could work. But, if the basic COSO framework or some other requirement that is also less susceptible to auditor understanding is prescribed by the SEC, then the proposal will increase the difficulties auditors face in determining weaknesses in controls' design and effectiveness.

12. Major problems in applying the proposed standards should be expected.

The "top-down, risk based" audit and its application in a "principles" based standard will be difficult to implement. Similar approaches in the past were unsuccessful. Even if strengthened as I have suggested, it will need interpretive guidance and more competent audit teams.

Large auditing firms using the knowledge and experience of their top professional people may be able develop appropriate interpretive guidance before a new standard becomes effective. The guidance will probably reinstate some of the specifics that the proposals seek to reduce.

It will take longer to build audit teams with the necessary higher skill levels and mature judgment to apply the standard successfully. Better training, development of existing staff, bringing in people with experience and putting more partners on the job will all be necessary.

The problems of smaller firms will be greater, and those will be accentuated by the demand for "scaling".

Audit failures will be high in what is likely to be a long shakedown period.

Conclusions:

The Board has used a flawed "top-down, risk based" approach and encouraged the use of audit judgment in a "principles based" proposal in ways that will substantially increase the risk of audit failure.

The proposal does not cure an important existing shortcoming in AS #2, and fails to make changes in other existing standards that are important adjuncts to an effective internal control standard.

All the effects of the proposal are difficult to comprehend.

I think the comment period should be extended to allow time for investors and their representatives to understand it and express their concerns, so that all the necessary amendments can be considered, and hopefully made.

Sincerely yours,

Donald H. Chapin

End Note:

I am submitting a copy of this critique to the cognizant Congressional Committees as a supplement to my report dated January 3rd titled "Fraud Related Auditing Standards are Inadequate".

Investors and their representatives can obtain an E-mail copy of the January 3rd report, by sending a request to DonChapin@gmail.com.

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February 26, 2007

Office of the Secretary
Public Company Accounting Oversight Board
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Re: PCAOB Rulemaking Docket Matter No. 021

Cisco Systems ("Cisco") appreciates the opportunity to provide our 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").

Overall Observations

Cisco supports the Proposed Standards and their intent to assist auditors in making the audit process more efficient and cost-effective. We also appreciate the standard setting process whereby the audit requirements are further developed and refined in light of feedback from constituents and results from PCAOB examinations. We believe that the top-down, risk-based approach described in the Proposed Standards, will provide an opportunity for companies to work with their external auditors to develop an audit of internal control over financial reporting ("ICFR") that is more cost-effective and focused based on appropriate risk assessments. We also are supportive of the principles based approach which allows for an appropriate level of judgment to be exercised by auditors. We have included our observations and concerns herein regarding the Proposed Standards that we believe would help clarify certain of its provisions.

We believe that the Proposed Standards should be more closely aligned with the interpretive guidance for management proposed by the U.S. Securities and Exchange Commission ("SEC Guidance"). The level of detail in the Proposed Standards seems to be greater and more prescriptive as compared to the SEC Guidance. This could result in a misalignment of risk assessments and test plans between auditors and management which could result in inefficiencies and unnecessary costs.

To date, many companies' Sarbanes-Oxley Section 404 compliance approaches have been largely driven by the requirements set by external auditors. External auditors have been overly prescriptive in their requirements due to their perceived inability to apply judgment using a risk-based approach. Due to the absence of management guidance and an allowable risk-based approach, companies have been required to follow AS2 as well as strict interpretive guidance from the audit firms to satisfy the requirements of the integrated audit without the use of appropriate judgment. With proper alignment, the Proposed Standards and SEC Guidance should provide companies the flexibility to apply a top-down, risk-based approach using an appropriate level of judgment with external auditors being able to leverage a similar approach. We expect companies and auditors would focus their efforts on high risk areas achieving a better balance between internal control risk and the cost of compliance. Without alignment of the external audit standards and the SEC Guidance, companies would continue to focus efforts on the assessment of lower-risk control areas and incur additional costs failing to achieve the objective of a more risk-based and cost effective assessment.

We are also concerned that external auditors will need to be assured that the PCAOB examinations will align with the Proposed Standards. Consistent with the initial implementation of the AS2, auditors will be reluctant to adopt changes in their approach until sufficient PCAOB inspections of their firm's audits have occurred which will effectively result in a delayed implementation of the Proposed Standards. We encourage the PCOAB to provide auditors timely and sufficient guidance as to its inspection expectations under the Proposed Standards to allow for earlier realization of the benefits for both auditors and companies inherent in the Proposed Standards and SEC Guidance.

Other Observations

Top-down, Risk-based Approach

The risk assessment provisions in the Proposed Standards should allow auditors to eliminate excessive or redundant testing as well as for the varying of testing based upon prior knowledge of the company and audit results, as well as entity-level controls. The Proposed Standards include a description of risk factors in determining both significant account risk (paragraph 26) and operating effectiveness risk (paragraph 52). It is not clear from reading the note to paragraph 51 as to whether each control needs to be tested by the auditor. We are not clear whether the note is addressing all controls or those controls selected for testing. We believe that clarification on this point would be beneficial.

We believe that the Proposed Standards set the expectation that there would be one or a small number of controls for each combination of significant accounts and related assertions and that the auditors should test only those controls necessary to obtain reasonable assurance. More examples of the application of the top-down risk-based approach would be helpful to both management and auditors in order to strike the intended balance. This would be particularly helpful in the consideration of the interplay and balance of testing and reliance between entity and process level controls.

Rotational Testing

We support the focus in the Proposed Standards on the use of prior knowledge and audit results in the current year risk assessment and testing approach. The Proposed Standards allow for reduced testing in subsequent years based on the results of prior year testing and extent of changes in the controls. The Proposed Standards also allow for the benchmarking of automated controls. These approaches will result in increased efficiencies for both management and auditors resulting in lower compliance costs. We believe further efficiencies could be gained, without increasing risk, by allowing for the rotation of control testing. The current expectation of "each year standing on its own" would be required to be modified in order for this approach to be utilized. The rotation of controls should, of course, be based on an assessment of changes in controls, control design, prior year test results and the overall control risk.

Entity-level Controls

Companies that have put considerable effort in enhancing entity-level controls should be able to leverage these controls to reduce testing at the transaction level. Paragraphs 16 and 17 of the Proposed Standards 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. The Proposed Standards do not clearly indicate how the testing of company-level controls impacts the extent of other testing. We recommend that the PCAOB more clearly describe, using examples, how strong entity level controls and their testing can be used to reduce the extent of transactional level controls.

Assessment of Deficiencies

We are supportive of the change in the definitions of significant deficiencies and material weaknesses. The change from the "more than remote" likelihood criteria to "reasonable possibility" will provide greater clarity and reduce the time spent discussing internal control deficiencies. Additionally, the change in the significant deficiency definition from "more than inconsequential" to "significant" will also be similarly beneficial. These definitional changes along with the factors indicated in the Proposed Standards that should be considered will provide consistency in the identification and reporting of these deficiencies across companies and audit firms eliminating the need for firm specific criteria.

Interim Financial Statements

The definitions of "significant deficiency" and "material weakness" in the Proposed Standards include a reference to the misstatement of the company's "annual or interim financial statements." The SEC Guidance indicates 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". The assessment of ICFR under Section 404 of the Sarbanes Oxley Act is an annual process designed in order to make a determination as of the end of a company's fiscal year as to the effectiveness of its controls. Consequently, the reference to the "interim financial statements" in these definitions seems inconsistent with that objective. We recommend that the reference to "interim financial statements" be removed with the focus limited to the annual financial statements.

Removal of Opinion on Management's Assessment

We do not expect to see substantial efficiencies result from the removal of the opinion on management's assessment as companies will continue to have a need to align their assessment process with those of their auditors. However, we do believe that the opinion should be eliminated as it does not provide any further assurance to investors. The removal of the opinion will provide companies the choice and ability to develop assessment processes that are tailored to their control environments.

* * * * * *

We are supportive of the Proposed Standards and SEC Guidance. We would encourage the PCAOB and SEC allow for their implementation as soon as possible in order to realize their benefits providing for a more efficient and effective audit process. We appreciate the opportunity to comment on the PCAOB's proposed auditing standards. Please feel to contact me at (408) 527-0448 for any further discussion of our comments.

Sincerely,

Jonathan Chadwick
Vice President, Corporate Controller, Principal Accounting Officer

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February 21, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 021

Ladies and Gentlemen:

In December 2006, the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) issued proposals with the intent of reducing the costs of compliance with Section 404 of the Sarbanes-Oxley Act of 2002 (SOX). On December 19, 2006, the PCAOB issued its 131-page proposal for a new standard on auditing internal controls over financial reporting that would supersede its Auditing Standard No. 2 (AS No. 2). Additionally, on December 20, 2006, the SEC issued its 71-page interpretive guidance for management regarding management's evaluations of internal control over financial reporting (ICFR). This ICFR guidance, which describes a "top-down, risk-based" approach that will assist companies of all sizes to complete their annual evaluation in an effective and efficient manner is intended to provide relief to smaller companies by offering a flexible and scalable approach to these issues. In proposing the new AS No. 2, the PCAOB intends to eliminate unnecessary audit requirements and provide direction on how to scale the audit for "smaller and less complex" companies, a concept not featured in the SEC's proposal. In making these proposals, the PCAOB and SEC intend to respond to the high costs of implementing SOX Section 404. I am President and Chief Executive Officer of Citizens South Banking Corporation, a one-bank holding company with approximately 1,700 registered stockholders. Here are some of my observations and suggestions regarding both the proposed guidance from the SEC and the proposed AS No. 2 from the PCAOB.

I believe that everyone would concede that, despite the new guidance, the amount of work needed by companies and their external auditors to assess controls has resulted in higher costs derived from greater effort than was originally expected. But, may I

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respectfully suggest that we welcome and appreciate the SEC and the PCAOB proposals that should enable companies to utilize the top-down, risk-based approach to evaluating ICFR. I would also suggest that companies in certain highly regulated industries, such as financial institutions, are already subject to an additional layer of evaluations of controls in the form of safety and soundness examinations by Federal and state banking regulatory authorities. This additional layer of evaluations of ICFR, that are performed by skilled persons well informed on the complexities of the financial industry, should be included in helping to define effective control and determine when effective control has been attained.

In conclusion, I have one additional observation. The SEC guidance needs to clarify that the Internal Control – Integrated Framework created by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) does not specifically define effective control. The COSO framework lists things to consider, but it does not quantify what should be in place in such a way as to provide a definition of effective internal control. Continued progress should be made towards quantifying the requirements. The guidance explicitly calls for assessing two things: (a) the design of the control system, and (b) the operating effectiveness of controls within the control system. Operating effectiveness is considered on a control-by-control basis and focuses on whether the control is being carried out as originally designed. While these assessments form a part of any evaluation, there are other approaches that can be used.

Thank you for this opportunity to comment.

Very truly yours,

CITIZENS SOUTH BANKING CORPORATION

Kim S. Price
President and Chief Executive Officer

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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." See 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.

* * *

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: <u>Public Company Accounting Oversight Board</u>
Hon. Mark W. Olson, Chairman
Hon. Kayla J. Gillan, Member
Hon. Daniel L. Goelzer, Member
Hon. Bill Gradison, Member
Hon. Charles D. Niemeier, Member

<u>Securities and Exchange Commission</u>
Hon. Christopher Cox, Chairman
Hon. Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner
Hon. Kathleen L. Casey, Commissioner
Hon. Annette L. Nazareth, Commissioner

<u>Securities and Exchange Commission – Division of Corporation Finance</u>
Mr. John W. White
Ms. Carol A. Stacey

<u>Securities and Exchange Commission – Office of Chief Accountant</u>
Mr. Conrad Hewitt

Committee of Sponsoring Organizations of the Treadway Commission
American Accounting Association, American Institute of Certified Public Accountants, Financial Executives International, The Institute of Institute of Management Accountants, The Institute of Internal Auditors

COSO Chairman

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February 22, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 021

On behalf of the COSO Board, I am submitting our comments on the proposed revision to AS 2. COSO is supportive of the PCOAB in its objective to revise AS2. We find the focus on a top-down risk-based approach to be consistent with the COSO internal control framework.

COSO is committed to the proposition that all companies ought to have effective internal controls. The response to our guidance for smaller public companies has been quite positive as companies have found the principles in the guidance to be scalable across different sizes and industries.

COSO is currently working on a project to better define the monitoring component of the COSO *Internal Control - Integrated Framework* (ICIF). It is our sense that many companies have not fully integrated the monitoring component into their overall control structure, and therefore they have not effectively utilized the monitoring component to better manage the costs of meeting the Sarbanes-Oxley Section 404 requirements. Our original publication of the internal control framework (1992) states that:

> "Monitoring ensures that internal control continues to operate effectively. This process involves assessment by appropriate personnel of the design and operation of controls on a suitably timely basis, and the taking of necessary actions." (Chapter 6, p. 1)

The monitoring concept is more fully articulated in the COSO *Internal Control over Financial Reporting – Guidance for Smaller Public Companies.* Internal control is a process that is ongoing, as is illustrated on page 11 of Volume II of the smaller business guidance. Monitoring is an integral part of that process, and can be performed in a number of different manners ranging from computerized continuous monitoring to separate corroborating reviews by internal audit.

The current project on monitoring is being conducted in two phases: the first phase will lead to the publication of a preliminary "white paper" [pre-exposure draft] articulating the concepts of the monitoring component of the COSO ICIF. The second phase – which includes an exposure process - will seek public comment on the white paper concepts along with an identification of approaches that companies are using to implement both on-going and separate evaluations of their internal control structure. COSO believes that this guidance will provide more insight into situations in which management will be able to utilize effective monitoring, along with other assessment methods, where applicable, to support their assertion on the effectiveness of internal control over financial reporting. .

We are planning on the release of the white paper by late March. We will share that document with you as soon as it is ready. We plan on issuing an exposure draft for public comment during the summer and completing the project by January 2008. We have a very broad task force working on the project including representatives from the user community, preparer community, government officials, auditors, and consultants. We are very optimistic about the potential contribution of this project to better develop cost-effective approaches to internal control monitoring.

We have two comments for the PCAOB's consideration:

1. We encourage the PCAOB to consider our forthcoming white paper on monitoring, as well as our guidance for smaller businesses that was issued last year, as you further develop the new audit standard. Our objective is to have organizations recognize that monitoring can be built-in and that management's assessment of internal control is not necessarily an addition to, or layered on top of, the entity's system of internal control over financial reporting. Our whitepaper and forthcoming guidance will further articulate the concept and provide guidance for organizations to help them build effective monitoring into their internal control structure. Although directed at management, the guidance may also be useful for auditors and audit committees.

2. Your proposed guidance suggests one approach to monitoring which you refer to as *Benchmarking.* The term is described in the context of evaluating continued reliance on application controls in an IT environment. COSO believes that the general concepts you describe as benchmarking may be applied across the organization as an example of one approach to effective monitoring, i.e. understanding the control environment, identifying process changes that have a reasonable possibility of materially impacting the financial

statements, ensuring processes are in place to test those changes (including interaction with other processes), and determining if the monitoring is working effectively. We also believe that consistency in terminology would be helpful, i.e. both of the examples refer monitoring.

COSO believes that monitoring is an essential part of an organization's internal control structure. We would be pleased to work with the PCAOB to increase the understanding of monitoring. The COSO Board would be pleased to further discuss the monitoring project or any other aspect of internal control over financial reporting as captured in the COSO *Internal Control Integrated Framework.*

Sincerely,

Larry E. Rittenberg

Digitally signed by Larry E. Rittenberg
DN: cn=Larry E. Rittenberg, c=US, o=Univ. of Wisconsin, ou=Accounting, email=lrittenberg@bus.wisc.edu
Date: 2007.02.22 11:16:12 -06'00'

Larry E. Rittenberg, PhD, CPA, CIA

COSO BOARD MEMBERS

Larry E. Rittenberg, Chair
Chuck Landes, AICPA
Mark Beasley, AAA
Edith Orenstein, FEI
David Richards, IIA
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COMMITTEE ON CAPITAL MARKETS REGULATION
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February 26, 2007

Office of the Secretary
Public Company Accounting Oversight Board ("PCAOB")
1666 K Street, N.W.
Washington, DC 2006-2803
comments@pcaobus.org

Re: Release No. 2006-007, Rulemaking Docket Matter No. 021

Dear Office of the Secretary:

The Committee on Capital Markets Regulation (the "Committee") appreciates this opportunity to comment on proposals made by the PCAOB relating to the obligations of auditors under Section 404(b) of the Sarbanes-Oxley Act of 2002 ("SOX") to assess the adequacy of internal controls.

The Committee is independent and bipartisan, composed of twenty-two corporate and financial leaders drawn from the investor community, business, finance, law, accounting, and academia. The Committee issued its Interim Report on the state of the U.S. public equity capital market on November 30, 2006. The Committee's purpose is to explore a range of issues related to maintaining and improving the competitiveness of U.S. capital markets. As stated in its Interim Report, the Committee believes that maximizing the competitiveness of U.S. capital markets is critical to ensuring economic growth, job creation, low cost of capital, innovation, entrepreneurship, and a strong tax base.

The loss of U.S. public market competitiveness compared to other major markets worldwide results from a number of factors: foreign markets have closed the technology gap and narrowed the confidence and liquidity gaps that traditionally favored the U.S. market. Clearly, regulation and litigation play central roles in protecting investors and the efficient functioning of our capital markets, particularly in light of recent, highly-publicized abuses. Yet excessive regulation, problematic implementation, and unwarranted litigation—particularly when occurring simultaneously—make the U.S. capital markets less attractive and, therefore, less competitive with other financial centers around the world. Enhancing shareholder rights and reducing overly-burdensome regulation and litigation are the twin pillars of the recommendations released by this Committee in November.

In the late 1990s, the U.S. exchange-listed capital markets were attracting forty-eight percent of the value of all global initial public offerings ("IPOs"). By 2006, U.S. market share had fallen to 7.2 percent. If U.S. investors are to have access to a vibrant U.S. IPO market and all the protections it affords, then U.S. regulators must work to reverse this trend.

Our report also documents the tremendous growth in private equity capital and going-private transactions—which deprive public investors of access to a growing share of U.S. equity investments. One of the reasons for the increasing attractiveness of private equity markets is concern over the costs of going or remaining public. Since 2001, the number of venture capital ("VC") backed acquisition exits with disclosed values has exceeded the number of VC-backed IPO exits by more than ten-to-one (1919 to 171), with a difference of value of $95 billion as compared to $12 billion, albeit that IPO exits, unlike private exits, typically involve the sale of only a portion of the company.

The Committee believes that Section 404 has provided significant benefits to both investors and business by increasing the reliability of financial statements, strengthening internal controls, improving the efficiency of business operations, and helping to reduce the risk of fraud. The Committee strongly supports the need for effective internal controls. However, the Committee also believes that this objective can be achieved at much lower overall cost than the average cost per company during the first year (approximately $4.4 million) and second year ($3.8 million) of SOX implementation, as reported by the Financial Executives International (FEI) in its cost survey of 2006

We commend the PCAOB for its stated intent to make Section 404 implementation more efficient while working to ensure its effectiveness. We support the top-down, risk-based approach that allows auditors to make use of management judgment in tailoring their evaluations of controls to the individual circumstances of the companies they audit. We also support the proposal that eliminates the requirement for an auditor to examine management's evaluation process. We further support the increased flexibility provided for auditors to rely upon the work of others and to limit the testing of low-risk controls. Auditors should be able to adjust the nature, timing, and extent of their procedures based on knowledge obtained during previous audits, particularly as such knowledge impacts the auditor's assessment of risk.

We believe the PCAOB's proposal importantly directs the auditor to scale the audit so that it is appropriate *vis-à-vis* a company's size and complexity. This is much preferable to a "design-only" standard for small companies, under which outside auditors would only assess the overall adequacy of the design of controls without testing their operating effectiveness.

We also believe, however, that the PCAOB's revised guidance on materiality is the most important issue affecting the cost of Section 404(b) implementation and must be considerably strengthened if SOX costs are to be significantly decreased. Under current guidance, a material weakness is defined as a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. We support the PCAOB's proposal to replace this standard with a requirement that there be a "reasonable possibility" that a misstatement could result in a material misstatement. Nevertheless, we believe the PCAOB should go farther in clarifying the definition of materiality.

There is no reason to examine internal controls that, even if deficient, could have no material impact on the financial statements of the company. Unfortunately, this appears to be happening today. As the Committee's report shows (Figure V.3, p. 123), based on an analysis by Mercer Oliver Wyman of the 2006 GAO study, fifty-three percent of the restatements between 2002-05 had either a negligible negative (less than one percent) or a positive impact on company market value.

The Committee has recommended that materiality for internal control reviews should be defined consistently with the definition of materiality in financial reporting. Specifically, the Committee recommends that materiality for scoping an assessment should be defined, as it was traditionally, in terms of a five percent pre-tax income threshold. This standard would be consistent with the overall risk-based approach taken by the PCAOB in this proposal. In cases where the five percent test would not be meaningful, the PCAOB should allow companies and their auditors to exercise their reasoned judgment in choosing other measures to evaluate materiality in ways that are relevant to investors. We also believe that this standard should be applied to annual, rather than interim, financial statements.

Finally, with only three years of experience, the fact base relating to Section 404 implementation is still fairly limited. As a result, we believe the SEC and PCAOB should continue to collect better and more complete information relating to the costs and benefits of Section 404.

The Committee's Interim Report may be accessed through its website at http://capmktsreg.org/research.html. Specific references to SOX 404 may be found on pages 19-21 and 115-135 of the Interim Report. If the PCAOB staff should have any questions or comments concerning this submission, please do not hesitate to call Hal S. Scott (617-495-4590) at your convenience.

Sincerely,

Hal S. Scott
Director
Committee on Capital Markets Regulation

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State Employees' Retirement System
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SERS

April 2, 2007

RECEIVED
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Office of the Secretary
PCAOB
1666 K Street, NW
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

I am writing on behalf of the State Employees' Retirement System ("SERS"), one of the oldest and largest pension systems in the United States, managing over $32 billion for the exclusive benefit of SERS' 213,000 members and beneficiaries.

I wish to express SERS' strong support for the Sarbanes Oxley Act ("SOX"), and the Public Company Accounting Oversight Board's ("PCAOB") auditing standard, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements And Other Related Proposals* ("Proposal").

Section 404 of the Sarbanes-Oxley Act of 2002 has been critical in rehabilitating investor confidence and restoring the overall integrity of the United States ("U.S.") capital markets over the past several years. Therefore, we strongly support the PCAOB's audit standard with regard to the implementation of Section 404. Auditing standard 5 enhances the auditor's ability to provide necessary assurances more efficiently, making it a more balanced approach for both the company and the auditing firm without diluting the benefits to users of financial statements.

As a longstanding member of the Council of Institutional Investors ("CII"), SERS has been at the forefront of the national debate on the importance of enhancing auditing and accounting standards and related corporate governance issues. Peter M. Gilbert, SERS Chief Investment Officer, has been a member of CII's Board of Directors and its Policies committee which have been active proponents of the benefits of SOX. In that regard, SERS supports the views expressed by the CII in its letter to you dated February 13, 2007, addressing the PCAOB's implementation of the new audit standard.

In addition, during the past year Mr. Gilbert served as Co-Chair of a joint Task Force formed by the Council of Institutional Investors ("Council" or "CII") and the National Association of Corporate Directors ("NACD"), which specifically researched the controversy surrounding the implementation of SOX and Section 404. The end result of this research was a report in January 2007 entitled: "*Looking Back, Looking Forward: Recommendations on Majority Voting, Section 404 and Executive Compensation.*" The most relevant finding of this Task Force specifically addressed this issue with the following language:

> Strengthened internal controls have increased investor confidence in the accuracy of U.S. corporate financial disclosures. Implementation costs, particularly for smaller companies, remain a concern. Management and external auditors should work to make the process more cost efficient. ***Despite that challenge, task force members believe Section 404 must not be weakened. (Emphasis added.)***

SERS is supportive of the SEC's determination that all public companies covered by the reporting requirements must adhere to the same standards. Investors must be able to rely on the fact that all publicly traded companies provide the same level of assurance that their internal controls are satisfactory. We also agree with the SEC that the implementation can be scaled to reflect the operating realities of small companies. The PCAOB's new auditing standard makes significant progress towards this objective.

SERS has over $9 billion of its assets exposed to the U.S. capital markets, which would be at risk if the investor protections provided by SOX were diminished. We strongly urge the PCAOB to implement the auditing standard, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements,* without weakening any of its provisions.

Sincerely,

Eric Henry
Executive Director

Michael E. Keane
Vice President and Chief Financial Officer

February 26, 2007

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W., 9TH Floor
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021, "An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements and Related Other Proposals"

FILED ELECTRONICALLY (comments@pcaobus.org)

Dear Board Members and Staff,

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (the "Board") proposed Auditing Standard, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements and Related Other Proposals," Release No. 2006-007 (the "Proposed Standard" or "Proposed Standards," as appropriate), which was issued December 19, 2006 (PCAOB Rulemaking Docket Matter No. 21).

Computer Sciences Corporation (CSC) has actively supported the efforts of the President, Congress, NYSE and SEC to enhance investor confidence, corporate governance, financial reporting and the capital markets. While management's representations and auditors' reports on internal control over financial reporting may help improve investor confidence, it is encouraging to note the developing attention toward balancing the cost with resulting benefits.

The costs borne by companies in reporting on internal control over financial reporting significantly exceeded all estimates and remains a matter of great importance to the U.S. economy, capital markets, investors and overall business climate. Costs, under the current approach, have been recognized as disproportionate to the benefits. Some companies have, in fact, de-listed their securities, delayed offerings, or turned to markets outside the U.S., particularly foreign corporations, to avoid these costs.

We commend the Board on the improvements incorporated in the Proposed Standards. We also commend the Board's decision to move toward a more principles-based, rather than rules-based, approach. This will enable greater flexibility and scalability and more readily facilitate application to all issuers. We feel the following improvements are particularly important:

Computer Sciences Corporation
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- Adopting a top-down, risk-based approach focused on the most important controls with the audit scope predicated more on risk than coverage;
- Eliminating the auditors' opinion on management's assessment;
- Clarifying the definitions of significant and material weaknesses;
- Using the same materiality for controls as the financial statement audit;
- Considering knowledge obtained in prior audits in determining the nature, timing and extent of procedures;
- Encouraging reliance on company level controls rather than transaction controls;
- Streamlining walkthrough procedures to focus on significant processes;
- Expanding areas of auditor reliance on the work of others (i.e., control environment, period-end financial reporting process and walkthrough procedures);
- Allowing reliance on the work of management, in addition to internal audit, subject to competency and objectivity; and
- Eliminating the "principal evidence" provision of AS No. 2.

These improvements should result in a significant reduction in compliance costs, and we believe further efficiencies are possible and necessary to maintain the competitiveness of U.S. capital markets.

The vast majority of both issuer and auditor effort and costs arise from the documentation, testing and evaluation of voluminous transaction controls, despite the fact that these controls are least effective in addressing the issues which led to the types of financial improprieties witnessed at Enron, World Com, Tyco and others (i.e. fraud, improper financial reporting, conflicts of interest and management override of internal controls).

We recommend the Board further address the following in the Proposed Standards:

- Clarify and provide further guidance and examples to facilitate reliance on entity-level and company-level controls rather than process-level controls testing;
- Clarify auditor risk assessment processes and provide examples of risk criteria, low-risk areas and extent of testing for low-risk areas to facilitate risk-based scoping;
- Emphasize the importance of entity-level and company-level controls, controls over management override, the period-end financial reporting process and the control environment, in identifying material misstatements;
- Expand the discussion of the period-end reporting process to incorporate controls over GAAP and SEC compliance, account reconciliations, unusual and non-routine transactions, review of operating results, significant, complex or subjective estimates and related party transactions;
- Permit multi-year rotation of testing for low risk areas;

- Continue to refine the definition of significant deficiencies to focus on truly significant matters;
- Incorporate cost benefit considerations in evaluating and remediating deficiencies;
- Encourage auditors to rely on management testing where personnel performing testing are objective and competent;
- Permit auditors to rely on walkthrough procedures performed by management;
- Clarify the "base line" testing approach for IT general controls;
- Further align the Proposed Standards with SEC issuer guidance; and
- Allow a one year transition period, but permit early adoption to realize efficiencies as quickly as possible.

We have included additional recommendations in our detailed responses to the Board's Request for Comments set forth in Exhibit I.

We appreciate the opportunity to express our views and offer our suggestions. We remain committed to working with the Board, the SEC, other issuers, investors and others on refinements and improvements which will enhance the effectiveness, and significantly reduce the cost, of these reporting requirements. We would be pleased to discuss at your convenience our recommendations. If you have any questions or would like to further discuss our comments, please feel free to contact Dennis Dooley at (248) 372-3306 or me at (310) 615-4821.

Sincerely,

Michael E. Keane
Vice President and Chief Financial Officer

cc:

PCAOB
Mr. Mark W. Olson, Chairman of the PCAOB
Ms. Kayla J. Gillan, Board Member of the PCAOB
Mr. Daniel L. Goelzer, Board Member of the PCAOB
Mr. Bill Gradison. Board Member of the PCAOB
Mr. Charles D. Niemeier, Board Member of the PCAOB
Mr. Thomas Ray, Chief Auditor and Director of Professional Services
Ms. Laura Phillips, Deputy Chief Auditor

SEC
The Honorable Christopher Cox, Chairman, Securities and Exchange Commission
The Honorable Paul S. Atkins, Commissioner

The Honorable Roel C. Campos, Commissioner
The Honorable Kathleen L. Casey, Commissioner
The Honorable Annette L. Nazareth, Commissioner

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Exhibit I

An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements and Related Other Proposals (Proposed Standards)
Request for Comments

<u>Directing the Auditor's Attention Toward the Most Important Controls</u>

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

The Proposed Standard clearly describes the general manner in which a top-down, risk-based approach to auditing internal control should be applied. However, the guidance in the Proposed Standard may not be sufficiently specific to overcome auditor tendency to over-scope audit procedures by using lower materiality parameters for auditing internal controls than that used in financial statement audits to allow for tolerable error, and their reluctance to:

- Rely on risk assessments to reduce the scope of their procedures, particularly detailed testing of transaction controls,
- Test and rely on company-level controls in place of low-risk, detailed transaction controls, and
- Exercise judgment in executing their audits of internal control, generally due to risk aversion.

In fact, the initial response of audit firm's to the Proposed Standards seems to indicate they do not expect implementation of the Proposed Standard, in its current form, to result in any significant reduction in audit effort or fees. Rather, they have cautioned the Proposed Standard could actually increase audit fees if management employs a "non-audit" approach in their assessment. For example, where functional personnel, not responsible for the operation of controls, perform testing rather than direct testing by internal audit, auditors have indicated they may no longer be able to rely on the Company's testing, regardless of the competence and objectivity of such personnel.

We think the scope of management and auditor testing should be based on: (1) the materiality factor used in the financial statement audit without adjustment to allow for tolerable error (generally materiality would be equal to 5% of earnings before tax, rather than lower thresholds of 2-2.5% which auditors had implemented to "allow for tolerable error"), (2) a risk-based, rather than coverage-based assessment of account balances and related financial statement assertions to be subjected to testing, and (3) assessment of the effectiveness of entity-level and company-level controls. As a practical matter, the types of "tolerable errors," so defined, generally are self correcting and non-cumulative, giving further support to the recommended materiality factors within assessed risks and controls.

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

Yes, the Proposed Standard does place appropriate emphasis on the importance of identifying and testing controls designed to prevent fraud.

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

Without question the top-down approach will better focus attention on the most important controls. In addition, we recommend the Board specifically emphasize the critical importance of entity-level and company-level controls, programs and controls over management override, controls over the period-end financial reporting process and the pervasive impact and importance of the overall control environment, in preventing and detecting financial statement misstatements. These were the control areas which resulted in the most pronounced instances of fraudulent financial reporting and malfeasance. Auditor testing and evaluation of controls in these areas is far more effective in preventing material misstatements and fraud than extensive testing of detailed, low-risk process-level transaction controls.

In addition to the elements identified in the Proposed Standard, the discussion of the period-end financial reporting process should also address the following areas which are equally critical to preventing financial statement misstatements:

- The company's process for ongoing monitoring of technical compliance with financial accounting and reporting requirements in accordance with GAAP, as well as SEC requirements,
- Account reconciliations,
- Review of operating results,
- Accounting and reporting of unusual or non-recurring transactions,
- Significant and complex or subjective estimates, and
- Accounting and reporting for related party transactions.

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?

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We believe further guidance and examples may be necessary to overcome auditor reluctance to rely on testing of company-level controls in place of detailed transaction controls (refer to our response to Question 1).

Emphasizing the Importance of Risk Assessment

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

We endorse the concepts proposed and believe further guidance regarding the risk assessment may be necessary to effectively implement risk-based scoping. Examples of areas which may be evaluated as low-risk, criteria used in evaluating risk, and the manner in which the nature and extent of testing may be reduced would facilitate more expeditious and effective implementation of a risk-based audit approach. This could either be addressed in the Proposed Standard, or the Board may wish to update and expand SAS No. 47, "Audit Risk and Materiality" to clarify this area.

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

Yes, performance of walkthrough procedures may be sufficient to test design and operating effectiveness where underlying processes and controls have not changed significantly since the last audit or for low-risk and medium-risk processes.

Revising the Definitions of Significant Deficiency and Material Weakness

7. Is the proposed definition of significant deficiency 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?

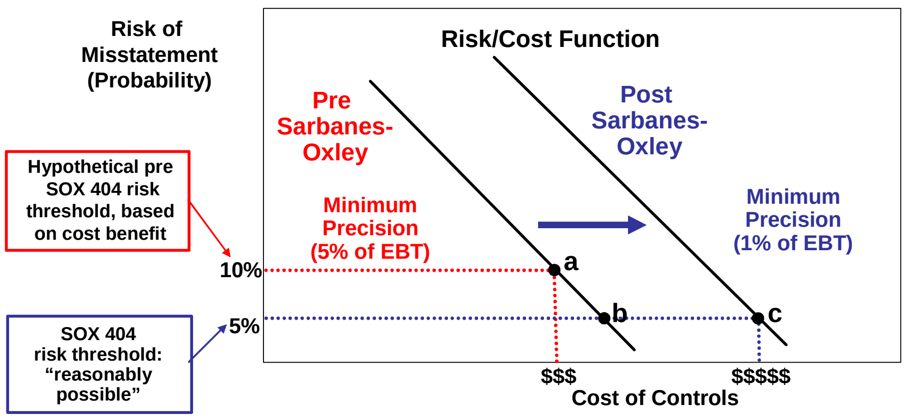
We suggest the Board further refine the definition of significant deficiency to focus on truly significant matters. Although the Board modified the definition to focus on "significant" matters, rather than "more than inconsequential" matters, and misstatements which are "reasonably possible," rather than "more than remote," we understand the profession intends to continue to interpret these parameters using the same quantitative thresholds: 1% for "significant" and 5% probability for "reasonably possible." This makes it difficult to distinguish more significant deficiencies from matters of far less importance. Moreover, the definition encompasses potential control deficiencies and misstatements which although possible are, in fact, neither likely nor truly significant.

As a result of the overly broad definition of significant deficiencies, the cost of implementing, maintaining, monitoring, evaluating and reporting on internal controls has fundamentally increased in two ways. First, Section 404 has brought about a material adverse shift in the financial reporting cost-benefit relationship by essentially requiring companies to detect misstatements in excess of "significant" rather than material amounts. Second, the risk threshold encompasses any control deficiencies where potential misstatements are more likely than "reasonably possible".

The following chart, from our letter dated September 18, 2006, illustrates the impact of this definition on the cost of controls:

Sarbanes-Oxley Impact on the Cost of Controls

Costs increased from "a" to "b" due to the redefined level of tolerable risk ("reasonably possible"). Costs further increased to "c" to detect potential "significant" misstatements (1% of EBT), rather than material (5% of EBT) as under the FCPA.



Note: the profession has defined "reasonably possible" to be 5% (FAS No. 5) and "significant" to be 1% of EBT (20% of materiality, or 20% of 5% of EBT).

8. Are auditors appropriately identifying material weaknesses in the absence of actual material misstatement, whether identified by the auditor or management? 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?

In many cases auditors have only identified material weaknesses at the time financial statements are restated. However, if the auditors focus on the critical importance of entity-level and company-level controls, programs and controls over management override, the period-end financial reporting process and the pervasive impact and importance of the overall control environment in preventing and detecting financial statement misstatements, material weaknesses will be identified on a more timely basis. The Board may wish to provide further examples and guidance in this area to assist in identifying such situations.

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 do not believe the proposed changes to the definitions will reduce effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of financial statement misstatement because the definition of a significant deficiency remains overly broad (refer to our response to Question 7).

Revising the Strong Indicators of a Material Weakness

10. Should the standard allow the 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?

The Proposed Standard should allow the auditor to conclude that no deficiency exists when one of the "strong indicators of a material weakness" is present. For example, generally we believe a material weakness exists where a control deficiency results in a restatement. However, there may be situations where a control deficiency existing in prior years resulted in a restatement of previously issued financial statements but the deficiency has long since been remediated. This change should allow for the appropriate use of greater judgment and should not result in inconsistency in practice.

We recommend the Proposed Standard incorporate the language in the Proposing Release which indicates the auditor would not have to conclude a deficiency exists, and "strong indicators of a material weakness" would not necessarily result in a significant deficiency. We further recommend the Proposed Standard also include the language in the Proposing Release indicating failure to remediate a significant deficiency would only constitute a "strong indicator of a material weakness" if it were indicative of a deficiency in the control environment. There may be valid commercial reasons a significant deficiency is not remediated, particularly in view of the overly-broad scope of the definition of a significant deficiency (refer to our response to Question 7).

Clarifying the Role of Interim Materiality in the Audit

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

Yes, further clarification of materiality and risk-based scoping may be necessary to overcome auditor reluctance to reduce the scope of procedures relating to low-risk; process-level transaction controls (refer to our response to Question 1).

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?

Yes, reference to interim statements should be removed from the definition of a significant deficiency and material weakness because it presumes a level of precision that is not feasible given the fundamentally subjective nature of these

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assessments. In addition, in view of the overly-broad scope of the definition of a significant deficiency to begin with, this results in identifying, evaluating, reporting and remediating fairly insignificant items (refer to our response to Question 7).

Removing the Requirement to Evaluate Management's Process

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

Yes, this will not only eliminate unnecessary audit work, it will enable management to exercise greater flexibility in the approach used in its assessment. Previously, management had defaulted to an "audit approach" due to the absence of any SEC guidance specifically focused on management's assessment. This due, in part, to the fact the auditor's opinion encompassed management's assessment.

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

Yes, while we agree with the Board that the auditor should review management's assessment process, as a part of the overall review of the control environment, specifically evaluating and reporting on management's assessment is not necessary to express an opinion directly on the company's internal controls.

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?

Yes, we believe this manner of reporting better communicates the scope and results of the auditor's work. The auditor should be required to form only two opinions, one on the financial statements and the other on the effectiveness of internal control over financial reporting. The auditors' opinion on management's assertion is redundant and does not provide further assurance for the investor. The opinion on the effectiveness of internal control over financial reporting provides the more conclusive assurance and is similar to the manner in which the auditor expresses his attestation on fair presentation of the issuer's financial statements. We would further recommend these two remaining opinions be integrated into one published opinion (a reporting method which is currently permitted but not required). This approach would serve to further underscore the risk-based, integrated nature of these audits.

Permitting Consideration of Knowledge Obtained During Previous Audits

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

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Generally, the Proposed Standard appropriately incorporates the value of cumulative knowledge. However, in the area of IT general controls we believe further efficiency can be gained by refining the approach to "base lining" IT application controls.

IT Application Controls

The evaluation of IT application controls is an area in which significant efficiencies could be achieved. We were hopeful in year two we would be able to apply a "base lining" approach in testing IT application controls. This is a long established, widely accepted practice used in audits of service providers under Statement on Auditing Standards No. 70 ("SAS 70 audits"). Under this approach, if IT application controls have been previously tested (either in conjunction with the initial system implementation or as a part of a subsequent audit), it would only be necessary to test changes in subsequent periods, assuming the auditor has satisfactorily tested IT general controls (including program change controls). The Proposed Standard requires the company to meet certain criteria to apply a "base lining" approach. These criteria require the issuer to demonstrate there have been no changes, not only in the IT application control itself, but also in any other application controls, data files, tables, interfaces or related applications which could conceivably affect the IT application control. In most cases, satisfying these criteria would be far more arduous than retesting the controls. Moreover, we believe the criteria are not only impractical but also unnecessary since program change controls are already subject to testing in conjunction with tests of IT general controls. Many issuers have initiated programs to further centralize, standardize and automate their processes and related controls in an effort to reduce the cost of compliance with 404. As these issuers further automate their systems of controls, modifying these criteria to permit more wide-spread use of a "base lining" approach would provide a powerful means of reducing the cost of compliance.

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?

Reliance on walkthrough procedures would be appropriate where underlying process and controls have not changed or in testing controls over low-risk and medium-risk areas.

Refocusing Multi-location Testing Requirements on Risk Rather Than Coverage

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?

We recommend the Board provide the following guidance regarding a multi-location engagement to further encourage a risk-based approach in determining the scope and nature, timing and extent of tests. Further, we recommend the

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Proposed Standard incorporate rotation of testing, as well as reliance on higher level controls:

To achieve testing of all significant process level transaction controls over multiple years, process controls for low-risk and medium-risk business unit locations and account balances would be subject to evaluation on a rotation basis (e.g., once every three years).

- Walkthrough procedures would be performed for the account balances and related classes of transactions which are subject to review of process controls in any given year (as set forth in the rotation plan).
- In addition, issuers should be able to rely on supervisory activities. Most large issuers have multiple layers of review to determine controls are operating effectively and financial reporting is accurate and complete.

During the course of Roundtable discussions, the Comptroller General of the United States indicated a risk-based audit approach has been in use in Government Accountability Office audits of Federal government agencies for some time. The risk-based approach is used in tandem with a multi-year rotation plan to determine all areas are subject to audit testing over a multi-year time frame. The approach described above parallels the risk based rotation approach employed by the GAO.

We further recommend the Board endorse issuer monitoring controls in place of separate evaluation type testing of controls. Monitoring activities could include a wide assortment of activities, ranging from management oversight and testing of controls themselves to detailed review of the results of operations in combination with testing of controls over the period-end reporting process. Such activities might also include management's operating procedures and supervisory activities, especially in areas where measurements require greater judgment and have potentially greater impact on performance and reported results.

In addition, commercial software packages have been developed which enable issuers to monitor user and security access privileges to applications, operating system security configurations and certain other IT general controls, segregation of duties and ongoing monitoring of application and transaction controls, as well as automating system and application user provisioning. The capabilities of these monitoring tools is evolving rapidly and will likely enable far greater automation not only of the issuer assessment process but of the underlying system of controls as well. These types of monitoring tools potentially improve the effectiveness of the system of controls, provide a more robust foundation for issuer reporting on controls, significantly reduce compliance costs and deliver operational benefits.

<u>Removing Barriers to Using the Work of Others</u>

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?

Yes, the Proposed Standard's single framework for using the work of others is appropriate for both an integrated audit and an audit of only financial statements.

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 controls framework?

Yes, the definition of relevant activities adequately captures the proper scope of activities, including the monitoring component.

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

Yes, requiring auditors to understand relevant activities should improve both the effectiveness and efficiency of the audit.

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

No, we agree with the Board's decision to remove the "principal evidence" requirement. This should improve the efficiency of audits without any reduction in investor benefits.

23. Does the proposed standard provide an adequate 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?

Yes, the Proposed Standard provides an adequate framework for evaluating the competence and objectivity of personnel performing tests of the operating effectiveness of internal control which should protect against inappropriate use of the work of others while not unduly restricting auditor reliance.

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

Yes, the factors for assessing competence and objectivity are appropriate.

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

Inclusion of the compensation arrangements seems appropriate in evaluating objectivity; however, we suggest the Board further indicate compensation incentives alone would not necessarily preclude reliance but that the factors have to be considered in totality.

Recalibrating Walkthrough Requirements

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

Yes, limiting walkthrough procedures to significant processes rather than major classes of transactions should result in some reduction in work effort without impairing audit quality.

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?

Yes, it is appropriate for the auditor to use direct assistance in performing walkthroughs and as indicated above we believe the auditor should, in fact, be allowed to rely on the work of others in this area without direct supervision, provided personnel performing the walkthroughs are competent and objective.

Scaling the Audit for Smaller Companies

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?

No comment regarding smaller companies.

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

No comment regarding smaller companies.

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 comment regarding smaller companies.

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

No comment regarding smaller companies.

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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 controls?

No comment regarding smaller companies.

Proposed Rule 3525 – Audit Committee Pre-approval of Services Related to Internal Control

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?

We do not believe any further information is necessary for pre-approval of internal control-related services.

Effective Date

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?

We recommend the Proposed Standards be effective for years beginning one year after the date of adoption, but that early adoption be permitted. In this way, audit firms may voluntarily implement the Proposed Standards more quickly, where feasible, and take advantage of the resulting efficiencies.

Consumer Federation of America
Consumer Action
U.S. Public Interest Research Group

February 26, 2007

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

Re: Rulemaking Docket Matter No. 021

Dear Sir:

We are writing on behalf of the Consumer Federation of America,[1] Consumer Action,[2] and U.S. Public Interest Research Group[3] in response to the Board's request for comments on its proposal to replace its existing standard governing audits of internal controls over financial reporting with a new set of standards. CFA, CA, and U.S. PIRG support the stated intent of the proposed standards – to ensure that internal control audits are focused on the areas that pose the greatest risk of material error or fraud, to eliminate unnecessary procedures that drive up the cost of audits without delivering significant benefits, and to ensure that audits are designed with the specific characteristics of the audited company in mind. We also recognize that, in arriving at the proposed approach, the Board rejected a number of alternatives – such as design-only internal control audits for smaller companies, single walkthrough testing of controls, or multi-year rotational testing – that would have effectively eviscerated the control audit both as a deterrent to fraud and as a means of preventing financial statement errors.

That said, we are not convinced that the proposed revisions will accomplish the stated goals. First, although the Board describes the new standards as principled-based, they provide no clear articulation of investor protection principles to guide their implementation. As a result,

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[1] The Consumer Federation of America (CFA) is a non-profit association of approximately 300 consumer groups. It was established in 1968 to advance the consumer interest through research, education, and advocacy.

[2] Founded in 1971, Consumer Action works on a wide range of consumer issues through its national network of 6,500 community based organizations.

[3] The U.S. Public Interest Research Group serves as the federation of state PIRGs, which are non-profit and non-partisan public interest advocacy organizations with one million members across the country.

the proposal has the worst characteristics of a principles-based approach, lack of clarity, without its chief benefit, a plainly articulated desired outcome that auditors can be held accountable for achieving. Second, the Board has proposed a top-down, risk-based approach to the internal controls audit without in any way addressing the short-comings that have made that approach such an abysmal failure in the audits of financial statements. Until the Board analyzes the many failed risk-based financial statement audits and determines what went wrong, it cannot in good conscience propose a risk-based approach to the internal control audit with any confidence that it will provide an appropriate level of investor protection. Finally, the Board sends the strong message throughout this proposal that reducing costs is more important than improving, or even maintaining, the effectiveness of these audits. This not only results in serious weaknesses in the standard itself, it suggests that the Board will not provide the strong regulatory and enforcement backing needed to make a principles-based approach effective. As a result, we are deeply concerned that the current proposal, if adopted, will fatally undermine the effectiveness of Section 404 of the Sarbanes-Oxley Act (SOX 404) just as it is beginning to deliver real benefits to investors.

On the other hand, we are convinced that it is possible to achieve the stated objectives of the proposal without the profound threat to investors that this proposal entails. Specifically, we believe this could be accomplished through a combination of: 1) improved guidance from the Securities and Exchange Commission, particularly for smaller public companies, on their obligations under SOX 404;[4] 2) better individualized and generalized guidance from the PCAOB to auditors on how to ensure that their audits of internal controls are appropriately designed and implemented; and 3) minor tweaking of those aspects of the existing standard, if any, that appear to promote excessive testing.[5]

A Major Rewrite of the Standard is Unwarranted

The PCAOB's decision to rewrite Audit Standard 2 appears to be driven more by political expediency than by any evidence either that the costs of the rule exceed its benefits or that its costs, where excessive, could not be reduced through other, less radical means. Certainly, the Board has produced no cost-benefit analysis justifying its actions. In fact, there is little meaningful record on which to base such an assessment. As the Board's Release points out, only "two annual financial reporting cycles have been completed since auditors began to apply AS NO. 2 to audits of accelerated filers."

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[4] The proposed guidance currently under consideration by the SEC suffers from many of the same short-comings as this proposed standard and therefore does not, in our view, satisfy this condition.

[5] The fact that some commentators complain about a particular aspect of the standard on the grounds that it promotes excessive testing should not be taken as proof of that fact. This sort of complaint is the near universal response of the business community to any increase in regulatory requirements. Instead, the Board should base its assessment on its own evaluations of audits.

For a variety of reasons, the first year's experience under the new standard can hardly be viewed as representative. First, no reasonable person would expect implementation of a major new requirement such as this to go off without a hitch. Beyond the problems inherent to introducing any major new standard, many public company managers were ill-prepared and slow to perform their own documentation and assessment of internal controls, without which the auditor's assessment could not go forward. This, combined with the arrival of the standard and guidance on implementation after planning and data gathering for financial statement audits had already begun, effectively prevented auditors from conducting an integrated audit of financial statements and internal controls in most cases during that first year.

We frankly question whether the remaining one full year's experience with AS2 provides an adequate basis on which to assess the costs and benefits of the standard. To the degree that such a record exists, however, it strongly supports the conclusion that the benefits substantially outweigh the costs. Given that fact, it is difficult to understand the reasoning behind the Board's decision not only to reopen the standard at this point, but to rewrite it completely.

The Benefits of the Existing Standard Outweigh the Costs

We are aware of two leading surveys that attempt to assess the costs of compliance associated with Section 404 of the Sarbanes-Oxley Act – one by Financial Executives International and one by Charles River Associates. The FEI survey, which did not differentiate among companies based on size, found average second-year 404 compliance costs among its members of $3.8 million.[6] For its assessment, CRA did divide companies by size and found second-year costs of $4.77 million for larger companies (those with more than $700 million in market capitalization) and $0.86 million for smaller companies (those with market capitalizations between $75 and $700 million).[7]

As expected, both surveys showed a marked drop in costs between the first and second year of implementation. Specifically, FEI members reported 404 cost declines of 13 percent between 2004 and 2005. On the CRA survey, costs were found to have declined by 43 percent for larger companies and by 31 percent for smaller companies. There is every reason to believe that the smaller companies that have yet to implement the rule would experience still lower costs, even without any adjustments to the standard or additional learning from further experience implementing the internal control audits.

Moreover, substantial evidence supports the conclusion that SOX 404 brings benefits that greatly exceed its costs. That evidence takes a number of different forms. These include:

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[6] "FEI Survey: Sarbanes-Oxley Compliance Costs are Dropping," Financial Executives International Press Release, April 6, 2006.

[7] "CRA Survey: SOX Costs Falling from 2004 to 2005," *Big Four Blog*, April 2006, found at http://bigfouralumni.blogspot.com/2006_04_01_archieve.html. This information is also reported in the Interim Report of the Committee on Capital Markets Regulation, Table V.3, page 135.

statements by institutional investors that they have seen significant post-SOX improvements in the quality of financial reporting;[8] statements from senior managers of public companies that it has helped them to streamline and improve processes and make better business decisions;[9] evidence that, absent the requirement, many public companies had failed to maintain adequate internal controls or report weaknesses in those controls; and academic research on the effects of SOX 404.

One important goal of SOX 404 is to improve the accuracy of financial disclosures, which should then reduce the incidence of financial restatements.[10] These restatements result in substantial costs to investors, beyond the misallocation of capital that can result when financial disclosures are erroneous or misleading. A recent analysis by the General Accounting Office, looking at financial restatements from July 2002 through September 2005, found an average negative market impact of 1.9 percent in a three-day window around the restatement.[11] Based on its data, and using this very narrow time frame, the GAO calculated an aggregate negative market impact from financial restatements of $40.9 billion in 2004 alone and $63 billion for the entire period of the study, far above even the most inflated estimates of SOX 404 compliance costs.[12]

Given the significant negative effect restatements can have on share price, investors stand to benefit greatly if SOX 404 improves the reliability of financial statements and reduces the incidence of restatements. Early evidence indicates that this is occurring. First, financial restatements are up dramatically since the implementation of SOX, indicating that it has helped bring to light a number of problems that had previously gone undetected. A recent analysis by AuditAnalytics reported 1,876 restatements in 2006 by 1,591 unique filers.[13] That represents a 17 percent increase over 2005, which itself saw a 57 percent increase over 2004.

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[8] "Not Everyone Hates SarbOx," by David Henry, *BusinessWeek Online*, Jan. 29, 2007. Found at http://www.businessweek.com/print/magazine/content/07_05/b4019053.htm?chang=gl.

[9] "Examining Section 404, With Two Years of Hindsight," by Richard M. Steinberg, *Compliance Week,* Jan. 24, 2006.

[10] Although the long-term goal is to reduce restatements, a short-term rise in restatements is predicted as a result of the new level of scrutiny being applied to corporate disclosures and public company audits as SOX is implemented.

[11] *Interim Report*, Committee on Capital Market Regulation, Dec. 1, 2006, pg. 120.

[12] Ibid., Table V.2, page. 122. Also, footnote 138. Table V.3 on Page 135 shows estimated aggregate compliance costs of $15 to $20 million in 2004 and $11 to $13 million in 2005.

[13] *Audit Analytics Briefing Paper: 2006 Financial Restatements, A Six Year Comparison*.

Of particular note when considering the effect of SOX 404, however, is the fact that restatements among accelerated filers (those that have implemented AS2) are down significantly – from 16.1 percent of such companies in 2005 to 13.3 percent in 2006.[14] Meanwhile, the number of restatements among non-accelerated filers has continued to increase – from 921 in 2005 to 1,318 in 2006.[15] One clear implication of these findings is that the large companies that have already implemented SOX 404 have begun to improve their procedures and clean up their books. As one commentator noted, this appears to indicate that "the Sarbanes-Oxley law is working and investors are getting higher-quality financial statements than ever before."[16]

Many of these financial restatements were accompanied by reports of a material weakness in internal controls. In fact, since SOX 404 was implemented, several thousand companies have reported material weaknesses in their internal controls (more than 1,500 in 2005, and 1,105 through September 2006).[17] In most cases, the disclosure of material weaknesses came only after an independent audit of the controls. Specifically, only one out of eight of these companies had reported a material weakness as recently as the quarter preceding the filing in which the material weakness was disclosed.[18] In other words, the certifications that many CEOs and CFOs had been making since 2002 attesting to the adequacy of their controls were unreliable.[19]

The significant difficulty that many public companies experienced in implementing Section 404 – a factor that has helped to drive up implementation costs – has been taken by some to imply a problem with the standard itself. AS2 can hardly be blamed, however, for public companies' poor compliance with a requirement that has been on the books for decades, for their lack of adequate competent personnel to oversee controls, or their failure to adopt adequate control systems. The costs associated with deferred maintenance should therefore not be laid at AS2's door. Nor should AS2 be blamed for the SEC's failure to provide clear and timely guidance to public companies on how best to comply with their obligations under SOX 404. Indeed, the widespread failure among public companies to maintain an adequate system of internal controls or report in a timely fashion on weaknesses in those controls is evidence, if anything, of how badly SOX 404 was needed, and of how essential the independent audit component of the rule is to ensuring its effectiveness.

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[14] Ibid.

[15] Ibid.

[16] Ibid.

[17] Glass, Lewis & Co., LLC analysis of company filings.

[18] "Learning from Accounting History: Will We Get It Right This Time?," by Lynn Turner, *Issues in Accounting Education*, Nov. 2006.

[19] Ibid.

Several recent academic studies have also helped to document the substantial benefits of SOX 404. One study found, for example, that companies with poor internal controls have poorer quality financial reporting. When they improve their internal controls (as reflected in an auditor attestation that they have corrected a reported weakness) the quality of their financial reporting improves.[20] A separate study found that, after controlling for other risk factors, firms with internal control deficiencies "have significantly higher idiosyncratic risk, systematic risk, and cost of equity capital."[21] Furthermore, this study found that "remediation of an internal control deficiency is followed by a significant reduction in the cost of equity capital" and that "the magnitude of the cost of equity capital effects of the internal control deficiency are economically important, ranging from 50 to 150 basis points depending on the analysis."[22] In other words, not only is SOX 404 improving the quality of financial statements, but these improvements are recognized and rewarded by the market with a lower cost of capital.

The Global Competitiveness Argument against SOX 404 Has Been Discredited

In making its case against SOX 404, the business community has repeatedly argued that a relaxation of the standard is needed to preserve the competitiveness of U.S. securities markets. Recent reports have thoroughly discredited this argument. For example, a study by Thomson Financial analyzing 20 years of initial public offerings (IPOs) reportedly found no noticeable ill effects from SOX.[23] Instead, they found that foreign IPOs accounted for 16 percent of IPOs in the United States last year, the highest proportion in the 20 years covered by the study. Furthermore, the $10.6 billion foreign companies raised through U.S. IPOs last year represented a 23 percent share of U.S. IPO volume, the highest level since 1994, according to the study.

To the degree that the United States has seen a decline in its share of global IPOs, a number of analyses, including recent reports by Goldman Sachs[24] and Ernst & Young[25], have

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[20] *The effect of Internal Control Deficiencies and Their Remediation on Accrual Quality*, Ashbaugh-Skaife, H. (University of Wisconsin-Madison), Collins, D. (University of Iowa), Kinney, Jr., W., (University of Texas at Austin), and LaFond, R. (Massachusetts Institute of Technology-Sloan School of Management) May 30, 2006.

[21] *The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital*, Ashbaugh-Skaife, H.; Collins, D.; Kinney, Jr., W.; LaFond, R., April 2006.

[22] Ibid.

[23] "Do Tough Rules Deter Foreign IPO Listings in U.S.?," by Yvonne Ball, *The Wall Street Journal*, Feb. 20, 2007.

[24] "Is Wall Street Doomed?," by Jim O'Neill and Sandra Lawson, *Global Economics Weekly*, Goldman Sachs Economic Research, Issue No. 07/06, Feb. 14, 2007.

[25] *Global Capital Market Trends*, by Maria Pinelli and Joseph A. Muscat, Ernst &

clearly documented that other factors are primarily responsible. The Goldman Sachs analysis notes that U.S. share of global equity market capitalization dropped dramatically from 1970 to 2000, long before the passage of SOX, attributes recent IPO trends to "economic and geographic factors" as well as the spread of the "U.S. capital market 'culture,'" and notes that U.S.-based but globally minded firms stand to benefit from the growth of world markets. The Ernst & Young analysis demonstrates that companies have always tended to list close to their home markets, that as a result only a very small percentage of international listings can truly be viewed as competitive, and that U.S. markets have done extremely well in recent years in attracting listings from among those that are competitive.

Indeed, even those who have argued most strenuously for a relaxation of internal control audits have been forced to acknowledge that SOX 404 is, at most, a minor influence on recent IPO trends. Despite their obvious biases, both the Interim Report of the Committee on Capital Markets Regulation and the McKinsey Report commissioned by Sen. Schumer and Mayor Bloomberg clearly document that global economic and market trends, rather than the U.S. regulatory or legal environment, are the key factors behind a drop in the U.S. share of foreign IPOs. Although they continue to argue for a relaxation of U.S. regulatory standards, they offer no evidence that these measures would have any beneficial effect on the global competitiveness of U.S. markets.

The PCAOB has made clear that its proposed revisions were developed in response to complaints from the business community about the costs of AS2. We are deeply concerned that the Board appears to have made so little effort either to verify the validity of these complaints, which are typical of complaints from industry any time they are faced with a major new regulation, or to explore alternatives means of driving down the cost of SOX 404 compliance. It is ironic, to say the least, that members of the business community arguing for weakened investor protections have not been required to meet the same cost-benefit test they would impose before protections could be strengthened – a test they would clearly fail. We are similarly concerned that the Board has failed to seriously explore whether its proposed top-down, risk-based approach is likely to be effective. For a number of reasons, as described below, we believe it is not.

Risk-based Audits Have Not Proven Effective

Everyone can agree in theory that audits should take a top-down, risk-based approach that focuses on those areas that present the greatest risk of a material misstatement. In analyzing the merits of this approach, however, we need not rely solely on theory. Audit firms have been conducting top-down, risk-based audits of the financial statements for several decades – with often disastrous results. In fact, many of the failed audits implicated in recent massive accounting scandals were risk-based audits.[26] Time and again – in audits of companies like Enron, WorldCom, Tyco, HealthSouth, Global Crossing, Bristol Myers, and an endless litany of

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Young, Jan. 2007.

[26] "Behind Wave of Corporate Fraud: A Change in How Auditors Work," by Jonathan Weil, *The Wall Street Journal*, March 25, 2004.

others – audit firms have shown that they are unable to correctly identify high-risk issues, to appropriately design the audit to address those issues, or to stand up to high-risk clients.

There are doubtless a variety of reasons for this. Likely causes include poor training of auditors in subjects related to risk-analysis and excessive reliance on junior team members to perform the bulk of the work in the audit, including in areas that require analysis of complex issues and the exercise of professional judgment. Other causes may include the pressure on auditors to reduce the cost of the audit, even at the expense of its effectiveness, and reluctance among auditors to risk losing an important audit client.

Although the PCAOB has extensive authority to review audits, we are unaware that the Board has undertaken any serious effort to determine what are the root causes behind the numerous recent massive failures of risk-based financial statement audits, let alone feed those results back into their audit standards. Yet, this would seem to be a minimum first step before proposing a major expansion of the risk-based approach. Not only does the current proposal reflect no effort to address weaknesses in the risk-based audit approach, it actually takes steps that are likely to exacerbate those problems. Of greatest concern in this regard is the expanded reliance on the work of others it allows without imposing appropriate limitations.

The Proposal Lacks a Clear Articulation of Investor Protection Principles

The PCAOB's proposal has been promoted as a principles-based approach. In fact, however, although the standard does allow extensive flexibility in its implementation, it does not include an up-front statement of principles that describe in straightforward terms the investor protection outcome the rule is intended to achieve. We believe the addition of such a statement is essential to ensure that auditors can be held accountable for achieving the appropriate level of assurance about the adequacy of internal controls. With this in mind, we believe the following principles are among those that must be clearly spelled out at the beginning of the standard:

An independent audit of internal controls over financial reporting provides an essential supplement to reporting requirements of managers, who may have incentives not to report weaknesses in their controls.

The purpose of the audit is to determine whether internal controls at the company are functioning at a level that provides reasonable assurance they will detect and prevent a material misstatement of the financial statements and, if not, to identify and report on material weaknesses.

In assessing internal controls, auditors are responsible for obtaining sufficient evidence to support their conclusion about the adequacy of internal controls.

The auditor must ensure that decisions regarding the audit that require the analysis of complex issues or the exercise of professional judgment are handled by members of the audit team with adequate experience and training to perform those functions.

To the degree that the auditor relies on the work of others in performing the audit, the auditor is responsible for ensuring that the individual performing the work is independent and has sufficient expertise to perform those functions and for reporting to investors on the extent to which it has relied on the work of others and for what purposes.

The auditor must maintain sufficient documentation to allow a third party to review the work performed and determine whether the conclusion reached by the auditor is reasonable.

The addition of this sort of statement identifying the desired investor protection outcome and the standards necessary to achieve it is a fundamental part of a principles-based approach to rulemaking. It is particularly badly needed in this case to counteract a pervasive message throughout the proposing release that reducing costs of the audit takes precedence over ensuring its effectiveness.

The Board Should Rewrite the Standard to Correct its Anti-Investor Tone

There are numerous examples throughout the standard where the language used sends the subtle and not-so-subtle message that a key concern of the auditor should be to reduce the costs of the audit, even at the expense of its effectiveness. An early example of this bias can be found in the note accompanying paragraph three of the proposed standard, which reads:

> "The auditor should select for testing ***only*** those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to a given relevant assertion that could result in a material misstatement to the company's financial statements." (Emphasis added.)

A pro-investor rewrite would state that the auditor should select for testing ***all*** those controls that are important to the auditor's conclusion. These differences in language matter. As written, the proposed standard sends the strong message that auditors may be asked to justify any decision to test controls that someone later deems were unimportant. As a result, it risks encouraging auditors to under-test – the very weakness that has been identified as central to the failure of risk-based audits of the financial statements.[27] The pro-investor alternative sends the opposite message, that auditors may be asked to justify a failure to test controls that are later deemed to have been important. Some would argue that this statement risks encouraging auditors to over-test, though experience based on the pressure audit clients are able to bring to bear on auditors suggests this concern is exaggerated. A neutral statement would simply state that the auditor should select for testing those controls that are important to the auditor's conclusion.

There are equally serious problems with the note accompanying paragraph 9. Having identified as a key principle behind the design of the rule that audits should be tailored to fit the specific characteristics of the particular company being audited, the proposal immediately

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[27] Ibid.

repudiates that approach by substituting a definition of "smaller companies" based on a combination of market capitalization and revenue.[28] Not only is this completely inconsistent with the principles-based approach the Board claims to have adopted, it sends the clear message that, regardless of the complexity and risks, companies in this size category should be treated as a small company. The underlying message is that auditors who seek to impose potentially costly testing requirements in such an audit – because of their perception they are necessary in light of the risks associated with the company or the complexity of its finances – will be accused, perhaps even by the regulators, of having engaged in excessive testing.

A further example can be found in paragraph 10 of the proposed standard, which lists factors that may call for a different audit approach in a smaller company. The items listed are exclusively those that would likely lead to reduced audit procedures at smaller companies. Among the items missing from the list are those that send the opposite message, such as lack of competent personnel overseeing financial reporting, lack of sufficient personnel to provide checks and balances through segregation of duties, and enhanced potential for management override. Also missing are items such as the complexity of marketing and distribution channels, geographic distribution of the company, and characteristics of the company's information technology systems.

When the proposed standard does deal with some of these issues in paragraph 12 – regarding segregation of duties, for example, and potential for management override – it doesn't emphasize the enhanced risks associated with these factors in a small company. It simply suggests that a different approach to internal control in these areas may be appropriate in a smaller company. In fact, if a small company of the type described here has insufficient controls to prevent management override, the rest of the control environment will be largely irrelevant. Furthermore, given the role of management override as the dominant factor in financial frauds at companies of all sizes, but particularly in smaller companies, evaluating controls designed to prevent management override would seem to be a topic that deserves far more extensive treatment than it receives in this proposed standard.

The note accompanying paragraph 53 provides another example, when it states: "Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, any individual control does not necessarily have to operate without any deviation to be considered effective." Although this statement is true as far as it goes, it omits an important point. Where auditors find a deviation in the operation of a control, they should have an obligation to determine why that deviation exists and whether it is indicative of a bigger problem. Without that addition, the proposed standard sends the strong message that auditors can simply ignore any deviations in controls that they

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[28] The definition is taken from the report of the Advisory Committee on Smaller Public Companies, a group whose make-up was heavily tilted toward those in the business community who favored elimination of SOX 404. The only legitimate investor advocate on the committee, a representative of the CFA Institute, dissented from its findings. It is incomprehensible that the Board would rely on the completely discredited findings of this committee as the basis for its proposal.

happen to uncover. Given the overall tone of the proposing release, it may even be read as discouraging them from conducting additional testing when they uncover such deviations.

These are a few of the most egregious examples that jumped out at us in our review of the proposed standard. Far more can be found in the text of the proposing release. We urge the Board to conduct a careful review designed to identify other similar examples and eliminate them from the standard. Ideally, the Board would replace them with language that sends the opposite message – that auditors are to take seriously their obligation to obtain sufficient evidence on which to base a reasonable judgment about the adequacy of internal controls. At the very least, however, the Board should remove the bias in the standard toward cost-reduction at the expense of everything else.

Specific Anti-Investor Provisions Should Also Be Eliminated

Problems with the standard are not limited to its tone. Several provisions of the standard threaten to directly undermine the effectiveness of the internal controls audit. These include provisions: allowing the auditor to use the work of others without adequate restrictions and in areas where it is inappropriate, recalibrating the walkthrough requirement, weakening the materiality standard, requiring the auditor to use the same framework in evaluating the controls that was relied on by the manager, and restricting the auditor to evaluating controls related to relevant accounts.

Work of Others: The proposal is designed to make it easier for the auditor to rely on work performed by others. In fact, it not only permits the use of work by others, it encourages it, by requiring the auditor to assess the extent to which they will use the work of others and by suggesting that management's own evaluation of internal controls is one aspect of the work of others the auditor should consider using. While we do not oppose all loosening of requirements in this area, we do believe the standard should recognize that this introduces new risks and potential for bias into the audit and, used in excess, could seriously undermine audit effectiveness. The proposal does not, in our view, take adequate steps to mitigate these risks.

Here again, the proposed standard governing use of the work of others fails to lay out clear investor protection principles to guide its implementation. Such a statement of principle should indicate, for example, that auditors are permitted to rely on the work of others to the extent that it improves the efficiency of the audit without undermining its effectiveness. Second, it should make clear that the auditor is responsible for ensuring that the individuals performing the work are both independent and competent. Third, it should state that auditors are responsible for providing adequate oversight and testing of work performed by others to form a reasonable basis for a conclusion that the work is reliable. By introducing these principles, the Board would help to ensure that auditors only rely on the work of others when it benefits shareholders, by improving the quality of the audit or by reducing its cost without compromising its quality.

In contrast, as described in paragraph 13, the proposed standard actually permits the auditor to rely on work performed by individuals who are both lacking in objectivity and of marginal competence. While it includes vague limits on the degree to which the auditor could use the work of such individuals, it discourages the auditor from reaching an absolute judgment that certain individuals lack the competence or objectivity necessary to perform work related to the audit. The standard should send precisely the opposite message, that auditors are responsible for reaching such judgments.

Second, the integrated audit standard permits use of the work of others in certain circumstances in which auditors should categorically be prohibited from doing so. Of particular concern is the fact that the proposal would permit the auditor to use the work of others when performing walkthroughs for significant processes. These walkthroughs form the basis for key decisions about the design and implementation of control testing. Moreover, the walkthrough provides a key test of whether control design is matched by how it functions in reality. It is inconceivable that the auditor could form an adequate understanding of the control environment or business operations without performing this function him- or herself.

Recalibrating the Walkthrough Requirement: Not only does the standard allow the auditor to delegate much of the work involved in the walkthrough to an outsider, it suggests that "probing inquiries" can substitute for actually following the transaction "through each minor variance in the process." The whole point of a walkthrough, however, is to determine how the process works in reality and whether that is consistent with how the process is described by management. No matter how "probing," using inquiries as a substitute for actually observing the process simply cannot supply the answer to that question. The standard should be rewritten to restore the integrity of the walkthrough process.

Weakening the Materiality Standard: In the name of "clarifying" the role of interim materiality in the audit, the Board essentially clarifies it out of existence. As the proposing release makes clear, concerns about misstatements of interim financial disclosures would not play a role in determining the scope of the audit, and that point is further driven home by the standard's discussion of the role of scoping and evaluation. Then, with its questions in the proposing release, the Board invites the business community to argue that further restrictions are need. Far from further weakening the materiality standard, the Board should restore the language on interim materiality from AS2 as essential to retaining the integrity of the internal control audit.

The Control Framework: Although the auditor will no longer be opining on the adequacy of managements control assessment, the audit standard requires the auditor to use the same control framework relied on by management in assessing the adequacy of internal controls. While this will often be the logical and appropriate course, we can foresee circumstances in which that would not be the case. In particular, we believe the auditor must be free to express a view on the control framework used by management where the auditor does not believe that framework adequately addresses the risks or complexity of the company in question. So, while it may be appropriate to encourage auditors to use the same control framework relied on by management, it should not be required. Furthermore, auditors should be encouraged to communicate concerns about the adequacy of the control framework used by management, where such concerns exist.[29]

Audit Scope: The proposal effectively restricts auditors to testing those controls that are directly related to significant accounts and disclosures, relevant assertions, and significant processes. This approach seems to prohibit auditors from stepping back and taking the kind of broader look that would allow a more informed view of the general environment at the company and the quality of the financial reporting. In several recent accounting scandals, errors surfaced a variety of areas, some in areas that would have been unlikely to have been assessed as high-risk. At Qwest, for example, a matter as relatively simple as payroll wasn't recorded correctly. It is highly unlikely that payroll would be identified as a high-risk area deserving audit attention under the top-down, risk-based approach described in the proposal. But evidence that a company is getting even the simple things wrong would be an enormous red flag of potential problems elsewhere. As such, it ought to inform decisions about the design of the audit and the scope of testing needed. We believe the standard should not only permit, but encourage, auditors to do a basic level of testing designed to give them a better sense of the lay of the land at the company they are auditing before they reach conclusions about the areas where problems are most likely to emerge.

Pro-Investor Provisions Should Be Added

Adequate Documentation: In addition to including this as a fundamental principle, the standard should include provisions regarding documentation of the audit. Those requirements should ensure that auditors provide sufficient documentation to allow a third-party to review the work conducted, understand the basis for the auditor's conclusions, and assess the reasonableness of those conclusions.

Responsibilities of the Audit Partner and Audit Team Manager: The proposed standard relies heavily throughout on exercise of professional judgment. While this may be appropriate in an ideal world, it makes it all the more important that key aspects of the audit are handled by members of the audit team with adequate experience and expertise. It is our understanding that this is often not the case. On the contrary, we understand that the vast majority of the work on most audits is performed by audit team members with zero to six years experience. We urge the Board to make clear that key aspects of the audit should be handled by the audit partner and audit team manager. These should include the risk assessment, but also other aspects of the audit that involve analysis of complex issues or extensive use of professional judgment.

Use of Information Obtained in Previous Years: The proposal encourages auditors to make use of information they have obtained through previous years' audits. This is a sensible approach that, properly implemented, should allow audits to gain in both efficiency and effectiveness from year to year. The Board should make clear in the standard, however, that auditors have an obligation to go back and assess periodically whether what they learned in previous years is still relevant or whether factors have changed in a way that require the auditor

[29] It may be appropriate, for example, to require the auditor to communicate any such concerns both the management and to the audit committee.

to reconsider that information.

Misstatements and the Presumption of a Material Weakness: The proposal states that a material weakness may exist even where there is no evidence of a material misstatement. This is appropriate. However, we encourage the Board to expand on this by indicating that the existence of a material misstatement creates the presumption of a material weakness and that, where the auditor determines that this is not the case, the auditor has an enhanced responsibility to provide evidence to support that conclusion. As with all areas of the audit, we believe documentation should be sufficient to allow a third party to review the evidence and assess the reasonableness of the auditor's conclusion.

Report to Investors: The standard details what information should be provided to investors and in what form. This seems to us to be largely boilerplate that does little to actually provide investors with useful information. Among other things, we believe the report should detail the nature and extent of testing performed by the auditor. It should also be required to describe the extent to which the auditor relied on the work of others. This would provide investors with valuable information they could use to assess for themselves the thoroughness and reliability of the audit. We believe it is absolutely essential in light of the flexibility, even encouragement, the standard provides to short-change the audit.

Conclusion

We recognize that the Board has been under enormous political pressure to scale back the requirements of AS2. We nonetheless urge the Board to resist that pressure, assert its independence, and withdraw its ill-founded, ill-advised rewrite of the standard. Not only would that benefit investors directly, by ensuring that internal control requirements continue to work to improve the quality of financial disclosures, it would also benefit investors indirectly, by sending the message that the Board cannot be bullied by a business community intent on achieving cost savings at the expense of investor protections.

Respectfully submitted,

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Edmund Mierzwinski
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Consumer Action

cc: Mark Olson, Chairman, PCAOB
Kayla Gillan, Member, PCAOB
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Via Email

February 13, 2007

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

I am writing on behalf of the Council of Institutional Investors ("Council"), an association of more than 130 public, corporate and union pension funds with combined assets of over $3 trillion. As a leading voice for long-term, patient capital, the Council believes that Section 404 of the Sarbanes-Oxley Act of 2002 has been critical in restoring investor confidence and the overall integrity of the United States ("US") capital markets and welcomes the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements And Other Related Proposals* ("Proposal").

We believe that effective internal controls, long required of public companies by the Foreign Corrupt Practices Act of 1977, are the backbone of high quality financial reports. All companies tapping the public markets to raise capital, regardless of size, should have appropriate controls in place and management should be responsible for assessing those controls with meaningful review by external auditors.

Section 404 is improving companies' internal controls. A recent study revealed that the number of restatements filed by large public companies, which adopted Section 404 in 2004, fell by nearly twenty percent in 2006, the first such decline since 2001.[1] By contrast, the number of restatements by smaller public companies with a public float of less than $75 million, companies that have yet to adopt Section 404, increased in 2006 by forty-two percent.[2]

[1] David Reilly, *Restatements Still Bedevil Firms,* Wall St. J., February 12, 2007, at C7.
[2] *Id*.

In May 2006, following our participation on the US Securities and Exchange Commission ("SEC") and PCAOB Roundtable on Second-Year Experiences with Internal Control Reporting and Auditing Provisions, we provided several broad-based recommendations to the SEC and PCAOB.[3] Those recommendations were designed to "preserve the investor protections provided by Section 404" [4] while addressing those legitimate concerns raised by some parties about certain difficulties and costs[5] in implementing the Section 404 requirements. They included the following:

> . . . *The PCAOB should offer clarification for and/or amendments to Auditing Standard No. 2 while maintaining the underlying principles behind the standard*. Although Roundtable participants appeared to be in agreement about the importance of maintaining the principles espoused in AS2, anecdotal evidence suggests some auditors have yet to fully embrace the related May 2005 Questions and Answers and Policy Statement issued by the PCAOB, specifically the guidance on using the work of others and producing integrated risk-based audits taking into account the scale, scope, and complexity of the companies operations. . . . The Council also supports additional guidance from the PCAOB to address remaining implementation problems and, if deemed helpful, integration of that guidance and the May 2005 Questions and Answers and Policy Statement into AS2.
>
> . . . The Council recommends that guidance tailored to the unique issues faced by smaller . . . audit firms be issued.[6]

The Council believes the Proposal is largely responsive to the Council's recommendations and we strongly support its prompt adoption and implementation as a final standard.[7] We also offer the following brief comments on four areas addressed in the Proposal that are of particular interest to investors.

Scaling the Audit for Smaller Companies

On average, Council members have more than fifty percent of their US equity holdings invested in indexed funds, including significant investments in the Russell 3000 stock index. Moreover, the evidence indicates that smaller public companies are especially prone to misstatements and restatements of financial information.[8] Thus, an audit of the internal control of the generally riskier smaller public companies is as important to our members and many other investors as an audit of the internal control of larger public companies.

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[3] Letter from Ann Yerger, Executive Director, *The Council of Institutional Investors*, to The Honorable Christopher Cox, Chairman, *U.S. Securities and Exchange* and The Honorable Bill Gradison, Acting Chairman, *Public Company Accounting Oversight Board* 2-3 (May 17, 2006).
[4] I*d*. at 2.
[5] Of note, Glass, Lewis & Co., LLC., has reported that a review of company filings for the Standard and Poor's 500 indicates that audit fees as a percentage of revenues *declined* in 2005. Lynn Turner, Remarks at the Duke-ILEP Conference on Reform Proposals of Committee on Capital Market Regulation and U.S. Chamber of Commerce 37 (February 2, 2007).
[6] *Letter from Ann Yerger,* at 2-3.
[7] *Cf.* Letter from Jeff Mahoney, General Counsel, *The Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission* 2-3 (September 14, 2006) (Explaining why a "serial extension of the Section 404 requirements" is not in the best interests of investors).
[8] *See, e.g.*, *Lynn Turner*, at 24.

We generally support the Proposal's guidance on "Scaling the Audit for Smaller Companies."[9] We, however, would respectfully request that the final standard emphasize that a scaled audit for a smaller company does not mean a less rigorous audit. For example, the final standard should explicitly state that a scaled audit for a smaller company does not exempt the audit from *any* of the principles set forth for planning the audit, testing controls, evaluating identified deficiencies, and reporting on internal control.

In addition, we generally support the guidance requiring the auditor to evaluate the size *and* complexity of a company in planning and performing the audit.[10] We would therefore oppose any revisions to the Proposal that would permit the scaling of the audit for smaller companies based solely on the rules-based size limits contained in the final report of the SEC Advisory Committee on Smaller Companies.[11] There is no evidence that we are aware of indicating that the size of a company decreases the risks of misstatement.[12]

Using the Work of Others

We generally support the Proposal's guidance on "Considering and Using the Work of Others in an Audit."[13] We, however, believe that an excessive use of the work of others in performing an audit of internal controls, particularly using work performed by company management, may weaken investor protection and impair the credibility of the independent audit and regulatory processes. Our support for the proposed guidance is therefore conditioned on the final standard containing a framework for evaluating the persons performing the work that is *no less restrictive* than that currently contained in the Proposal.[14]

For example, we would oppose the removal of any of the proposed factors for assessing the competence and objectivity of individuals performing tests, including the proposed factor that focuses on a company's policies addressing compensation arrangements for individuals performing the testing.[15] As indicated in many of the ongoing stock option backdating investigations, compensation arrangements can erode an employees' objectivity about the quality of, or even the need for, internal controls over financial reporting.[16]

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[9] Proposed Auditing Standard, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, ¶¶ 9-12 (December 19, 2006).
[10] *Id*. ¶ 9.
[11] *Id*.
[12] *Cf.* COSO, Internal Control over Financial Reporting—Guidance for Smaller Companies, FAQ, Item 19 (June 2006) ("Size of the organization does not decrease the need for effective internal control").
[13] Proposed Auditing Standard, Considering and Using the Work of Others in an Audit (December 19, 2006).
[14] *Id*. ¶¶ 10-19.
[15] *Id*. ¶ *15(c).*
[16] Cf. *Lynn Turner*, at 13 (Noting that 40 of 225 companies that have announced internal or governmental reviews of stock-option backdating have reported material weaknesses and 99 have reported restatements).

Special Considerations for Subsequent Years' Audits

We generally support the Proposal's guidance on "Special Considerations for Subsequent Years' Audits."[17] We agree that the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision making process for determining the nature, timing, and extent of testing necessary in the current year.[18] Those requirements would appear to be consistent with applying sound professional judgment as part of an audit of internal control.

We continue to strongly oppose any form of rotational testing of sections of internal control.[19] The final standard should be clear that auditors are not permitted to assume that the company's controls are functioning each year without testing them. As we have stated in prior comment letters on this topic, rotational testing

> . . . is comparable to telling drivers that the state police will only patrol the interstate on Tuesdays and Fridays. Any such alternative would likely only confuse investors and open the process to problems that could harm the investing public.[20]

Clarifying the Role of Materiality in the Audit

We generally support the Proposal's guidance on "Materiality."[21] We agree with the proposed clarification that the auditor should plan and perform the audit of internal control using the same qualitative principles-based materiality measures used to plan and perform the audit of the annual financial statements.[22]

We would oppose any revision to the Proposal that would establish a rules-based numerical formula, such as five percent of net income, for assessing materiality in the audit of internal control. Numerical thresholds for materiality in the context of financial reporting have been extensively studied by many parties over many years.[23] We note that the SEC,[24] the Financial Accounting Standards Board,[25] and the US Supreme Court [26] have all reached generally consistent conclusions indicating that investors are best served by a qualitative principles-based approach to materiality.

In conclusion, we applaud the PCAOB on developing a thoughtful proposed standard that is responsive to the recommendations of the Council. We look forward to a prompt adoption and implementation of the Proposal as a final standard. Investors have long demanded, and have long deserved, a full and cost effective implementation of the requirements of Section 404 by all companies—large and small—that access the public markets.

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[17] *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, ¶¶ 65-69.
[18] *Id.* ¶ 65.
[19] Letter from Jeff Mahoney, General Counsel, *Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission* 5 (September 14, 2006).
[20] *Id.*
[21] *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, ¶¶ 14-15.
[22] *Id.* ¶ 14.
[23] *See*, *e.g.*, SEC Staff Accounting Bulletin: No. 99 – Materiality, 17 C.F.R. § 211 (August 12, 1999).
[24] *Id.*
[25] *Id.* at 3.
[26] *Id.*

The Council appreciates the opportunity to comment. We would be happy to respond if you have any questions or need additional information.

Sincerely,

Jeff Mahoney
General Counsel

cricket
February 26, 2007

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Reference: Rulemaking Docket Matter No. 021

We are an innovative company providing value-driven wireless communications services. Our success stems in part from our strong commitment to being a cost leader. Compliance with the Sarbanes-Oxley Act, particularly section 404, has added significant costs which reduce our ability to spend funds on providing innovative services to underserved consumers. Rather than drive shareholder value, SOX compliance has had the opposite effect. We spend money on systems and controls and not on creating business value through innovation.

We are pleased to see the Board take action to put risk assessment back into the equation. Risk is not inherently bad, just another aspect of the business to be managed. Complete risk mitigation for purposes of SOX 404 compliance drove compliance costs to unreasonable levels without creating commensurate benefits. Pursuit of more cost effective SOX compliance efforts have been stifled by the pervasive focus on near complete risk mitigation.

The Proposed Auditing Standard has 34 questions that the Board seeks comments on; the following are responses to two of those questions.

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?

We believe that reliance on a robust walkthrough is sufficient evidence of both the design and effectiveness of a low risk process regardless of transaction volume. However, this calls into question when the walkthrough should be performed and how it will be followed up. Is a walkthrough sufficient evidence for frequently occurring manual controls, and is it sufficient evidence for reliance in subsequent years?

Walkthroughs are usually performed at the beginning of the SOX testing process, often in Q2.

- Would this be too early in the process?
- What would be the appropriate form of update?
  - Would inquiry be sufficient?
  - Would another walkthrough be required in Q4?
    - Would a general requirement for a second walkthrough late in the year focus efforts and hence costs on the most risky areas?

We suggest that walkthroughs which will be relied upon as the primary evidence of a control's effectiveness be performed late in Q3 consistent with the external auditors reliance on the test work performed by management, with updates consisting of inquiries conducted in Q4. Acceptance of this approach would require updating or clarification of paragraph 64 to ensure the auditor understands how to interpret the sufficiency of the evidence collected through the walkthrough and what additional procedures are necessary.

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Further, if the Board accepts walkthroughs as primary evidence of effectiveness, paragraph 62 which states:

> *"Frequency of operation. Generally, the more frequently a manual control operates, the more operations of the control the auditor should test to obtain sufficient evidence ..."*

should also be updated to indicate that this does not apply in those cases where walkthroughs are used as the primary source of evidence.

Another area of focus should be paragraph 66 which could be seen to limit the use of walkthroughs to one year if the board interpreted:

> *" ... The nature, timing, and extent of procedures performed in previous audits,"*

to mean that a walkthrough provided insufficient evidence in subsequent years. Again, if this is not the intent of the Board, they should clarify that obtaining evidence through a walkthrough is sufficient and would not preclude the use of a walkthrough as the primary source of evidence in the subsequent year. Failure to do this would likely result in full population testing every other year regardless of the risk and results of prior year's walkthroughs.

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

Yes. We believe the Board should bifurcate the elements of market cap and complexity. While we are a large company as defined by market cap we are not complex having only one ERP system, a centralized accounting function, no international markets, no segment reporting, and a very engaged senior management team. If not for our size, we would be able to make use of many of the accommodations made for small cap companies at no increased risk to the investing public all the while reducing our costs of compliance. Conversely, there are companies which are much more complex but would qualify as small cap and be able to benefit from the revised standards. Often, it is these smaller, less structured companies where controls are weak and increased focus may be more warranted.

Overall we are pleased to see the Board take measures to re-balance the process. While investors have a right to know that the financial statements presented are materially free from error, they also expect companies to use their assets in ways that add value to the business and grow their equity investment. In order to achieve these two goals, the SOX requirements must be more balanced.

Please note that this letter expresses my personal views and does not necessarily represent the views of the Company.

Sincerely,

Catherine A. Young
Director, Internal Audit
Leap Wireless International, Inc.

cc. Amin Khalifa, CFO

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February 26, 2007

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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*, PCAOB Release No. 2006-07**

Dear Office of the Secretary:

Crowe Chizek and Company LLC appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") 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 "Proposed Standard"). Our comments on the Proposed Standard contemplate the U.S. Securities and Exchange Commission's ("SEC") proposed interpretation and rule, *Management's Report on Internal Control Over Financial Reporting* (the "Proposed Interpretation"). The Proposed Standard and Proposed Interpretation are clearly meant to provide a joint framework under which issuers and their auditors can work to optimize the cost effectiveness of meeting their internal control reporting obligations. Our comments on the PCAOB's proposed auditing standard, *Considering and Using the Work of Others in an Audit,* are in the section below, "Removing Barriers to Using the Work of Others."

We support the Proposed Standard, and the use of the top-down, risk-based approach. We believe this will serve to accelerate efficiencies that issuers and their auditors have been discovering and implementing as part of the learning curve associated with internal control assessment and auditing. The overall tone of the Proposed Standard is a meaningful improvement, emphasizing use of auditor's professional judgment and thoughtful consideration of relative risks. Replacing the more detail oriented language of Auditing Standard No. 2 ("AS No. 2") with a standard that establishes a tone more consistent with pre-existing auditing standards should provide auditors, working with their issuer clients, opportunities to achieve audit objectives in more cost effective ways.

While cost considerations have driven a great deal of the debate regarding audits of internal control over financial reporting ("ICFR"), we are pleased that the PCAOB and SEC are proposing an approach that preserves the significant benefits that internal control auditing bring to the financial reporting process. The major concepts, including management taking responsibility for and assessing their internal control structure, and auditors conducting an independent assessment of internal controls, are important factors resulting in improved financial reporting. The decision to include all issuers within a single framework ensures that investors in companies of all sizes can expect comparable assessments of internal controls and financial reporting quality. The Proposed Standard provides guidance to better scale the cost so that all issuers can be included in the process in a cost effective manner.

This letter provides responses to the 34 questions for which the Board requested public comment. Following that, we have provided other observations and comments to help the Board better achieve its goals for this Proposed Standard.

Directing the Auditor's Attention Towards the Most Important Controls

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

   The general top-down approach concept described is clear and understandable. We do suggest further guidance in the section "Identifying Company Level Controls." Paragraph 18 provides eight bullet points describing types of company level controls. We believe that auditors are already considering certain of these points in their ICFR audits in a cost effective manner. However, we believe that auditors may not have yet focused to the fullest extent on "controls to monitor results of operations" or "controls to monitor other controls."

   Many companies, particularly those with disaggregated operations, maintain centralized monitoring systems, such as monthly budgetary reviews and analyses. In instances where such systems are effective at detecting errors at a precision level of less than materiality, the auditor could elect to rely solely on that system to form his or her conclusions regarding the relevant control objectives. We believe that the PCAOB should include a number of illustrations of such centralized review systems, control environment controls, controls over the period end financial reporting process or other controls operating at the company level which provide comprehensive evidence of control effectiveness at the account level. That would help auditors more fully understand how to identify such controls and evaluate their effectiveness. We believe that this will be particularly important for audits of smaller companies.

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

   Yes, the proposed standard places appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud. The link to materiality could be clearer as there should not be excessive focus by the auditor on fraud that is immaterial, as this would be inefficient.

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

   The Proposed Standard places appropriate emphasis on focusing the auditor's attention on the most important controls. The PCAOB describes the overall approach articulated in the Proposed Standard as a "risk based, top down approach." We believe that the concept of "risk based" should be the more determinative concept that focuses the auditor's attention on the most important 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?

   No. More examples of company level controls which can have a direct account level impact should be provided.

Emphasizing the Importance of Risk Assessment

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?

   The Proposed Standard appropriately incorporates risk assessment.

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

   The effective application of a risk-based approach allows reduced testing of selected lower risk controls due to the performance of a walkthrough. However, we believe paragraph 36 should be expanded to allow the auditor to exercise judgment relative to the nature and extent of walkthrough procedures to perform based on the auditor's assessment of risk. Certain large accounts and processes with few transactions may have control structures that are quite simple in nature. Examples might include property and equipment and long term debt at many issuers. In such cases, an auditor might not need to "follow a transaction from origination through the company's processes, including information systems, until it is reflected in the company's records." Where few transactions exist in such areas we do not believe a walkthrough is a cost effective way of obtaining an understanding of the account processing and control structure. Instead, the auditor might focus on determining the design effectiveness of individual key controls. We encourage the PCAOB to modify the approach to walkthroughs to be based on judgments about risk rather than requiring a specific walkthrough for every significant process.

   The requirement for numerous walkthroughs may not result in a risk-based or efficient audit approach. There may be many internal control assessment techniques that could be used in a variety of circumstances other than a walkthrough of one transaction from initiation to recording in the general ledger. Experienced auditors can determine the most appropriate approach, which may be a walkthrough but equally likely may be other approaches. Further, the requirement to walkthrough one transaction from initiation to recording in the general ledger is can be inefficient because of two reasons. First, an auditor may walk one transaction "part of the way" through the process during an interim audit period, and when returning for a later audit period, it may be more efficient and effective to walk a separate transaction forward from the intermediate step, as systems may have changed. The proposed standard anticipates this in paragraph 60 which says that superseded systems need not be tested for the ICFR portion of the audit. Second, an auditor may walk one transaction "part of the way" through the process until it arrives at an intermediate point, say a sales journal. The auditor may have already walked through another transaction all the way through from origination to the sales journal to the general ledger, to the financial statements. The auditor should not have to redundantly walk the second transaction through from the sales journal just because the second transaction originated in a different spot than the first transaction. This concept should be reflected in paragraph 36.

Revising the Definitions of Significant Deficiency and Material Weakness

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?

   Yes, the definition is sufficiently descriptive.

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?

   Auditors are identifying material weaknesses in the absence of an actual material misstatement. Auditors are able to effectively consider the potential error in circumstances where an actual misstatement has not been found. However, an auditor will more frequently conclude that internal control over financial reporting provides reasonable assurance that a material misstatement will not occur, when a material misstatement has not yet occurred due to the control deficiency being evaluated.

   More guidance on the assessment of potential error, rather than known error, would be helpful. Additionally, if the PCAOB has identified examples where auditors have commonly reached inappropriate conclusions as to the existence of material weaknesses in the absence of actual material misstatements, such examples should be provided as additional guidance.

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?

   The changes to the definitions will not reduce the amount of effort devoted to performing an integrated audit. The definitional changes are an important part of the PCAOB's objective of resetting the overall tone associated with internal control auditing. However, the definitions are substantively unchanged and were likely being applied similarly and appropriately in practice.

   Further, all deficiencies must still be communicated to management according to the Proposed Standard, even if not a significant deficiency. This will lead to expenditure of audit effort in conveying things that are not material weaknesses or even with reasonable possibility of being a material weakness. In the interests of efficiency, only significant deficiencies should be required to be communicated to management. The auditor can use professional judgment to determine whether to communicate lesser items.

Revising the Strong Indicators of a Material Weakness

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?

    Yes, such a conclusion should be allowed. Certain financial statement errors cannot be prevented based on knowledge reasonably available to issuers or their auditors. It is not uncommon for issuer specific technical issues that are interpretive in nature to be informally addressed by FASB, SEC or large accounting firms with conclusions formed regarding the appropriate treatment. Often generalized conclusions are then drawn from the specific fact patterns, yet in many cases, only specific issuers or accounting firms are aware of the interpretive guidance. This happens because standard setters do not have sufficient capacity to publicly discuss every issue that arises and the mechanisms in place to distribute such knowledge do not ensure that all such relevant interpretations with general application are made widely known or available to all.

Clarifying the Role of Materiality in the Audit

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

    Yes. Our comments on the scope of the audit of internal control are provided in other comments in this letter.

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?

    Yes, the reference should be removed. The reference to interim financial statements is inherently inconsistent with the concept of reporting on ICFR "as of" the end of a fiscal year. Removing the reference to interim financial statements is consistent with the overall objective of focusing the auditor on the most important matters, and removing this reference would eliminate the inconsistency of planning the audit to identify material weaknesses defined in one manner ("as of" year end) and evaluating the deficiency on another basis (at interim date). Removing the reference would not impact the scope of the audit, but it would have an appropriate impact on the evaluation of deficiencies. Should the reference be retained, guidance on assessment of interim materiality for evaluation of deficiencies should be provided as well as guidance on how a material weakness involving interim but not "as of" the end of the year is to be assessed and reported.

Removing the Requirement to Evaluate Management's Process

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

    Yes, but the amount of work eliminated will vary widely. Many auditors were not conducting significant incremental work on the evaluation of management's process solely for the purpose of reporting on management's process. This is particularly true for accelerated filers that have now completed a third year of evaluating ICFR. Many auditors were appropriately using the work of others in concluding on the effectiveness of management's conclusions. The existence of the requirement did cause the auditor to formally consider management's process and document that consideration and the related conclusions. Such consideration and documentation did create a cost which would now be removed.

    If, as suggested in the Proposed Interpretation, management reduces their assessment process and documentation such that auditors are required to obtain more evidence from their own testing, the resulting increase in auditor costs could likely exceed the cost reduction resulting from the auditor no longer having to formally evaluate management's process.

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

    The approach described in the Proposed Standard is workable. The auditor will still gain a great deal of knowledge from reviewing or using management's process. Any effective and efficient approach to assessing ICFR by both management and the auditor will still benefit by coordination of effort. The auditor should obtain a sufficient understanding of the quality of management's process through such coordination for purposes of considering the auditor's approach.

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?

    Yes. The previous opinion on management's assessment was confusing to users and added little value.

Permitting Consideration of Knowledge Obtained During Previous Audits

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

    Yes. The guidance strikes a proper balance in permitting consideration of prior results in setting scope, yet still requiring each year to effectively stand on its own.

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?

    Yes. This could occur with low risk significant accounts and processes, and the auditor may also consider the results of substantive testing performed on the account, as well as whether more extensive control testing was performed in prior years. The auditor may also conclude this is appropriate in instances where the issuer had company level controls operating at a level of precision that permit the auditor to draw conclusions regarding control objectives at the account level.

Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage

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?

    Yes. This is an appropriate change. While auditors could often get to the same results applying either concept, we believe that the "coverage concept" in AS No. 2 injected a greater bias toward more extensive testing than the risk concept. Additionally, the risk concept more appropriately allows the auditor to use judgment to determine the testing approach.

Removing Barriers to Using the Work of Others

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?

    The proposed replacement of the existing PCAOB standards for using the work of others may lead to conclusions resulting in inappropriate reliance on others. The framework is workable, but it might imply a greater ability for the auditor to incorporate the work of others than is reasonably appropriate. Under the previous guidance, where two frameworks were presented, the auditor inherently considered the competence and objectivity of the "others" in the context of the assignment—financial statement auditing or internal control auditing. Under the new framework this consideration is less explicit, yet must still be applied. This single framework to using the work of others will make it very important for the auditor to understand the competence and objectivity of each of the "others" in relationship to the specific work (relevant activities) they conduct, and this relationship should be clarified in the Proposed Standard.

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?

Yes.

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

Probably not, and this will require additional cost and likely loss of efficiency. This requirement should be made optional based on auditor judgment. Paragraphs 3 through 6 in the proposed standard on considering and using the work of others in an audit describe the auditor's responsibility to determine whether there are activities performed by others that can be used in connection with the audit. We believe that these paragraphs will likely lead to effort expended looking for activities significantly removed from those of internal auditors and similar groups described in AU sec 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* which may not be useable because of issues related to competence and objectivity. It is inefficient as well to search internal audit work and the work of similar groups that may not be deemed likely to affect areas material to the financial statements. Further, if such a search is performed once and the auditor determined that the work of others was not useful, the same exercise should not be required in later years. Accordingly we see little benefit to adding these paragraphs. If the PCAOB adopts the standard on considering and using the work of others in an audit then we recommend that the consideration of what groups within the entity have the needed competence and objectivity be located before the consideration of relevant activities in order to be more efficient.

In addition, the PCAOB should describe the extent of documentation of these search activities that it would consider appropriate.

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

No. Removal of the provision results in the Proposed Standard being more consistent with other generally accepted auditing standards. The auditor is still responsible for accumulating the evidence necessary on which to base their conclusion.

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?

    As discussed above, the single framework makes it very important for the auditor to understand the competence and objectivity of each of the "others" in relationship to the specific work (relevant activities) they conduct. The Proposed Standard should be clarified to emphasize the importance of this relationship.

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

    The factors identified appear to be appropriate.

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?

    In concept this is an appropriate factor to consider in assessing the objectivity of "others". However, the practical effect will be expansion of audit procedures to develop understanding of the compensation arrangements of internal audit personnel and other internal groups and performing the required compliance testing. As written, it appears that the auditor may be required to evaluate the compensation arrangements for each person whose work may be used, which could be a very large number of people.

Recalibrating the Walkthrough Requirements

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

    This will result in modest efficiency improvements. As mentioned previously in #6 above, we believe the Proposed Standard should provide more flexibility in determining the nature and extent of walkthrough procedures.

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 Standard reaches an appropriate conclusion on use of others on walkthroughs.

Scaling the Audit for Smaller Companies

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?

    The guidance properly identifies areas in which the level of documentation, and approach, can vary significantly due to the size of the company.

    The title of the section "Scaling the Audit for Smaller Companies" is not appropriate, and may lead users to incorrectly conclude that this section only relates to smaller companies. Since the large majority of the U.S. issuers are smaller companies as defined in the guidance, it may be more appropriate to suggest that the major portion of the Proposed Standard is written for smaller companies, and that any special emphasis would be better focused as "Scaling the Audit for Large Accelerated Filers."

    The implementation of the original standard, which focused on larger companies first, has caused a point of view that the standard on audit of internal control is primarily written for larger companies and that an auditor must consider "smaller companies" in a different way. However, the Proposed Standard achieves the scalability objective. Accordingly, the "special guidance" should be for the relatively fewer audits of larger companies.

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

    See our recommendation above relative to the scalability section of the Proposed Standard. Other factors that may need to be considered for smaller, less complex companies may include sufficiency of management financial reporting expertise, qualifications of audit committee members and the quality of management's testing and documentation.

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?

    See discussions above.

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

    The items discussed are worthy of consideration. However, we are concerned about one area of guidance, "*Evaluating Financial Reporting Competencies*" which states "…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." This attribute, in a list of how an audit of smaller, less-complex companies differs, can be read to suggest there can be a lower threshold for performance for smaller companies in connection with their financial reporting.

Most would agree that an effective system of ICFR means that an issuer can produce financial statements that reflect the financial position, results of operations and cash flows of the issuer in accordance with generally accepted accounting principles, without relying on the auditor to detect and suggest corrections for errors. This is an objective overarching statement regarding financial reporting competencies. Within this is the concept that companies have varying degrees of complexity, and that a company need not have the competencies necessary to deal with accounting standards and reporting issues which are not relevant to the company. However, they do need to have the necessary skills to successfully manage with the standards and reporting issues which are relevant.

The inclusion of this topic in the list of attributes could cause some issuers to incorrectly assume a lower level of performance than anticipated by the Sarbanes-Oxley Act, SEC rules, or the Proposed Standard. If this topic is maintained in the listing of considerations we recommend a more detailed discussion of anticipated minimum threshold performance.

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?

When applying a single, scalable standard across all issuers, arbitrary classifications of size do not add much value. The considerations described should be thought through in every assessment of ICFR. The considerations listed become more relevant as companies become smaller, but they also become more relevant as companies become more centralized, have fewer product lines, engage in activities with more straight-forward accounting, etc. A qualitative description centering on the general concepts of smaller and less complex would be a more effective classification system.

If quantitative thresholds are considered necessary to provide relevant guidance, we believe that the guidance included in the proposed standards is incomplete. The Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (the "Committee") recognized this point by including certain revenue considerations in their proposed definitions which are the referenced source of the size criteria in the Proposed Standard. Comment letters provided in response to the Committee's draft report commentators, including ours, indicated that a size based criteria would be incomplete without an asset consideration as well as a revenue consideration. However, our primary point is that size should be described qualitatively rather than quantitatively, allowing all issuers to benefit from the thinking inherent in the considerations.

Audit Committee Pre-approval of Services Related to Internal control

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?

No.

Effective Date

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?

    An answer to this question depends on the requirements included in the final standard. It may be appropriate for the effective date to be for audits as of December 31, 2008 as it is likely the standards will not be finalized soon enough for auditors and issuers to be able to fully implement changes resulting from the Proposed Standard and the Proposed Interpretation for earlier periods. However, auditors should be encouraged to utilize the greater flexibility in the proposed standards as the auditor deems appropriate for each issuer circumstance. Hence, allowing early adoption of all or parts of the final standard can achieve desired efficiencies.

Other Comments

Directive Nature of Proposed Standard:

While the Proposed Standard encourages use of judgment and scalability in the audit, it is still prescriptive and detailed. The PCAOB has previously established rules indicating a "must" direction is always required, and the word "should" indicates a responsibility that is presumptively mandatory, such that auditors will comply with requirements of these types specified in the Board's standards. There are hundreds of such specific matters that the auditor will need to perform in the Proposed Standard, which will make it more difficult to properly scale the ICFR audit for smaller companies. Some of the requirements may also lead to unneeded documentation when considered in light of the requirements of Auditing Standard No. 3, Audit Documentation. Some directives might be replaced by language to indicate the guidance is illustrative, rather than mandatory. We recommend that each of the presumptively mandatory requirements provided in the Proposed Standard be reviewed to ensure it is appropriate and needed.

Paragraph 8 – The Proposed Standard addresses several ways for the auditor to better focus on the most important controls. We are concerned with the language in this paragraph that indicates "it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements." This statement may cause the auditor to consider the potential impact of each individual control at the risk of not identifying a material weakness based on the evaluation of aggregate controls in one area.

Paragraph 12 – We recommend adding to the end of the attribute "Evaluating the risk of management override and mitigating factors" guidance for when there is a lack of effective audit committee oversight.

Paragraph 15 – We recommended above that the references to interim financial statements be removed from the definitions of significant deficiency and material weakness. If the references are retained, paragraph 15 which now states "…the auditor must consider the possibility of misstatement to both annual and interim financial statements" should be clarified. The definitions of significant deficiency and material weakness use "or" rather than "and". Does this evaluation require that both periods must be misstated to result in a significant deficiency or material weakness, or does it require that 'either annual or interim' be misstated?

Paragraphs 17-22 – These paragraphs indicate that the auditor should evaluate company level controls that are important; however, it appears that an evaluation is only required for the control environment and the period end financial reporting process. The PCAOB should clarify that the elements of company level controls described in the other 6 bullets in paragraph 18 may not need to be evaluated if the auditor does not consider them to be important.

There may be valid alternatives which may be more efficient, and just as effective to the "must test company-level controls" first approach based on specific facts and circumstances. The PCAOB should recognize this by providing a presumption that company level controls would be tested first, but allow alternatives when deemed more efficient. Thus, paragraph 17 should start with "The auditor should usually", instead of "The auditor must". Examples of when it may not be efficient to test company-level controls first would be simultaneous testing of company-level controls and other audit tests when only a short time period is available for the audit; delaying testing of company-level controls until later in the audit when the auditor knows the company-level controls are being revised and will be superseded (such as changes in information technology controls); or waiting to use the work of others not yet completed for company-level controls when it is reasonable to perform other audit tests based on prior knowledge of company-level controls.

Paragraph 25 – The PCAOB should clarify the meaning of "significant accounts should be the same for both audits." How is a significant account defined for audits of financial statements? Is an account significant for a financial statement audit if substantive procedures are performed? Is an account significant for a financial statement audit if the auditor performs simple analytical procedures on account balances considered to be low risk? PCAOB should allow differences, especially in audits of smaller companies, to consider facts and circumstances.

Paragraph 26 – This paragraph describes risk factors that the auditor should consider in determining whether an account is significant. The PCAOB should clarify what is meant by needing to consider "changes from the prior period in account characteristics." It appears as though the other bullets already address the nature of the account, so this bullet seems to imply that an account might be considered significant just because the characteristics of the account change.

Paragraph 36 – This paragraph states that a walkthrough should be performed for each significant process. The PCAOB should clarify whether walkthroughs are required for entity level controls (except for period end financial reporting practices for which paragraph 23 specifically requires a walkthrough). We do not believe walkthroughs should always be required and the standard should state that.

Paragraph 43 – We believe that a statement after the 2nd sentence of this paragraph should be added to indicate "In such circumstances, testing of other controls should be reduced and/or eliminated." We believe this will further emphasize the auditor's ability to rely on appropriate company level controls.

Paragraph 46 – The word "alter" in the last sentence should be "consider". This reflects that often the procedures to be performed in the financial statement audit may not yet have been prepared, pending results of controls testing, so there would be nothing to "alter" yet.

Paragraph 51 – The first sentence of this paragraph indicates that "[F]or each control selected for testing, the auditor should assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result." This requirement could generate a level of documentation that may not necessarily add to audit effectiveness. We recommend that the PCAOB consider providing additional guidance as to what and how much documentation is required in documenting the risk that a control might not be effective on a control by control basis.

Paragraph 53 – The note to this paragraph indicates that a control does not have to operate without deviation to be considered effective. We believe additional guidance should be provided regarding the level at which the auditor might reach such a conclusion. This is particularly important since audit testing is generally done on a sampling basis, and often some exceptions are noted in the detail items that comprise the sample, even if the overall result is an acceptably low error rate. As an example, a sample of 100 items might have 1 error, and the overall error rate is deemed acceptable in terms of acceptable control risk – does paragraph 53 however view the 1 individual error as a deviation from the company's established controls that requires further auditor consideration and documentation?

Paragraph 73 – The Proposed Standard provides that among the risk factors that affect the likelihood that a deficiency will result in a misstatement of an account balance or disclosure not being prevented or detected in a timely basis include "The possible future consequences of the deficiency." Although the audit is "as of" a period end date, this will require evaluation of future unknown events. While such predictions would certainly be useful, they may not be relevant to the impact as of the current date of assessment, and may require sophistication in forecasting that may not be achievable. This requires an auditor to look to the future for a possibility of a material weakness "as of" today for something that may not be a material weakness for the current financial statements.

Paragraph 74 – The last factor here also requires development of what"is expected in future years". This has the same concerns as noted for paragraph 73.

Paragraph 77 –This discussion should also include materiality consideration and the effect of disclosure deficiencies.

Paragraph 79 – The auditor is directed to treat "Restatement of previously issued financial statements to reflect the correction of a misstatement." as a strong indicator that a material weakness in internal control over financial reporting exists. However, restatement of previously reported financial information should not necessarily lead to a conclusion that there is a material weakness in ICFR as of a current date. A company may have improved systems as of the assessment date that detects an error, or perhaps a previous weakness was remediated during the year such that at the "as of" date, no material weakness exists, even if a restatement was required during the year. Additionally, we believe that it is important to clearly define what management should have known in making this determination. Certain restatements take place because of the evolution of thinking regarding the application of accounting standards.

Paragraph 89 – The second sentence should be clarified that it refers to the communication with management, not informing the audit committee as mentioned at end of previous sentence. Recommend "When making this communication to management…"

Paragraph 89 – The use of "all deficiencies" should be clarified, as noted above in discussion of paragraph 53.

Paragraph 96 – For consistency, we recommend addition of "over financial reporting" in third use in second to last sentence in scope paragraph: "…testing and evaluating the design and operating effectiveness on internal control over financial reporting…"

Paragraph 107 – This paragraph requires the auditor to include an explanatory paragraph describing a subsequent event and its effects that have a material effect on ICFR, or directing the reader to management's disclosure of such. This should be restricted to those matters that have a "…material <u>adverse</u> effect…" The PCAOB has existing standards for reporting on whether a previously reported material weakness continues to exist, and the explanatory paragraph required in this paragraph 107 should not substitute for such reporting.

* * * * * * * * * * * *

We hope that our comments and observations will assist the Board in finalizing a new standard for audits of internal control over financial reporting that is integrated with an audit of financial statements. Crowe Chizek and Company LLC fully supports the Board's efforts to improve audit quality with the objective of furthering the public interest.

We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff. If you have any questions or would like to discuss these issues, please contact Wes Williams at (574) 236-8626, James Brown at (574) 236-8676, or Richard Ueltschy at (502) 420-4446.

Cordially,

Crowe Chizek and Company LLC

Crowe Chizek and Company LLC

From: Malcolm Schwartz [mailto:malcolm@crsassociatesllc.com]
Sent: Monday, February 26, 2007 3:31 PM
To: Comments
Subject: Comments on PCAOB Release 2006-007 of December 19, 2006

The basis for these comments includes my following experiences, as:

- One of the four principal contributors to Internal Control – Integrated Framework ("IC-IF"), issued in 1992 and which provided The COSO Framework used by many companies for complying with Sarbanes-Oxley ("SOX")
- One of the management consulting leaders at Coopers & Lybrand (later, PricewaterhouseCoopers) and in my current consultancy, in applying The COSO Framework from the time of its publication to date (review the web site of my current company for a complete list of my articles and speeches, www.crsassociatesllc.com)
- A member of -- and team leader of -- the recent COSO task force dealing with simplified guidelines for internal control over financial reporting ("ICFR") for smaller registrants
- A speaker and writer on the subjects of internal control and risk management, recently including:
  - A Financial Executives Research Foundation four-part series, titled "A Top-Down Approach to Risk Management & Internal Control," and dealing with:
    1. "Having a Business-Process Focus Tied to Business Planning," issued in May 2006
    2. "Using an Aggregated Risk Assessment to Reduce Documentation Costs," issued in August 2006
    3. "Using a Process Point of View to Reduce Documentation Costs," Issued in January 2007
    4. "Relying on Ongoing Monitoring to Test Controls Performance, to Reduce the Scope of Separate Testing," to be issued shortly

    This series uses case studies and a generic business template of processes and their component activities, as well as the activities' characteristics, to show how the costs of SOX compliance have been reduced by as much as a factor of five when this approach is followed
  - An article in the December 2006 issue of Strategic Finance, published by the Institute of Management Accountants, focusing on smaller companies and including a case study illustrating similar costs and benefits, and titled "Make Risk Management & Internal Control Work for You"
  - A January 18, 2007, program for the Institute of Management Accountants "Inside Talk Webinar Series," titled "SOX & Small Business: Less Is More," showing the above approach and using a case study, with the CFO of the study company participating.
- Having been a CFO of a corporation filing with the SEC (Booz, Allen & Hamilton), and a business unit controller, treasurer and CFO; and a group financial executive over a number of business units
- Having led consulting projects dealing with, among other matters, internal control and risk management, and business process and organization analysis and improvement, in financial management, general management and operations management, for clients in a number of industries.

Based on these experiences and my developed point of view, I believe that the proposed auditing standard is a major improvement. However, some further important improvements could make its impact clearer and greater.

These improvements would go further in clarifying that the proposed standard is for auditors, and not for managements; and that auditors should not expect managements to follow the proposed standard. As many have commented, Auditing Standard No. 2 ("AS2") became the de facto standard for many companies, who interpreted AS2 as providing the management approach in the absence of guidelines for SOX compliance. Now, with guidelines being provided by the SEC concurrently with this PCAOB Release, it is clearer that the proposed standard is to shape how auditors are to audit. However, there is the risk that misinterpretation will continue, and incorrect inferences will be drawn, unless the PCAOB is quite explicit that: (1) this is a standard for auditors to perform audits, (2) the approach that managements take can be distinctive as long as the auditor is able to both perform the required audits and meet the proposed standard, and (3) companies that apply business process management ("BPM") or related techniques often embed internal control and risk management in their basic management and business processes, and derive ICFR as a byproduct.

This latter approach is deemed by many to be the most cost-effective way to enable ICFR. It integrates internal control and risk management into its management processes, thereby reducing the costs of developing and maintaining ICFR. It aggregates risk assessment – for a top-down perspective – from risk assessment built in to key activities. It begins with activity analysis, so that only activities whose inherent results are significantly uncertain need to be controlled (and this typically is the case for only 10% to 20% of the activities in any significant process). It integrates governance and management processes with business – or transaction – processes, so that costs are reduced by not having to maintain connectivity among checklists, process write-ups and other forms of documentation. It further integrates fraud detection into basic internal control and risk management, further reducing costs. It uses fully the principles of the COSO Framework. And it, as the COSO Framework recommends, relies on ongoing monitoring to confirm the performance of control activities, thereby reducing the costs of separate evaluations. Yet it could be inferred by an auditor, based on the PCAOB proposed standard, that this is not an acceptable way for management to enable ICFR. One reason for this incorrect inference is that BPM often identifies the activity components of each process, associates risk with the results of performing the activities, and then from this business template assesses top-down risk for the purposes of achieving its objectives (among which can be ICFR). When applied to ICFR, this approach derives the relationships to financial reports and disclosures, as opposed to beginning with them. Because the proposed standard states that a risk assessment begins with the financial statement accounts – as it should for the auditor – some auditors had not accepted the management approach as outlined in this paragraph, causing redundant and standalone approaches to use BPM on the one hand for sound business management, and to satisfy auditors on the other hand by separately building an audit-centric approach to compliance. In reality, having these separated approaches inherently adds risk, and cost, to a business. Further to support the position in this paragraph, recognizing that there are two approaches to risk assessment is consistent with the audit of financial statements, where business activities are performed to generate information used for financial reporting – financial reports are derived from business activities, in other words -- whereas audits begin with the derived financial reports.

Recognition of this approach also requires that BPM techniques and definitions be acceptable to, and generally understood by, auditors; so some wording in the proposed standard could be made clearer. Suggestions follow, for the Release itself and for the proposed standard, to avoid incorrect inferences, to not foreclose distinctive management approaches to ICFR, and to recognize that top-down risk-based assessments might not always begin with the financial statement accounts.

I. Introduction

Herein, it would help to avoid incorrect inferences by stating that: "…As described below, these proposals are designed primarily to …eliminate unnecessary audit procedures…"; and: "…simplify the audit requirements…"

II. Significant Changes to the Standard – would avoid incorrect inferences if it were changed to: "Significant Changes to the Auditing Standard"

II.A Focusing the Audit on the Matters Most Important to Internal Control -- would help to avoid incorrect inferences if it were to state that auditors use "…a top-down approach appropriate to auditing…"

- **II.A.1 Directing the Auditor's Attention Toward the Most Important Controls** – would help to avoid incorrect inferences if it were to state: "…by starting at the relevant top…" and later: "…to the significant activities in significant processes…"

II.B Eliminating Unnecessary (insert) **Audit Procedures** – would help to avoid incorrect inferences if it were to state that: "…the proposals would eliminate the requirement for the auditor to evaluate the process that management used…"

- **II.B.1 Removing the Requirement to Evaluate Management's Process –** would help to reinforce the compatibility of the audit approach with a management approach using BPM if it were to state that: "…Under the proposed standard, an auditor still would need to obtain an understanding of management process, such as a reliance on business process management as a means of establishing internal control and risk management of the activities of a business…"

- **II.B.2 Permitting Consideration of Knowledge Obtained During Previous Audits –** would further reinforce this compatibility by stating that: "…the risk factors described in the proposed standard and determining that an activity presents low risk overall (because, for example, the activity has low inherent risk and a low degree of complexity, or the activity has some risk that is mitigated by a following control activity, there were no changes to…"

- **…**

- **II.B.5 Recalibrating the Walkthrough Requirements –** would balance the discussion if it focused not only on transactions (and hence only business transaction process and their activities) but also on management and governance processes and their component activities, and if did not appear to restrict the tools supporting processes only to information systems, as follows: "…In performing a walkthrough, the auditor follows the selected governance, management or business process and its component activities from the information input to the originating activity and considers the activity flow and associated tools, such as policies and procedures, forms, and information systems, until the information output of the last activity is reflected, indirectly or directly, in the company's financial reports…" and "…the auditor must complete walkthroughs of all significant activities in significant processes…"

- **…**

- **II.D Simplifying the** (insert) **Audit Requirements**

- **…**

In regard to Appendix 1, the Auditing Standard itself, the following suggestions, by paragraph, are made, to avoid the incorrect inferences discussed earlier, and to reinforce the distinctiveness of and the compatibility between the auditor's approach and the approach that many managements might use to integrate ICFR with their basic internal control and risk management processes

- **5 –** would avoid incorrect inference by including a footnote to clarify that The COSO Framework is the framework itself, and not the accompanying illustrative evaluation tools (some auditors had interpreted that the evaluation tools are integral to the COSO Framework and had held clients responsible for applying those evaluation tools)

- **6** – would avoid incorrect inference by modifying the first bullet, as: "…knowledge of the company's internal control over financial reporting, which might be embedded in the company's management processes through its use of business process management tools, to integrate internal control over financial reporting with internal control over business operations…"

- **8** – would reinforce the compatibility of the two types of risk assessment, as: "…Risk assessment linked to the financial statements underlies the entire audit process described in this standard, and is compatible with the form of risk assessment used by many companies that links to their business processes and the component activities…"

- **16 –** would further reinforce this compatibility by stating that: "…A top-down approach for the auditor begins at the financial statement level (for management, a top-down approach might begin with the risks of uncertainty in the outputs of activity components of processes)…" and: "…and then works down to significant accounts and disclosures, relevant assertions, and significant activities in significant processes…"

- **18** – would further reinforce this compatibility if it stated that "…Company-level controls, at both the business unit and the corporate organization levels…"

- **20 –** would align with The COSO Framework, which is used rather widely, if the list of bullets included: "…whether, as a commitment to competence, there exists the knowledge and skills needed, and that these are specified…," and "…management's philosophy and operating style are consistent with sound internal controls and risk management…," and "…human resource policies and practices, and organization structure, are current, defined and communicated, and reinforce the control objectives of the company…"; and the bullet regarding misstatement would be modified to state that: "…pressures on management and employees…"

- **21 –** would avoid incorrect inference if the four bullets would begin with "…Activities…" instead of "…Processes…," and if the first bullet stated: "…to enter transaction totals into the general ledger or other consolidating device…"

- **22 –** would reinforce alignment with the management approach if the first bullet stated: "…Inputs to activities, including constraints and controls, tools and resources, and the work itself, the procedures performed, and outputs…" and in the fifth bullet: "…adjusting and consolidating entries, including standing and one-time entries…"

- **25 –** would avoid incorrect inference by stating that "…The risk factors the auditor should evaluate in identifying that significant accounts might be misstated include…";` and by expanding the listing to include the impacts of judgment, estimation, the potential of management override, the traceability of postings, the frequency of postings, the currency and completeness of related policies and procedures, and the timeliness of postings

- **28 –** would reinforce the compatibility of approaches if it stated that: "…and significant activities of significant processes, and also…"

- **32 –** would avoid incorrect inference if it stated that: "…Different types of major classes of transactions might result from activities that have different inherent risks associated with them…"

- **33 –** would avoid incorrect inference if it stated that: "…The controls over major classes of transactions exist within the company's significant activities in significant processes…"

- **34 –** would avoid incorrect inference if it stated that "…For each significant activity identified, the auditor should…" and "…understand its impact on major classes of transactions…" and "…Identify that it is an activity at which a misstatement…"; also, the last bullet does not deal with all frauds, but only those that could result in a material misstatement of the financial statements, so this could be further clarified and elaborated, to avoid audit work dealing with frauds that do not cause material misstatements.

- **37 –** would reinforce the compatibility with management approaches by stating that: "…the auditor has identified the activities in the process…" and, to reinforce the point about fraud discussed in paragraph 34, above, by stating that: "…the design of controls, including those related to the prevention or detection of fraud as described in paragraph 34…"

- **39 –** would further reinforce the above if it stated: "…At the activities at which important processing occurs, the auditor should question…"

- **43 --** would further reinforce the compatibility with management's approach by stating that: "…the auditor should recognize that control activities in governance and management processes vary in precision…" and "…some of these controls are designed to operate at the activity, process, transaction or application level…' and "…On the other hand, some of these control activities may be designed to operate…"

- **45 –** would further reinforce the above by beginning as: "…*Controls dealing with fraud and management override*…"

- **47 –** would avoid incorrect inference by beginning with a title stating: "…**Separately Evaluating Design Effectiveness**…" and stating that: "…The auditor should separately evaluate…"

- **48 –** would avoid incorrect inference by stating that: "…Procedures that the auditor performs to separately evaluate design effectiveness can include one or mix of inquiry of…"

- **49 –** would avoid incorrect inference by beginning with a title stating: "…**Separately Evaluating Operating Effectiveness**…"

- **50 –** would avoid incorrect inference, as well as align with the approach that some management use, by stating that: "…The procedures the auditor uses to separately evaluate operating effectiveness can include one or a mix of…walkthroughs, review of the results of ongoing monitoring (such as the recording of control performance using key control indicators, or KCIs, for such categories as accuracy, completeness, compliance and timeliness), and reperformance of the control

- **52 –** would align with management approaches by including as a bullet: "…The level of judgment and the related objectivity of the control activity

- **A13 –** would align with the above comments by changing the definition to: "…A **significant process** can be a business process that initiates, authorizes, processes and records a major class of transactions, or a management or governance process that provides the controls or constraints, or the tools or resources, to such a business process; and a **significant activity** is any specific step in such a process for which the output is sufficiently inherently uncertain as to cause significant risk of misstatement of financial results…"

If you deem it worthwhile, I will be happy to clarify or elaborate on these comments.

Sincerely,

R Malcolm Schwartz
Chief Operating Officer
CRS Associates LLC

office: 908-273-6967
cell: 908-803-8918
fax: 908-273-6226

From: Danka, R. Faisal [FaisalRDanka@FastMail.CO.UK]
Sent: Thursday, January 25, 2007 7:59 AM
To: Comments
Subject: Docket 21

My Comments are below for:

PCAOB Release No. 2006-007: Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements
http://www.pcaob.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf

Comment #1

On page A2-4. number 7 reads "The auditor should evaluate the extent to which he or she will use the work of others. Areas in which the auditor might use the work performed by others to reduce the procedures the auditor otherwise would have performed include –

• Procedures the auditor performs when obtaining an understanding of the

company's internal control over financial reporting;

• Procedures the auditor performs when assessing risk;

• Procedures the auditor performs when testing the effectiveness of

controls; and

• Substantive procedures the auditor performs when testing account

balances and disclosures."

My comment/query is that, shouldn't the auditor initially focus, whether he/she can rely on the risk assessment performed by others instead of performing walkthroughs to understand the internal control?

Secondly, in a situation where auditor cannot rely on risk assessment performed by others, is it still applicable to go further with re-testing of walkthroughs and operating effectiveness assessment performed by others. Keeping in view that for an auditor, the unsatisfying risk assessment work done by others will follow through in their similarly unsatisfying scoping, walkthroughs and operating effectiveness assessment as well.

Comment #2

In relation to above, as it then related to page A2-8 number 18 which reads "*Testing the Work of Others*. If the auditor uses the work of others to reduce the procedures the auditor otherwise would have performed, the auditor should test some of the work of others to evaluate the quality and effectiveness of the work. The nature and extent of the tests that the auditor should perform depend on the effect of the work of others on the auditor's procedures but should be sufficient to enable the auditor to make an evaluation of the overall quality and effectiveness of the work the auditor is considering. The auditor also should assess whether this evaluation has an effect on his or her conclusions about the competence and objectivity of the individuals performing the work."

My comment/query is that, the wording "some of the work of others" is very subjective, a minimum baseline should be recommended. Also the wording states "auditor should test some of the work of others", does it mean re-performing the test of the same controls with different samples? or same samples? or desktop review of evidence and testing documentation performed by others would suffice.

Regards,

FD

Note: This submission is made on my personal behalf and as such reflects my personal views only and not the views of my employer or clients.

Faisal R. Danka
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February 23, 2007

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

Dear Sir or Madam:

Deloitte & Touche LLP is pleased to respond to the request for comments from the PCAOB with respect to its 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; PCAOB Rulemaking Docket Matter No. 021]. The comments provided herein are based on our insights and experiences in performing integrated audits. Our insights and experiences include those of the non-U.S. member firms of Deloitte Touche Tohmatsu.

Overall, we are supportive of the fundamental concepts within the proposals, and we commend the PCAOB for its efforts in their development. We believe investors have greatly benefited from reporting about the effectiveness of internal control over financial reporting (hereinafter ICFR) and that such reporting by management and the related requirement for an auditor's attestation report has improved disclosures to investors about internal control related matters, enhanced the reliability of financial statements, and has placed a stronger focus on the importance of management's responsibilities relative to the establishment and maintenance of effective ICFR. There are three overriding concepts within the proposals for which we would like to specifically express our support.

First, we strongly support the PCAOB's commitment to a single, scalable audit standard. We strongly believe that applying a single, scalable standard for performing integrated audits is in the best interest of investors. A system whereby different rules apply to issuers of different sizes would be very difficult for investors to understand, and we believe would result in much confusion and less valuable information being provided to investors. Moreover, only a truly scalable system is consistent with a principles-based and top-down, risk-based approach to assessing ICFR. A tiered system with different requirements for various categories of issuers based on bright-line rules such as company size, as has been suggested by some commentators, would constrain the use of auditor judgment in favor of artificial criteria. A single, scalable system, on the other hand, is consistent with the use of judgment by auditors in considering the risks and circumstances of each company, based on its nature and complexity.

Second, we strongly support the requirement that the auditor perform an audit of the effectiveness of ICFR, including an evaluation of design and operating effectiveness. Alternatives based on limiting the scope of the auditor's work in some or all circumstances, such as reporting only on design-effectiveness and implementation of internal control (i.e., not testing operating effectiveness), would be confusing to understand and would substantially decrease the benefits of Section 404 to investors.

Third, we strongly support the principles-based nature of both the proposed standard on auditing ICFR and the proposed standard on considering and using the work of others in an audit. We believe that the proposed standard on auditing ICFR will allow the auditor to effectively use judgment to tailor the audit to accommodate a company's specific characteristics (e.g., size and complexity) within the framework of a top-down risk based approach. It is however important to note that the principles-based nature of the proposed standards and the increased focus on the use of judgment will result in variability in the application of the standards by auditors. We believe that such variability is appropriate and ultimately will increase the effectiveness and efficiency of the integrated audit as auditors use judgment to tailor their processes to specific companies. We encourage the Board to continue to support the use of appropriate judgment by auditors in its standard setting process and to also encourage support thereof in its inspection program.

Based on our analysis of the proposed standards we have identified two broad issues which in our view, if addressed by the Board, will greatly contribute to the accomplishment of the Board's overall objective of preserving the intended benefits of an audit of ICFR while improving the efficiency of the process. We strongly believe that addressing the issues described below will allow the auditor the flexibility to exercise professional judgment in a manner that will facilitate an audit of ICFR in the most efficient manner, but at the same time not jeopardizing audit quality.

- *Use of the Work of Others*

  We support the Board's objective of "removing the barriers to using the work of others", and we therefore support the elimination of requirements within Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AS No. 2) that restrict the ability of the auditor to use management's work in an audit of ICFR in situations where it might otherwise be appropriate. We believe that the proposed standard on auditing ICFR will better provide the auditor with the appropriate flexibility to exercise judgment in using management's work in a manner that will improve the efficiency of the audit, without compromising audit effectiveness.

  Additionally, we are supportive of the principles underlying the proposed auditing standard on using the work of others in an audit; however, we do not believe that these principles and the overall intent of the proposed standard differ substantially from AU sec. 322 *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AU 322).

  We recommend that instead of proposing a new standard, that the Board modify AU 322 to specifically indicate that this standard is not limited only to internal auditors, but that it is also applicable to others who have the appropriate levels of competency and objectivity. We believe that this modification of AU 322 together with the proposed modifications to AS No. 2, would provide the auditor with the appropriate framework to work with his or her client in order to use management's work in an appropriate and efficient manner. We are concerned that by replacing AU 322 with the proposed standard, the Board may inadvertently create confusion and possibly incremental effort for the auditor, without necessarily enhancing audit quality and efficiency.

- *Use of Certain Terms*

  Under the Board's Rule 3101 *Certain Terms Used in Auditing and Related Professional Practice Standards*, the auditor is required to fulfill specific responsibilities within an audit standard based on use of the word "must" or a "should" (i.e., an "unconditional" or a "presumptively mandatory" responsibility, respectively). In order for the auditor to demonstrate that he or she has fulfilled these responsibilities, and to comply with Auditing Standard No. 3, *Audit Documentation* (AS No. 3), he or she must have appropriate documentation within the working papers demonstrating what procedures were performed relative to each instance of a "must" or "should". We noted that there are in excess of 250 instances within the proposed standards where either an unconditional or presumptively mandatory responsibility is created for the auditor. These requirements will result in required procedures and a level of documentation that will have a significant impact on the time and effort involved in the audit, but may not add to the level of audit effectiveness.

  Additionally, we noted certain instances where it is not clear how the auditor would be expected to document or demonstrate compliance with the presumptively mandatory responsibilities imposed within the proposed standards. In some cases, what are drafted as presumptively mandatory requirements (i.e., "should") appear to be factual statements, guidance or factors for the auditor to consider in fulfilling responsibilities relative to a higher level requirement. Therefore, we recommend that the Board limit the use of "must" and "should" within the proposed standards to only the primary objectives, or the broad principles applicable to performing an audit of ICFR (such as "the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant assertions"). This will allow the auditor to work with his or her client to plan and perform the most effective and efficient audit and not focus on performing procedures and preparing excessive documentation to demonstrate compliance with all of the over 250 occurrences of these words. (See our response in the section titled "Other Comments" below for further details.)

Finally, we support all efforts to continuously improve the effectiveness and efficiency of the Section 404 assessment process (including both management's assessment and the integrated audit). We believe the steps underway to provide principles-based guidance to management and to replace AS No. 2 with the proposed standard (both endorsing a scalable risk-based approach and allowing auditors to use more judgment) will achieve the goal of making the Section 404 process more cost-effective. We believe experience in the last several years indicates that costs associated with the Section 404 process have been declining. For example, various studies and surveys have shown that there have been significant reductions in overall Section 404 costs (internal costs, third party costs, as well as external audit fees) in the second year of implementation for accelerated filers.[1] We believe that the combined efforts underway by the Securities and Exchange Commission (SEC), the PCAOB (including work being done to develop guidance for conducting audits of ICFR of smaller public companies), as well as other efforts by the Committee of Sponsoring Organizations (COSO) will support additional improvements and refinements in the Section 404 process.

[1] The Sarbanes-Oxley Section 404 Costs and Implementation Issues: Spring 2006 Survey Update by CRA International indicates that total 404 costs declined significantly in year 2 of implementation, falling 30.7 percent for Smaller Companies and 43.9 percent for Larger Companies. Additionally, results of the March 2006 FEI Survey on SOX Section 404 Implementation indicates that the total average cost for Section 404 compliance was $3.8 million during fiscal year 2005, down 16.3 percent from 2004.

Specifically, we expect the proposed changes, along with the proposals by the SEC, will result in a reduction of total Section 404 costs, due to various specific, positive changes in the proposals. These would include the ability of an auditor to (a) determine audit coverage based upon risk, without any pre-established quantitative coverage requirement, relative to an issuer's operations, (b) adjust, under certain conditions, the nature, timing and extent of testing of particular controls, based in part on cumulative experience gained in prior audits, c) adjust and scale the nature, timing and extent of audit work, based on the size and complexity of an issuer's operations, and (d) increase the use of the work of others, if certain conditions are met.

In voting to propose these standards, Board Member Kayla Gillan noted that, although she expected the proposals to result overall in more efficient audits of ICFR, “the proposal will not reduce audit costs by X percent for all companies.”[2] We agree with this statement because the efficiencies achieved will vary significantly based on the facts and circumstances for each particular company, the state of the ICFR within each company, and the extent to which management already has effective ICFR in place. We also believe that opportunities for efficiencies and effectiveness in the Section 404 process can be obtained if the auditor can use management’s work to the maximum extent permitted under the standards. While management’s evaluation and assessment of ICFR and the audit of ICFR are separate activities and need not be conducted in the same manner, there is important interaction between the two through the auditor’s consideration of the work of others and the ability of the auditor to use the company’s documentation as evidential matter to support the auditor’s opinion. As a result, the manner in which management conducts its assessment, the competence and objectivity of those testing ICFR to support management’s assessment, and the documentation available to support that assessment directly impact the potential efficiency of the audit process.

For example, to the extent management decreases its reliance on self assessment for the purposes of supporting its assessment of ICFR and increases the extent of direct testing performed by highly competent and objective personnel or third parties, the auditor’s ability to use management’s work is increased, which would result in decreased audit effort and expense. Similarly management’s approach to the documentation of its ICFR and its assessment of effectiveness also impact the work of the auditor in that, to the extent management’s documentation is sufficient to comply with auditing standards related to audit documentation, decreased audit effort and expense will be required to prepare the documentation necessary to evidence the procedures that the auditor has performed and the basis for conclusions reached.

We would also like to note that, although we support the objective of conducting an effective audit in an efficient manner, we are concerned that the heightened focus on efficiencies within the text of the proposed standards and related communications is unusual and may detract from the overarching objective of generally accepted auditing standards, which is to set forth the performance standards for an effective audit.

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[2]See opening statement by Kayla Gillan, PCAOB Open Meeting December 19, 2006. It is also important to note that there are other significant factors that impact audit costs besides costs associated with assessing ICFR. These include additional audit procedures and documentation requirements based on other new accounting and auditing standards (including the implementation of recommendations from the inspection process), increased demand and intense competition for accounting and auditing resources, increased compliance and regulatory requirements for auditors, practice protection costs, and litigation.

As discussed above, we are supportive of the PCAOB's proposals; however, based on our analysis of the proposed standards, we do have some specific comments in response to the questions posed in the release along with some additional comments. These are provided in the attached Appendix.

* * * * * *

The issues presented here are complex and may warrant further discussion to fully understand the implications of particular comments made by us and by other commenters. As such, we would suggest that the PCAOB engage in active dialogue with issuers and auditors as comments on the proposals are evaluated and changes to the proposed standards are considered. Such a dialogue will facilitate complete understanding of the comments and the consideration of related implications and likely results, and we believe, will ultimately improve the final standards and the ability for them to be implemented effectively and efficiently.

We would welcome the opportunity to further discuss these issues with the Board and the staff. If you have any questions or would like to discuss these issues, please contact Robert Kueppers at (212) 492-4241, James Schnurr at (203) 761-3539 or John Fogarty at (203) 761-3227.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: Mark W. Olson, Chairman
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
Bill Gradison, Member
Charles D. Niemeier, Member
Tom Ray, Chief Auditor and Director of Professional Standards

Chairman Christopher Cox, Securities and Exchange Commission
Commissioner Paul Atkins
Commissioner Roel Campos
Commissioner Annette Nazareth
Commissioner Kathleen Casey
Conrad Hewitt, Chief Accountant
John White, Director, Division of Corporation Finance
Zoe-Vonna Palmrose, Deputy Chief Accountant for Professional Practice

APPENDIX
Questions Regarding Directing the Auditor's Attention Towards the Most Important Controls

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

   We believe that the proposed standard adequately describes the steps involved when applying a top-down approach to auditing internal control over financial reporting. However, we believe that the proposed standard could be enhanced by more clearly describing the linkage between the auditor's understanding of management's control objectives and the selection and testing of controls relevant to achieving these objectives. As drafted, paragraph 47 of the proposed standard is the first time that control objectives are mentioned and this paragraph sets forth the requirement that the auditor evaluate the design effectiveness of controls by determining whether or not such controls satisfy the company's control objectives. In order to more effectively link this process with the auditor's requirements to identify and understand the company's significant processes and to identify relevant controls to test, we recommend that paragraph 34 be expanded to acknowledge that as part of understanding each significant process, the auditor should understand the control objectives that management has identified related to each significant account and the related relevant assertions and the related controls that are intended to satisfy these objectives.[3] We suggest that the third bullet in paragraph 34 be replaced with the following:

   - Identify the relevant control objectives and the controls that management has implemented to satisfy these control objectives

   Additionally, in paragraph 37, we recommend replacing the third bullet with the following:

   - Evaluate the effectiveness of the design of controls by determining whether the controls, if operating effectively, would satisfy the control objectives

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

   As written, we are concerned that certain aspects of the proposed standard may lead the auditor to believe that consideration of the risk of fraud and identification and testing of the related controls that address fraud risks is a separate and distinct process from the rest of the audit. Consistent with our response to the previous question, we believe management should identify control objectives related to each significant account and relevant assertion.[3] The proposed standard might emphasize that such control objectives should address the risk of material misstatement which might arise as a result of fraud or error.

   We recommend that paragraph 8 more clearly articulate that the auditor's assessment of the risk that a material weakness could exist in a particular area of the company's internal control over financial reporting specifically includes consideration of the risk of potential misstatement due to fraud and error, as well as the risk of management override of controls. Once the risk that a material weakness could exist has been properly assessed, then the underlying concepts of the

[3] The auditor would need to recognize that management may use terms other than significant account, relevant assertion, and control objective which have the same general meaning as these terms in the context of internal control.

audit procedures to understand and evaluate the relevant controls that address the assessed risks are the same regardless of whether the risk of potential misstatement is related to error or fraud. However, more rigorous procedures are clearly necessary related to controls that address the risk of potential misstatement due to fraud. The following are some examples where we believe fraud-related considerations could be better integrated, though these may not be the only instances where this concept could be incorporated:

- Paragraph 27 - This paragraph refers to the auditor's requirement to evaluate components of a potential significant account to determine if they are subject to substantially differing risks. This paragraph could be clarified to draw attention to the fact that this includes situations where components differ in terms of the risk of fraud (e.g., customer receivables versus related-party receivables within the trade receivables significant account).

- Paragraph 31 – The first sentence of this paragraph states that "to identify relevant assertions, the auditor should determine the likely sources of those potential misstatements in each significant account that would cause the financial statements to be materially misstated." This sentence could be modified to clarify that this includes potential misstatements due to error and fraud.

- Paragraph 37 – We recommend modifying the first bullet to clarify that the use of "significant risk of misstatement" includes the risk of misstatement due to error or fraud. If this amendment is made there would not be a need to include the words "including those related to the prevention or detection of fraud", in the second bullet under the premise described in the first paragraph above.

If our proposed amendment is made to paragraph 8 and appropriate clarifications are made throughout the standard that the risk of potential misstatement relates to the risk associated with fraud and error, then we do not believe that the separate section "Fraud Controls" (paragraph 45 and 46) is necessary. The concept in paragraph 45 is the one we believe should be incorporated into paragraph 8. Paragraph 46 as drafted seems to restrict the requirement to consider the impact of control deficiencies on the nature, timing and extent of procedures to be performed during the financial statement audit to deficiencies in controls designed to address the risk of material misstatement due to fraud. We believe that this requirement should apply to all controls, and therefore we suggest that the last sentence of paragraph 46 be moved into a separate section so that it does not appear only to be applicable to "fraud controls", and revised as follows:

> "If the auditor identifies deficiencies in controls ~~designed to prevent and detect fraud~~ during the audit of internal control over financial reporting, the auditor should alter the nature, timing, or extent of procedures to be performed during the financial statement audit to be responsive to such deficiencies~~, as provided in AU sec. 316 .44 and .45~~."

We also strongly recommend that the proposed standard include guidance related to the auditor's consideration of company-level controls when identifying controls to address the risk of material misstatement due to fraud; in particular whether a company-level control can, by itself, address such a risk, and if so, what the characteristics of such a control would need to be (including the degree of precision with which the control needs to be designed to operate). We believe guidance of this nature is necessary, given the emphasis on and importance of company-level controls when applying a top-down approach to auditing internal control.

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

We believe that applying a top-down, risk based approach enables the auditor to identify and test those controls that have the most pervasive effect in terms of addressing the risk of material misstatement to the financial statements (i.e., effective application of a top-down approach enables the auditor to minimize the number of controls that are tested by identifying those controls that address the greatest number of control objectives related to significant accounts and relevant assertions). It is important to highlight that, as stated in paragraph 3 of the proposed standard, in order for the auditor to obtain reasonable assurance about whether a material weakness exists as of a specified date, "the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant assertions". Consequently in evaluating whether it is necessary to identify a lower level control, or whether a high level control (if properly designed and operating effectively) sufficiently addresses the risk of material misstatement, a significant consideration is the level of precision at which the control needs to be designed to operate. A control that is not sufficiently precise will not provide sufficient competent evidence (see response to question 4 for additional comments).

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?

We believe that the proposed standard appropriately describes the auditor's consideration of company-level controls when performing an audit of internal control and also properly acknowledges the limitations of company-level controls. The discussion of these controls in the SEC's proposal "*Management's Report on Internal Control Over Financial Reporting*" contains similar guidance about the need for management to consider the nature of company-level controls and how they relate to the financial reporting element. The SEC's proposal also includes a useful discussion explaining that the more indirect the relationship to a financial reporting element, the less effective the control may be in preventing or detecting a misstatement, and provides illustrative examples of directly and indirectly related company level controls (see pages 26 and 27 of the SEC's proposal). We believe that the proposed auditing standard would be strengthened by inclusion of similar guidance. This would also contribute to the consistency of management and the auditor's approach to the consideration of company-level controls.

We strongly support the inclusion of Paragraph 43 in the proposed auditing standard, which appropriately indicates that "some company-level controls are designed to operate at the process, transaction, or application level and might adequately prevent or detect on a timely basis misstatements to one or more relevant assertions". Given that this is such an important and fundamental concept and also that many of the types of company-level controls listed in paragraph 18 would not fall into this category, we believe that it would be useful to provide an example of the type of company-level control that might adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. We also believe that acknowledgement of this concept in paragraph 17 where company-level controls are first discussed would be appropriate.

We also strongly support the parameter in paragraph 43 that company-level controls are not always designed to operate at a level of precision that would sufficiently address the risk of misstatement associated with significant accounts and assertions. We believe however that the proposed standard should more specifically recognize that in order to appropriately address the risk of misstatement for a given assertion, company-level controls must operate at a level of precision that would detect misstatements that are less than material to the financial statements, in order to appropriately consider aggregation risk. By way of illustration, if there are many company-level detective controls in a company with a large number of business units and such controls are designed to detect only material misstatements, the risk of misstatement for any given assertion addressed by those controls would not be properly addressed because of the strong likelihood that the misstatements not detected by these controls could aggregate to an amount in excess of materiality.

Additionally, as discussed in question 2 above, in order to illustrate how consideration of fraud is integral to the audit process, we recommend that the standard incorporate guidance regarding the role of company-level controls in the auditors' identification and testing of controls that address the risk of misstatement due to fraud. In particular we believe the standard should address whether company-level controls alone would be sufficient to address the risk of misstatement for a given assertion subject to a specific fraud risk.

Emphasizing the Importance of Risk Assessment

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?

We believe that the proposed standard appropriately incorporates risk assessment. However, as discussed in our response to question 2 above, we recommend expanding paragraph 8 to incorporate the fact that risk assessment includes the assessment of the risk of material misstatement due to fraud as well as error.

We also believe that additional guidance is necessary to assist the auditor to understand how to evaluate company-level controls and controls designed to address the risk of misstatement due to fraud and management override in the context of paragraph 51 when determining how much evidence is necessary and the nature, timing, and extent of the procedures to obtain such evidence. For example, we believe that there may be instances where company-level controls alone will not address a fraud risk.

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

We believe that the performance of a walkthrough would provide the auditor with sufficient evidence with respect to the design and operating effectiveness of controls that address low risk assertions in certain circumstances. See our response to question 17 for additional comments as to when this might be appropriate.

Revising the Definitions of Significant Deficiency and Material Weakness

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?

We believe the definition of "significant" is descriptive enough to be applied in practice. However, we recommend that the note to the definition be expanded to more specifically emphasize that the determination of whether or not a misstatement is significant includes consideration of both quantitative and qualitative factors.

Additionally, although we are supportive of the principles-based nature of this definition, we would like to highlight that the assessment of whether or not a control deficiency is a significant deficiency will rely substantially on the judgment of the individual auditor and his or her assessment of what is "important enough to merit attention by those responsible for oversight of the company's financial reporting". Consequently there will likely be diversity in practice (albeit within acceptable limits) as deficiencies that appear to be similar might be classified differently from one engagement to another.

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?

Identifying a material weakness in the absence of an actual material misstatement requires substantial judgment, including consideration of the likelihood of a misstatement occurring, the magnitude of the potential misstatement, and the effectiveness of any compensating controls that might exist. These considerations involve projecting and predicting actual outcomes that are similar to the judgments that management and auditors must make involving significant management estimates in financial statements. Similarly, when actual results vary significantly or materially from those estimated or expected, it does not necessarily mean that there was an error in the original judgment based on the information known at the time the original judgment was made. We believe that over time, as management and auditors gain more experience, practice will improve in this area.

It is also important to highlight that in performing procedures to support the assessment, management may identify and take action to remediate many deficiencies (including those deficiencies brought to their attention by auditors). If unremediated, some of these deficiencies might otherwise have resulted in material misstatements, or have otherwise escalated into material weaknesses at the annual reporting date.

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 do not believe that the changes in the definitions will substantively impact the effort involved in the identification and evaluation of deficiencies, as we have always understood the concepts of "more than remote" and "reasonably possible" to be the same. We also believe the standard is clear that the auditor is not required to identify deficiencies that do not present a reasonable possibility of a material misstatement to the financial statements. We do however support paragraph 70 of the proposed standard which requires the auditor to evaluate the severity of each control deficiency to determine whether they individually or in combination are significant deficiencies or material weaknesses as of the date of management's assessment.

<u>Revising the Strong Indicators of a Material Weakness</u>

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?

We believe the standard should allow an auditor to conclude that no deficiency exists when certain of the strong indicators are present. We believe that this change will improve practice by enabling the auditor to exercise greater professional judgment in this area, particularly in the case of a restatement of previously issued financial statements for the correction of an error and the identification by the auditor of a material misstatement not detected by the company's internal control over financial reporting. In these cases, we believe it is possible that a conclusion can be reached that no deficiency exists. Although we support this change it is important to note that we believe strongly that there are limited circumstances in which it would be appropriate for an auditor to conclude that a material weakness does not exist in the presence of one or more of the strong indicators.

Any change that encourages increased use of judgment carries with it the consequence of increased diversity in the manner in which it will be applied in practice. In order to further enhance the proposed standard and improve consistency of its application, we recommend that consideration be given to bifurcating the strong indictors between those for which it is possible that no deficiency exists and those for which it is less likely that no deficiency exists (i.e., all strong indicators except for the restatement and material audit adjustment). We also recommend that additional guidance, including illustrative examples, be provided as to when the auditor might appropriately conclude that no deficiency exists in the presence of the restatement or material audit adjustment strong indicators. In practice this is a complex area that causes frustration and difficulty for management and auditors alike.

Additionally, we have observed that the circumstances in paragraph 79 that the auditor should consider as a strong indicator of a material weakness differ from the circumstances that management would be required to consider as a strong indicator of a material weakness in the SEC's proposal "*Management's Report on Internal Control Over Financial Reporting*". Specifically, the SEC's proposed management guidance does not include as a strong indicator of a material weakness the circumstance of an ineffective risk assessment process or internal audit function at companies for which such a function needs to be effective for the company to have effective internal control over financial reporting, such as for very large or highly complex companies. With respect to an effective internal audit function, because not all companies have internal audit functions, we can understand not including an effective internal audit function among the list of strong indicators of a material weakness. However, because of the critical role of the risk assessment process within the SEC's proposed management guidance (in identifying financial reporting risks and controls) and because the risk assessment process is a primary component of internal control, we believe the lack of a risk assessment process or an ineffective risk assessment process should be considered a material weakness. As indicated in our comment letter to the SEC on its proposed management guidance, in order to make it clear that this is the case, we suggested the SEC guidance regarding strong indicators of material weaknesses be revised to include an ineffective risk assessment process or alternatively that it be explicitly stated that the lack of a risk assessment process or an ineffective risk assessment process is a material weakness.

We also wish to emphasize that different guidance for management and auditors with respect to evaluating deficiencies will result in confusion for management and auditors and will likely create inefficiencies in both management's process and the auditor's process for concluding on the effectiveness of internal control over financial reporting.

<u>Clarifying the Role of Interim Materiality in the Audit</u>

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

We believe paragraph 14 of the proposed standard appropriately sets forth that the auditor should use the same materiality considerations that he or she would use in planning the audit of the company's annual financial statements when planning the audit of internal control over financial reporting, and that no additional clarification is necessary.

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?

We believe that the reference to interim financial statements should be removed from the definitions of significant deficiency and material weakness. We believe that this change is consistent with scoping the audit of internal control over financial reporting using annual materiality and reporting on the effectiveness of internal control as of the end of each annual period. Scoping the audit using annual materiality would not result in the audit being designed to detect all material weaknesses as presently defined by the proposed standard, (i.e., the audit would not be designed to detect those material weaknesses that result in a reasonable possibility that interim financial statements, but not annual financial statements, could be materially misstated). Whether or not the reference to interim financial statements is removed from the definition to resolve this inconsistency, we recommend the proposed standard be modified to specifically indicate that the auditor's objective in an audit of internal control is to express an opinion on the company's internal control over financial reporting as it pertains to annual reporting, and the auditor has no responsibility to detect control deficiencies that might result in a material misstatement of interim financial statements. Similarly, it would need to be stated that the audit of internal control over financial reporting does not encompass the controls over the preparation of interim financial statements.

Nevertheless, we recognize that accurate interim financial reporting is important to the decision making process of investors and other users of financial information. We believe that as part of the evaluation of control deficiencies that exist at the balance sheet date, the auditor should consider whether any of the identified deficiencies as of the reporting date would have a material impact on interim reporting even if these deficiencies would not materially impact annual reporting, (i.e., would not be classified as material weaknesses and would not result in an adverse opinion on effectiveness of internal control). The auditor has responsibilities to communicate control-related matters of which he or she becomes aware to management and those charged with governance, so these deficiencies would be communicated to management and the audit committee. Additionally, as part of performing an interim review of financial information, the auditor is required to obtain sufficient knowledge of the entity's internal control as it relates to the preparation of both annual and interim financial information to identify the types of potential misstatements that might occur and to use such knowledge as a basis for the auditor's review procedures.

We would therefore be supportive of a requirement in the proposed standard for the auditor to communicate, in writing to management and the audit committee, control deficiencies that come to his or her attention that result in a reasonable possibility that a material misstatement to interim financial statements, but not the annual financial statements, could occur and not be prevented or detected. As indicated above, it should however be clearly stated in the proposed standard that the auditor has no responsibility to plan procedures to detect control deficiencies of lesser significance than those that result in a reasonable possibility that the annual financial statements could be materially misstated. Additionally, consistent with Question 32 of the Staff Questions and Answers on AS No. 2, it should be emphasized that the auditor also does not have any responsibility to evaluate and classify control deficiencies at dates other than the annual reporting date.

The impact of deficiencies that materially impact interim reporting, but not annual reporting are a consideration for management in evaluating on a quarterly basis, the effectiveness of disclosure controls and procedures, and the required quarterly disclosures about material changes in internal control in financial reporting, (i.e., including control deficiencies that materially affect or are reasonably likely to affect the entity's internal control over financial reporting, as well as the subsequent remediation of these deficiencies). Through these disclosures investors would be made aware of the existence of deficiencies that materially affect interim reporting and also when management has taken action to remediate them.

The inclusion of the reference to interim financial statements in the definitions of significant deficiency and material weakness currently drives an additional level of effort for issuers and auditors alike in the evaluation of deficiencies. The determination of materiality for quarterly reporting periods continues to present a major challenge for company management and auditors alike. In practice, materiality for quarterly reporting periods, including quarterly periods within previously issued annual financial statements, is often the subject of significant debate among management, auditors and audit committees and there are widely differing views. The lack of guidance on this subject has posed a particular challenge in the implementation of AS No. 2, because the assessment of whether or not a significant deficiency represents a material weakness depends on the potential impact of the deficiency on both interim and annual periods. We believe that this confusion and frustration would continue under the proposed standard absent further guidance from the SEC staff or others on what is considered material to interim financial statements.

<u>**Removing the Requirement to Evaluate Management's Process**</u>

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

We support the removal of the requirement for the auditor to evaluate management's annual process to evaluate the effectiveness of internal control over financial reporting; however we do not believe this change will significantly reduce the auditor's work in an audit of internal control over financial reporting. We do not believe that there is a significant level of effort involved in evaluating management's process under the current requirements of AS No. 2. We believe that this evaluation is accomplished primarily through an understanding of management's process which is still required under the proposed standard (and of which we are supportive) and through our use of management's work.

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

The auditor can perform an effective audit of internal control without performing an evaluation of the quality of management's process, however the auditor still needs to understand management's process in order to plan and perform the audit of internal control. The manner in which management completes its assessment directly impacts the work the auditor must do to complete an audit that complies with all applicable professional standards. For example:

- If management alters the manner in which it completes its assessment such that it is less objective (e.g., if management uses a self-assessment process rather than internal audit or a third party to perform testing to support its assessment), that will result in a decreased ability of the auditor to use management's work and would cause a corresponding increase in the work the auditor must perform.

- If management has limited documentation describing the company's significant processes, and/or limited documentation supporting the testing performed the auditor will be required to prepare more documentation to comply with the requirements of AS No. 3.

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?

Requiring the auditor to express an opinion only on the effectiveness of internal control will more clearly communicate the scope and results of the auditor's work. We believe that the requirement for the independent auditor to express separate opinions on (1) whether management's assessment of internal control over financial reporting is fairly stated and (2) whether the company maintained effective internal control over financial reporting is confusing to investors, auditors, and management. Many have misunderstood the language in the first part of the opinion to mean that the auditor is providing an opinion on the adequacy of management's assessment process, which is not the case.

<u>Permitting Consideration of Knowledge Obtained During Previous Audits</u>

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

We believe that the proposed standard appropriately incorporates the value of cumulative knowledge obtained by the auditor from past audits. We strongly agree with the parameters relating to the use of knowledge obtained from past audits as outlined in the proposed standard in paragraphs 65 to 69. Notwithstanding the fact that the phrase "each year's audit must stand on its own" has been eliminated from the proposed standard, the auditor is still required in each year's audit to obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant assertions (paragraph 3). While cumulative knowledge contributes to this evidence, it does not comprise sufficient and competent evidence on its own.

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?

As discussed in our response to question 6 above, we believe that walkthrough procedures would provide sufficient evidence of operating effectiveness of controls that address low risk assertions in certain circumstances. We believe that in circumstances in which the risk of misstatement associated with a particular control is low, past audits have indicated that the control is designed and operating effectively, and the auditor has evidence that there have been no changes in the design of the control or the significant process within which it operates, it may be appropriate for the auditor to rely upon the walkthrough procedures as sufficient evidence of operating effectiveness. The auditor would also need to consider the other guidance provided in paragraphs 51 through 69 of the proposed standard when making this determination.

<u>Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage</u>

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?

We support the change from a "coverage based" approach to a "risk based" approach when scoping the audit of internal control in a multi-location environment by eliminating the requirement to identify and test controls over a "large portion" of the company's operations or financial position. We believe that this approach will result in more efficient audits without jeopardizing audit quality in some circumstances, for example, where there are a large number of small decentralized locations with diverse systems and controls, and the company has effective and sufficiently precise company-level controls to detect material misstatements, after appropriate consideration of aggregation risk.

<u>Removing Barriers to Using the Work of Others</u>

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?

Please refer to our comments regarding use of the work of others in our cover letter where we set forth that we are supportive of the concepts underlying the proposed standard, but we suggest that the proposed standard on using the work of others in an audit is not necessary. We believe the objectives of the PCAOB could be achieved by making minor modifications to AU 322. Although that is our recommendation, we have included responses to the questions below in the event the PCAOB decides to move forward with the proposed standard.

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?

We believe that the proposed definition of relevant activities in paragraph 4 is appropriate. To the extent that activities that are part of the monitoring component of an internal control framework would qualify as relevant activities and meet the criteria of "tests performed by others", they could be considered as relevant activities, however not all activities that are part of the monitoring component will qualify.

We are concerned however, that as currently drafted, the proposed standard creates uncertainty as to the auditor's responsibility with respect to identifying relevant activities. We believe that paragraphs 3 and 5, as proposed are likely to establish a level of work that is unintended. For example, it is not clear whether inquiry of knowledgeable management is sufficient for the auditor to identify relevant activities or whether the auditor's responsibility extends beyond inquiries. If the auditor's responsibilities extend beyond inquiries we are unsure of the additional procedures to be performed to identify relevant activities and comply with the presumptively mandatory requirements in paragraphs 3 and 5. Also, as currently drafted, we do not believe that the proposed standard sets forth that the assessment of competence and objectivity should be applied as a "filter" to what the auditor might identify as relevant activities. We believe that in order to appropriately focus the scope of the auditor's work in identifying and understanding relevant activities, it would be appropriate for the auditor to first consider the objectivity and competency of personnel who might be performing those activities. In other words, the scope of the auditor's work in this respect would then be limited to identifying relevant activities being performed by persons who are sufficiently competent and objective such that the auditor might be able to use their work, as opposed to having to understand all activities that might be relevant activities, including those being performed by persons who are not sufficiently objective and/or competent.

We strongly believe that inefficiencies will result with no impact on audit effectiveness, if the intent of the proposed standard is for the auditor to go beyond broad inquiries in identifying relevant activities and identify all relevant activities, as opposed to identifying only those relevant activities that are performed by personnel considered to be sufficiently competent and objective such that the auditor would be able to use their work.

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

As noted in our response to question 20 above, we believe the auditor's responsibility to identify relevant activities is limited to inquiries of knowledgeable management. As the auditor already obtains written representations from management that it has made the auditor aware of all control deficiencies, fraud, or financial statement misstatements, we do not believe this requirement will have any incremental impact on audit quality.

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 do not believe that the term "principal evidence" as used in AS No. 2 is necessary to adequately address the auditor's responsibilities to obtain sufficient evidence in support of his or her opinion. In fact, the elimination of the term "principal evidence" will likely dispel many misconceptions that the determination of principal evidence was a mechanical or quantitative exercise. Notwithstanding that this term is not included in the proposed standard, we do not believe that the proposed standard changes the auditor's responsibilities, because the auditor must still obtain sufficient competent evidence to support his or her opinion, including obtaining evidence about the design and operating effectiveness of controls over all relevant assertions. We also believe that retaining AU 322, particularly paragraphs 18-22, will provide clarity with respect to the auditor's responsibility to obtain sufficient competent evidence to support the auditor's report. Please refer to our comments regarding the use of the work of others in our cover letter.

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?

Please refer to our comments regarding use of the work of others in our cover letter. We believe that the criteria in AU 322 for evaluating the competence and objectivity are appropriate.

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

Please refer to our comments regarding use of the work of others in our cover letter. We believe that the criteria in AU 322 for evaluating the competence and objectivity are appropriate.

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 agree that a company's policies addressing compensation arrangements for individuals performing the testing could impact an individual's objectivity. However, the proposed standard is not clear as to the nature of the compensation arrangements that the auditor should consider, (i.e., whether it applies to <u>all</u> compensation arrangements, or only those that are more likely to impact objectivity). For example, in a situation in which the individual performing the testing holds company stock in a company-sponsored 401(k) plan, specific consideration by the auditor of this compensation arrangement on the individual's objectivity may not be necessary. However in a situation in which the individual performing the testing has an incentive arrangement that is tied directly to the maintenance of effective internal control (e.g., the individual will receive a significant bonus based on the company receiving an unqualified auditor's report on the effectiveness of internal control), then we believe that this is a compensation arrangement that is far more likely to affect objectivity and therefore needs to be specifically considered by the auditor. We therefore believe that some additional guidance should be provided in the proposed standard as to the nature of the compensation arrangements about which the auditor should be concerned, otherwise we believe that as drafted, the proposed standard could be interpreted to require more audit effort than is intended or may be necessary.

<u>Recalibrating the Walkthrough Requirements</u>

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

We believe that it is possible that recalibrating the walkthrough requirements, as proposed, may in some circumstances result in a reduction in the number and detail of the walkthroughs performed. In general, however, we believe that major classes of transactions within significant processes are subject to different risks and involve different individuals and systems. Consequently, it is not appropriate to combine the walkthroughs of those classes of transactions. In the discussion relating to this topic in the PCAOB Release No. 2006-007 that accompanied the proposed standard, an example is provided that refers to retail sales as a significant process and distinguishes between two different major classes of transactions: store sales and internet sales. The example suggests that separate walkthroughs of the store sales and internet sales transactions would not be necessary. We disagree with this example because we believe that in practice these two transaction types would likely be identified as two separate and distinct processes because they likely would involve different personnel, systems, revenue recognition policies, and would be subject to different risks. We do however believe that once the two transaction types reach a common point within the overall process (e.g., customer billing/collection) then it would be appropriate for the auditor to continue the walkthrough of only one transaction at that point. We believe that including an example to this effect in the proposed standard would be useful in clarifying what we believe is intended.

We also believe the walkthrough requirements in the proposed standard can be further clarified. Paragraph 34 requires the auditor to identify controls within each significant process that management has implemented to address potential misstatements. It is likely that while understanding each significant process, the auditor will identify more controls than those that the auditor ultimately decides are necessary in order to address the relevant assertions (i.e., those controls that are identified from a top-down approach and therefore, will be subject to evaluation of the design and testing of the operating effectiveness). Paragraphs 36-37 however require the auditor to perform the walkthrough of the significant process and verify whether the "controls" have been designed appropriately and placed into operation. It is not clear whether this requirement pertains to <u>all</u> the controls identified in paragraph 34 or only those controls that the auditor has concluded are necessary in order to address the relevant assertions related to the significant accounts (i.e., those that will also be selected for operating effectiveness testing). We believe that it is the latter, but clarification of this in the proposed standard would address the risk that the requirements of paragraph 37 might be misinterpreted and cause unnecessary audit effort.

In addition, we recommend that within paragraph 37 the use of the word "verify" be replaced with the word "determine". The use of the word "verify" in this context could also drive more audit effort than what we believe is intended and which would be necessary.

Finally, page 27 of the PCAOB's release contains the statement that the "…proposed standard's emphasis on the role of probing inquiries is meant to clarify that the auditor is not required to follow a separate transaction through each minor variance in the process." In certain circumstances we believe this might result in a reduction in the detail of walkthroughs. The proposed standard does not however contain a clear description or discussion of this concept and we are therefore concerned that it will likely be overlooked or misapplied, and any potential efficiencies that may result would not then be achieved.

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?

We believe that it is appropriate for the auditor to be able to use others as direct assistance in performing walkthroughs. However, we do not believe that this would be appropriate in areas involving a high degree of judgment or subjectivity and/or if there is a high risk of material misstatement (e.g., a process to develop significant accounting estimates). We believe that the requirement to perform walkthroughs is one of the most significant aspects of an audit of internal control (i.e., walkthroughs directly support the auditor's evaluation of the design of internal control and also the assessment of the risk of misstatement, including the risk of fraud).

Scaling the Audit for Smaller Companies

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 are supportive of the guidance provided in the proposed standard regarding scaling the audit for size and complexity considerations. We also support the efforts of the PCAOB to develop guidance for conducting audits of internal control over financial reporting of smaller public companies. We believe that additional guidance as to how auditors might scale the audit for the size and complexity of a company would be beneficial.

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

No, we believe the attributes identified in the proposed standard are appropriate.

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, we believe the proposed standard has identified the primary differences that the auditor should consider in this regard.

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

We do not believe that the proposed standard inappropriately limits the application of the scalability provisions. However, we believe that in planning and performing an audit of internal control, the focus should always be on the specific characteristics associated with a company recognizing that not all small companies have simple operations, but may also have complex aspects. For example a start-up company may be simple in many respects; but it may have certain characteristics (e.g., complex financing, unique stock-based compensation arrangements) that are complex. The controls necessary to address the more simple aspects of the start-up might be different from those applicable to a large complex organization; however, the controls over the complex aspects of the business would be more similar to, or possibly more complex than those of the large organization.

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 believe that there is no one measure that alone is determinative of the size of a company. Additionally, as discussed in our response to question 31 above, based on our experience we believe that the complexity of a company's operations and the transactions entered into by a company are the primary factors when assessing the level of sophistication of internal control necessary to address the risk of misstatement associated with financial statement assertions.

Proposed Rule 3525 – Audit Committee Pre-approval of Services Related to Internal Control

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?

We believe that the information that would be required to be provided to the audit committee under the proposed rule is sufficient.

Effective Date

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?

While we acknowledge that many of the concepts within the proposed standards can be implemented currently, we believe that in order to obtain the maximum benefit of the proposed standards with respect to audits of financial statements for years ending on or after December 15, 2007, a final standard would need to be approved no later than June 1, 2007. This would allow auditors to work in collaborative manner with management during the planning stages of the audit in order to effectively implement the proposed changes including those not permissible under the current standard. The shorter the period of time engagement teams have to implement the final standard, the more inefficient and disruptive implementation is likely to be for audits in process.

Other Comments

Rollforward Procedures

We believe that additional guidance is needed with respect to "roll-forward procedures" the auditor is required to perform when controls are tested at an interim date. Paragraphs 63 and 64 of the proposed standard imply that the auditor may not have to perform any procedures to update his or her conclusions from an interim date. This does not seem appropriate and is not consistent with paragraph 99 of AU sec. 319 "*Consideration of Internal Control in a Financial Statement Audit*" which states:

> "When the auditor obtains evidential matter about the design or operation of controls during an interim period, he or she should determine what additional evidential matter should be obtained for the remaining period. In making that determination, the auditor should consider the significance of the assertion involved, the specific controls that were evaluated during the interim period, the degree to which the effective design and operation of those controls were evaluated, the results of the tests of controls used to make that evaluation, the length of the remaining period, and the evidential matter about design or operation that may result from the substantive tests performed in the remaining period. The auditor should obtain evidential matter about the nature and extent of any significant changes in internal control, including its policies, procedures, and personnel that occur subsequent to the interim period."

We would suggest modifying paragraphs 63 and 64 of the proposed standard to make the requirements of the auditor consistent with paragraph 99 of AU sec. 319.

Use of Certain Terms

As mentioned previously we noted certain instances where it is not clear how the auditor would be expected to document or demonstrate compliance with the presumptively mandatory responsibilities placed on him or her. In some cases, statements drafted as presumptively mandatory requirements (i.e., "should" statements) instead appear to be guidance or factors for the auditor to consider or address in fulfilling responsibilities relative to a higher level requirement. Examples include but are not limited to the following:

- Paragraph 11: "Because of these attributes, the auditor should recognize that a smaller and less complex company often achieves many of its control objectives through the daily interaction of senior management with company personnel rather than through formal policies and procedures."

- Paragraph 35 – "The auditor should apply this direction when auditing internal control over financial reporting."

- Paragraph 59 – "However, the auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness."

Please also refer to our comments in our cover letter regarding the use of certain terms.

Auditor's Responsibilities When Pervasive Weaknesses Are Identified

We believe in circumstances when there are pervasive weaknesses in fundamental areas of internal control (e.g., control environment, risk assessment, financial closing process), the auditor could conclude without performing additional audit work that the lower level transactional controls cannot be effective. Accordingly, we believe that in these situations the standard should allow the auditor to stop further audit work and conclude that the company does not have effective internal control over financial reporting. The auditor's report in this situation would contain an adverse opinion of the effectiveness of internal control, but would indicate that additional material weaknesses might have been identified had additional procedures been completed. An example of this situation might be when the auditor has determined that a company (1) has a poor risk assessment (including fraud risk assessment) or monitoring process, and (2) does not have a sufficient number of personnel with the requisite financial reporting competencies (either internal or external) to address the types of transactions and activities into which the company enters. Additionally, we do not believe that in these circumstances requiring the auditor to complete the audit would contribute further to the quality of the financial statement audit. We also believe that in these circumstances spending the time necessary to complete the audit would provide no additional benefit to management or investors.

Additionally, we believe that if the Board modifies the proposed standard to allow work on the audit to stop in these situations, it may reduce cost burdens associated with Section 404 when the conclusion regarding the effectiveness of internal control is readily apparent based on the severity of material weaknesses identified at the outset or early in the process. This would allow management to focus resources on taking corrective actions necessary to establish effective internal control over financial reporting rather than diverting limited resources towards completing an assessment for which the ultimate conclusion is already known.

Paragraph 53- Control Deviations

We are concerned that the note to paragraph 53 might be taken out of context. Paragraph 53 requires the auditor to determine the effect of identified deviations from the company's established controls on his or her assessment of risk associated with the control and conclusions on the operating effectiveness. The note to paragraph 53 implies in this context that the auditor would not necessarily have to consider the impact of all deviations identified in his or her testing, which is not the case. We recommend that the note to paragraph 53 either be deleted or modified to clarify that this does not apply to deviations detected by the auditor in a sample designed to test the operating effectiveness of a control.

From: curtisverschoor@sbcglobal.net [mailto:curtisverschoor@sbcglobal.net]
Sent: Monday, February 26, 2007 12:13 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 021

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,

Dr. Curtis C. Verschoor, L & Q Research Professor
School of Accountancy and MIS
DePaul University, Chicago

DOLLAR
FINANCIAL GROUP, INC.

February 26, 2007

Office of the Secretary, PCAOB
1666 K Street NW
Washington, DC 20006-20863

Re: Rulemaking Docket Matter No. 21.

Dear Sir or Madam:

Company Information:

Headquartered in Berwyn, Pennsylvania, Dollar Financial Corp. is a leading international financial services company offering a range of consumer financial products to our customers, many of whom receive income on an irregular basis or from multiple employers.

To meet the needs of our customers, we provide a range of consumer financial products and services primarily consisting of check cashing, short-term consumer loans, money orders and money transfers. The Company currently operates a network of 1,293 stores, including 892 company-operated stores and is the second-largest network in the United States and the largest network in Canada and the United Kingdom. Dollar Financial also has 401 franchised locations in Canada, the United Kingdom, and the United States.

We are a Delaware corporation incorporated in April 1990 as DFG Holdings, Inc. We operate our store network through our direct wholly-owned subsidiary, Dollar Financial Group, Inc., a New York corporation formed in 1979, and its direct and indirect wholly-owned foreign and domestic subsidiaries (collectively, "OPCO"). Our common shares are traded on the NASDAQ National Market under the symbol "DLLR." Our common stock was initially offered to the public on January 28, 2005.

Comments to Rulemaking Docket Matter No. 21:

Page A2-3 Paragraph 1:

This standard establishes requirements for, and provides direction on, the auditor's consideration and use of relevant work performed by others in an integrated audit of financial statements and internal control over financial reporting ("integrated audit") or in an audit of financial statements only. For these purposes, the work of others includes work performed by internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee.

Page A2-5 Paragraph 13 and Note:

Evaluating the Competence and Objectivity of Others. The auditor should evaluate the competence and objectivity of the individuals performing tests of controls, accounts, or disclosures to determine the extent to which the auditor may use their work. In performing this evaluation, the auditor should make judgments about the degree of competence and objectivity of the individuals rather than form an absolute conclusion about whether the individuals are competent or objective. The higher the degree of competence and objectivity, the greater use the auditor may make of the work; conversely, the lower the degree of competence and objectivity, the less use the auditor may make of the work.

Note: The auditor should not use the work of individuals who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of individuals who have a low level of competence regardless of their degree of objectivity.

COMMENTS -
We agree that allowing the auditor to more easily rely on the work performed by others will remove the barriers previously existing under AS2.

Understanding based on Page A2-3 Paragraph 1 – From this context, it appears the auditor may rely on the work of company personnel.

Clarification Questions -

- **Will this require the aforementioned company employees to have a sufficient knowledge base in either external or internal audit procedures?**
- **Or will it be sufficient that such employee's activities be monitored by an employee with a satisfactory base of knowledge?**

Sincerely,

Robin LaVigne, CPA, CRP
Director of Sarbanes Compliance
Dollar Financial Group, Inc.
1436 Lancaster Avenue
Berwyn, PA 19312

P.O. Box 466
Slatersville, RI 02876

February 24, 2007

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

To Whom It May Concern:

The purpose of this letter is to comment on the Board's proposed auditing standard related to the audit of internal control over financial reporting issued on December 19, 2006 (Rulemaking Docket Matter No. 021). I am an associate professor of accountancy at Bentley College and a former CPA. The views expressed in this letter are my own, and do not necessarily represent the views of my employer.

The proposed standard represents an improvement over the previously issued guidance (Auditing Standard No. 2, or AS 2), particularly in the adoption of a risk-based framework for approaching the audit of internal controls. However, I have a few concerns regarding the proposed guidance regarding risk assessment. Specifically, I wish to address matters related to Questions 5 and 6 raised on page 8 of Release No. 2006-007.

My first concern relates to the "change in the direction on integrating the audits" referred to on page 7 of the Release and covered in more detail in Appendix B of the proposed standard. It is my understanding that one of the expected benefits of integrating the audit of internal controls over financial reporting with the financial statement audit is to inform the financial statement audit about the effectiveness of internal controls, so auditors can better assess the control risk component of the audit risk model and thus better design their audits of financial statements. Indeed in Appendix B of the proposed standard paragraph B1, it states that "the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously," one of which is "to obtain sufficient evidence to support the auditor's control risk assessment for purposes of the audit of financial statements." The audit risk model is designed to determine the nature and extent of substantive testing needed to form an opinion on the financial statements, and control risk is a component of that model. To the extent that the audit of internal controls over financial reporting enables the auditor to assess control risk, then it necessarily has to precede the planning for the financial statement audit. Therefore, it is logically impossible for the findings of substantive tests to inform the audit of internal controls, since the substantive testwork would occur *after* the audit of internal controls. In this case, paragraph B11 seems to include a logical inconsistency in the following statement, "The absence of misstatements detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control." Perhaps the standard is referring to the use of findings from past year's substantive audits in informing the planning of the audit of internal controls over financial reporting in the current year, but this should be clarified in the standard.

My second concern has to do with the issue directly addressed in Question 6 on page 8 of the Release regarding whether a walkthrough would be sufficient to test the design and operating effectiveness of some lower risk controls. Paragraph 50 of the proposed standard states that, "Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, walkthroughs, and reperformance of the control." This implies that a combination of inquiry and walkthrough for example, may be considered a sufficient test of operating effectiveness. Walkthroughs are performed as part of the process for gaining an understanding of controls and evaluating design. However, in order to properly determine operating effectiveness, the controls must be tested (as noted throughout the proposed standard). It may be the case that the control appears to be working properly based on a walkthrough, but when a sample of items is selected to test by inspection of relevant documentation, the auditor may find breakdowns in the controls that are not identified in the walkthrough. Therefore the walkthrough cannot be considered equivalent to a test of operating effectiveness, and would not enable the auditor to provide assurance regarding the operating effectiveness of that control.

If a control is of sufficiently low risk that the auditor concludes tests of operating effectiveness are not necessary, and the auditor feels a walkthrough is sufficient to evaluate the design of the control, then it would make more sense to document the rationale for foregoing tests of operating effectiveness (for example if it is determined that a deficiency in the control would be unlikely to lead to a material misstatement on the financial statements). Care should be taken not to provide any positive assurance regarding the operating effectiveness of the control, since tests of operating effectiveness were not performed.

I appreciate the opportunity to comment on these issues and I hope that you find this feedback helpful. If you have any questions, please contact me by e-mail at cearley@bentley.edu.

Sincerely,

Christine E. Earley, PhD, CPA
Associate Professor of Accountancy
Bentley College

UNITED STATES OF AMERICA

Public Company Accounting Oversight Board

PROPOSED AUDITING STANDARD AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENT AND RELATED OTHER PROPOSALS	PCAOB Release No. 2006-007 December 19, 2006 PCAOB Rulemaking Docket Matter No. 021

Comments of the Edison Electric Institute

Introduction

The Edison Electric Institute (EEI) respectfully submits these comments in response to the Public Company Accounting Oversight Board's (PCAOB) Proposed Auditing Standard – "An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements and Related Other Proposals".

EEI is the association of the United States shareholder-owned electric utility companies, international affiliates, and industry associates worldwide. Our U.S. members serve 97 percent of the ultimate customers in the shareholder-owned segment of the industry, and nearly 70 percent of all electric utility ultimate customers in the nation, and generate over 70 percent of the electricity produced by U.S. electric utilities.

The proposed auditing standard is of vital importance to EEI, its member companies and their customers. We are therefore submitting our concerns with the hope that it leads to a clearer, more concise and simplified Auditing Standard for "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"- that would supersede Auditing Standard No. 2.

We have several concerns as outlined in these comments. We have captured in our executive summary those concerns and suggestions that we feel will have the most significant impact in achieving the efficiency, enhancements, and cost reductions that are the goal of the proposed PCOAB's standard. Following the executive summary, we have provided a response to the specific questions posed by the PCAOB that are of primary concern to our members. We hope that these comments will prove helpful to the Board in codifying Auditing Standard No. 5.

Executive Summary

We propose that the following items be addressed in the future PCAOB standard:

- **Provide clarification to the scope of the audit of internal control to avoid unnecessary testing.** As long as there are definitions for both significant deficiencies and material weaknesses, auditors will test to identify <u>both</u> types of weaknesses. We advocate the removal of the significant deficiency definition and concentrate testing instead on the identification of material weaknesses.

- **Provide additional guidelines to tie-in effective company-level controls to an appropriately reduced amount of testing of lower risk controls.** Less time should be spent on lower risk controls. Lower risk areas may be satisfied with company level controls. The net effect should be that some financial statement assertions and internal control objectives would be satisfied through company level controls.

- **Hold public accountants responsible for failing to effectively utilize the work of others.** Use of the work of others should not be an option for the public accountant. Currently, the proposed standard identifies criteria that define when the public accountant <u>can</u> rely on the work of others. Instead, we advocate that the standard identify criteria that define when the public accountant <u>should not</u> rely on the work of others. In the absence of such criteria discouraging reliance, the public accountant would need to be able to show cause to PCAOB audit staff when they opted not to rely on the work of others. This process should become a routine part of PCAOB audits of public accounting firms. Based on our review of the publicly released audit reports from the PCAOB, this evaluation of the reliance on others is not readily apparent.

Additionally, we propose that the following items be addressed:

- <u>**Define the scope of the Section 404 (a) Management Assessment to eliminate or reduce compliance requirements for subsidiary registrants.**</u> We support the proposal to eliminate the external auditor's opinion on management's assessment. Many corporations have multiple registrants, each of which is required to certify their Internal Control Over Financial Reporting (ICFR) in 2007. This creates multiple certifications within the same corporation. This is redundant. Instead of helping investors, these multiple certifications will contribute to investors' confusion. We advocate rules that alleviate the requirement for multiple certifications within the same corporation.

- <u>**Eliminate the Section 404 (b) requirement for a public accountant opinion on ICFR.**</u> Regardless of the rules established by the PCAOB, the inherent tendency of the public accountant is to be conservative. Further, due to the litigious history experienced by public accounting, as well as the PCAOB's own audit results, the public accountant is likely to be reluctant to reduce scope to fully incorporate a risk based approach. They simply have no incentive to do so. Thus, the public accountant will consistently require processes that exceed those necessary in management's point of view. To relieve this situation, we advocate the elimination of the public accountant audit requirement under Section 404 (b) to perform an audit of both management's assessment as well as ICFR. To fill the void in guidance left by this elimination, we suggest that the PCAOB adopts the previously utilized auditing standard covering internal controls, that is, Statement of Auditing Standard No. 55, Consideration of Internal Control in a Financial Statement Audit.

Specific Questions & Answers

A. Focusing the Audit on the Matters Most Important to Internal Control

1. Directing the Auditor's Attention Towards the Most Important Controls:

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

   Comment To some extent yes. However, it is unclear how the assessment of company level controls can be used to develop or limit the scope of the audit. Illustrative examples would be helpful in clarifying this area. It seems very subjective as to how much reliance the external auditor can have on the entity-level controls and how much reduction can occur. Also, the concern is that external auditors will exploit this loophole to push work and cost to management (paragraphs 16-17).

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

   Comment The new standard clarifies that the audit of internal control over financial reporting (ICFR) should ensure that controls are adequate to prevent or detect in a timely manner fraud that could cause a material misstatement (paragraphs 34 and 45). The standard also appropriately addresses the need to assess programs and controls that address risks related to fraud, and specifically those controls that address the risk of management override of controls. Additionally, the standard addresses the impact on the scope of the audit should controls related to fraud be found to be deficient.

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

   Comment We believe that it should, provided the auditor uses reasonable judgment in defining risk thresholds. However, some additional language emphasizing a focus on material controls should be included in paragraph 44, which discusses the process for selecting which controls to test. Alternatively, the definition of a relevant assertion could be reiterated in paragraph 44.

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?

    Comment Although the guidance does provide detail with regard to defining company-level controls and the control environment, it does not adequately provide details about ***how*** the assessment of company-levelcontrols specifically impacts the decisions as to which transactions and controls should be included in the scope of the audit. Please consider specifically addressing how the company-level controls will impact the selection of controls in paragraphs 41-46. The consideration is clearly outlined but more guidance is necessary on the application of the standard.

2. Emphasizing the Importance of Risk Assessment:

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?

    Comment The proposed guidance does provide the auditor with a risk based approach to determining the adequacy of the evidence related to the effective operation of controls in paragraph 52. However, the note at the bottom of that paragraph states that: "***Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively***". Our concern is that the auditor may interpret this note to mean *less evidence means less effective*. This note may drive auditors to a more conservative approach with regard to the evidence required to be created and maintained by management. For example, we believe that an auditor would gain sufficient evidence about the effectiveness of a control activity involving a supervisor's review of a report by interviewing the individual who performs that review and looking at review notes on the report. We are concerned that an auditor may conclude that the evidence is not sufficient, and therefore the control is not effective, if the report is not signed and dated. Again, our opinion is that less evidence does not necessarily mean that a control is less effective.

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

    Comment The proposed standard should emphasize that for controls that have sufficient risk to require testing, but are on the lower end of the risk scale. A walkthrough could provide sufficient evidence at greater efficiency. Some lower risk areas might even be covered by company-level controls. The question will then be is the timing of the walkthrough close enough to the period end. The walkthrough is performed at the front of the assessment process. If it is determined through inquiry and observation that a control that mitigates a lower risk control is sufficient, no further testing should be required. This should be specifically stated in the proposed standard (AS5). A compromise would be that for roll-forward testing "inquiry only" is an acceptable test for low risk controls that have tested effective earlier in the testing cycle. This also would need to be explicitly stated in AS5.

3. Revising the Definitions of Significant Deficiency and Material Weakness:

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?

Comment The definition has improved more so than in the previous guidance. However, it remains an area of great subjectivity. We believe that additional clarity is needed in this area, such as examples to clarify what is important enough to merit attention by those responsible for oversight of the company’s financial reporting. In practice, most firms have established a threshold for what they believe is significant. The new definition should not change those thresholds. Also, confusion and continued dialogue may occur since its application is unique to each company.

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?

Comment It appears that most material internal control weaknesses have been related to material misstatements. However, from that observation one cannot conclude that auditors are appropriately identifying weaknesses in the absence of actual material misstatements. The proposed standard, with its focus on using a top-down approach and scoping at the level to identify material weaknesses, will allow auditors to do a more thorough review of key controls as less effort will be expended on reviewing lower risk controls. This should increase the likelihood of the auditor detecting material weaknesses before a misstatement occurs.

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 statement?

Comment The change to the definitions does not raise the auditor’s threshold for classifying deficiencies. However, the concept of scoping to detect deficiencies that could result in a material misstatement should reduce the amount of effort dedicated to identifying and analyzing deficiencies. In addition, the concept should be reiterated in paragraph 43, which provides guidance related to selecting which controls to test.

4. Revising the Strong Indicators of a Material Weakness:

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?

Comment If one of the strong indicators exists, there is at least a deficiency. However, professional judgment should be exercised in evaluating whether a deficiency is classified as a significant deficiency or material weakness. For example, one strong indicator of a significant deficiency provided in the standard is the situation where the deficient control is related to period end financial reporting. In this situation, there could be varying degrees of a deficiency which range from a lower risk error (such as a missing signature on a work paper), to a higher risk error occurring in the analysis of the financial results. The above two examples of deficiencies should not be classified equally. The use of professional judgment will naturally produce some inconsistencies, but that is more acceptable than the inefficiency caused by utilizing a checklist evaluation approach that focuses on immaterial issues and does not incorporate the auditor's judgment. If a strong indicator is present, and management does not correct it or strengthen their controls, it should be reported as a deficiency.

5. Clarifying the Role of Materiality in the Audit

6. Clarifying the Role of Interim Materiality in the Audit

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

Comment As long as there are definitions for both significant and material weaknesses, auditors will test to identify both types of weaknesses. Remove the significant deficiency definition and concentrate on material weakness. The definition of relevant assertions should be reiterated in the proposed standard numerous times. In addition, the message in paragraph 70, related to the level at which an auditor plans and performs an audit, should be reiterated in paragraph 6. Additional guidelines should be provided related to the tie-in of company-level controls to the scope of the audit of transactions. The testing is supposed to be as of the reporting date.

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?

Comment Any reference to interim statements and materiality should be removed. The audit of internal controls provides an opinion on the effectiveness of those controls as of the fiscal year end. The assessment of the impact of control deficiencies should be limited to the annual financial reports. This could cause a lot of confusion and inconsistency in practice. The focus should be on annual financial statements.

B. Eliminating Unnecessary Procedures

1. Removing the Requirement to Evaluate Management's Process

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

Comment Currently the audit of management's assessment process is inefficient and redundant. Since the ultimate objective of SOX- 404 compliance is for registrants to have effective controls, the audit should focus on that objective. While there may be sound logic behind this requirement, the auditor performs his/her own work or reviews the work of others to make his or her opinion. How management comes to its conclusions should not, therefore, impact the auditor's ability to conclude on his/her own behalf.

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

Comment If management has an ideal assessment process, but the controls are not effective, that assessment is not beneficial to the users of the financial reports. The elimination of the audit of management's assessment process will not make the audit less effective. Again, since the ultimate purpose of the audit is to determine that management maintains effective internal control over financial reporting (ICFR), an audit of management's assessment process is unnecessary. We are now into our third year of SOX. The auditor should know management's process and feel comfortable with it. The auditor should be able to use management's testing as well, especially for low risk areas. The auditor can perform an effective audit of internal controls without performing an evaluation of the quality of management's evaluation process. The auditor does it all the time in other audits, including Financial Statement auditing.

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?

Comment Eliminating the requirement for an opinion on management's assessment of ICFR provides for a clearer and more focused scope and therefore the results related to that focused scope will be more easily interpreted by the user of the company's financial reports. It is what is most relevant to the stakeholder i.e., the independent review, and not Management's own opinion of itself.

2. Permitting Consideration of Knowledge Obtained During Previous Audits

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

Comment The auditors will be able to consider their cumulative audit knowledge and experience in determining the level of risk associated with a control. For lower risk controls, the auditor should be able to reduce the level of evidence needed to determine if the control is operating effectively. The annual rotation of test areas is acceptable - particularly for lower risk areas. Higher risk areas should be tested every year.

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?

Comment Consistent with paragraphs 52 and 66, a walkthrough should produce sufficient evidence of operating effectiveness in areas were the controls were effective in prior periods, the controls are low risk based upon the factors listed in paragraph 52, and where there have been no significant changes to ICFR. If the area has a history of effective internal controls, compensating controls exist, or the relative importance of the process is low. In lower risk areas - subsidiaries that are not major lines of business but have a separate management; lines of business that may marginally exceed the quantitative materiality threshold (higher revenue and expense), but the net effect to the consolidated company is very small. When the auditor uses these procedures to verify that nothing has changed and that those performing the controls have a clear understanding of what needs to be done and why - there is obvious ownership of the control by those performing it.

3. Refocusing the Multi-location Testing Requirement on Risk Rather than Coverage

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?

Comment Small, low risk locations may be addressed by management oversight and entity level controls, since the likelihood of a material misstatement should be remote. It eliminates the time required to test locations for business units that are clearly inconsequential (paragraphs B12-17). It also provides the auditor with the ability to coordinate work with the internal auditors, something the auditor should be able to do to a greater extent in most areas.

4. Removing Barriers to Using the Work of Others

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?

    Comment A single standard will meet both the needs of the financial audit as well as the audit of ICFR. The proposed guidance is a substantial improvement over the limits that are established under the current guidance. This improvement should lead to significant cost reductions for many registrants. Although we believe only one framework is required, it should be made clear to the auditor that coordinating work with the internal auditor is permissible. Otherwise, the efficiencies in relying upon the work of others may not be maximized.

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?

    Comment Although the definition of relevant activities is adequate, it was not easily located in the text of the proposed standard. Perhaps consider adding it in Appendix A.

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

    Comment Two points here - first, this would be reassessing the evaluation that management did, which supports the earlier point that eliminating the report does little to eliminate the work. Second, this statement needs to be qualified because it further leads to the disconnect. Paragraph 6 is what is stated above but the Note below 6 clarifies we are talking about risks of material misstatements. This should not be a note but rather included throughout the proposed standard. We are talking about material misstatements. Any time this is not identified as such, it will lead to more audit work. The auditor should have a full understanding of the relevant activities in order to efficiently plan and perform the audit.

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

    Comment That provision limited the auditor's use of professional judgment when determining the level of reliance that could be placed on the work of others. There should be no difference between using the work of others in a financial statement audit or an audit of ICFR. This ends up being one of the most inefficient aspects of Sarbanes-Oxley Section 404 implementation as there is much duplicative work. If the work of others is sufficiently documented and the evidence sound, there is no reason why the auditor should duplicate efforts. This strengthens the argument, however, for coordination with others (e.g., internal auditing) performing testing so that expectations can be managed. No one benefits from performance of work that could have been relied upon 'if only it had been taken a step further', for example.

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?

Comment The proposed standard does provide very good guidelines for evaluating competence and objectivity in paragraphs 14-15 in Appendix 2. However, the guidance in paragraph 15, section b may cause the auditors to avoid using the work of others that are not part of a formal internal audit function. This is still too restrictive as the proposed standard does not do enough to incorporate the concept of self-assessment of key controls. Self-assessment, if managed properly, is still the most effective and efficient way for management to conduct its assessment. With proper oversight of the self-assessment program, external auditors should be allowed to rely on self-assessment testing. Currently, this is a big gap in the Board's guidance as it seems to suggest that internal auditors should do all of the management testing. Having internal audit do all of the testing is far from efficient and far from a best practice.

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

Comment A missing factor is that effective oversight of the testers of key controls is an important element in improving objectivity and competence. Professional certification should not be a requirement. Instead, the quality of the work product and the process used by the client to evaluate risks and controls should be the key criteria.

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?

Comment Factors related to compensation of individuals performing testing should be addressed only as a part of the assessment of the individuals' objectivity. The practical effect of including a company's policy addressing compensation arrangements helps to ensure that the entity recognizes areas that could impair objectivity and by establishing compensation guidelines helps to support an environment for unbiased assessment of the effectiveness of controls. However, it is unclear how much weight to assign to this factor and how the auditor should assess the objectivity of individuals performing tests in the absence of such policy.

5. Recalibrating the Walkthrough Requirements

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

    Comment The language in the proposed standard provides the auditor with the opportunity to use his or her professional judgment in limiting the walkthroughs to those processes that are material to the audit. This will eliminate unnecessary efforts and could have a significant effect in reducing the number and detail of the walkthroughs performed without impairing audit quality.

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?

    Comment If the auditor applies the guidance in paragraph 21, the auditor should be able to rely on walkthroughs performed by other competent objective professionals.

Conclusion

EEI appreciates the opportunity to submit these comments in response to the PCAOB's Proposed Auditing Standard. We hope you find our comments relevant and timely towards a more effective, less cumbersome and less costly revised auditing standard.

Sincerely,

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February 26, 2007

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Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803
Reference: PCAOB Rulemaking Docket Matter No. 21

Eli Lilly and Company (Lilly) appreciates the opportunity to provide its views on the Public Company Accounting Oversight Board's ("PCAOB") proposed auditing standard, *An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements*. Lilly supports the PCAOB's continued willingness to solicit input and address various concerns of preparers and auditors on the important topic of internal control reporting. We have long supported the position that effective internal controls are vital to the integrity of the financial reporting process.

We believe passage of the Act has helped to restore investor confidence in the financial reporting and disclosure practices of larger companies. We agree that the proposed guidance has the potential to assist companies in achieving a better balance of benefits and costs while still achieving the legislative intent of the Act, consistent with the PCAOB's intent. 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 balance between costs and benefits of Sarbanes-Oxley compliance. The new standards open the door for productive dialogue with our auditors about how to make our assessments and their audits more efficient. We especially appreciate that the proposed standards have moved to a more principles-based approach. This allows 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.

Our primary concern is that 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.

Top-down, risk-based approach

We believe that 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 companies can significantly reduce the number of key controls to be assessed. This reduction will allow for a lower assessment 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. 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. 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.

Alignment between management and auditors

In the absence of management guidance, companies have had to follow AS2 to satisfy the requirements of the auditors. With the flexibility to focus on a top-down, risk-based approach to detect only material weaknesses, we expect to narrow our focus and align the level of testing with the level of risk assessed in the significant accounts and related processes, achieving a better tradeoff between the quality of controls assurance and the cost of compliance.

We want to emphasize how critical it is that the audit standards are aligned with the SEC's management guidance. The auditors must be comfortable with management's assessment approach to optimize reliance and achieve overall cost savings. And although the requirement for an opinion on management's assessment process has been eliminated, the opinion on the controls themselves remains. As currently written, the proposed standard will not allow management to make as significant of changes as the management guidance if management wants to continue or even expand the level of reliance on it's testing by the external auditors. In fact, we have heard from our external auditors that the proposed standards have caught up to their audit approach and expect minimal changes. A more detailed or conservative approach on the part of the auditors will drive the 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.

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. Barriers to change for the 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.

Removal of opinion on management's assessment

We support the elimination of the opinion on management's assessment process. However, we do not expect to see substantial efficiencies result from the change since the auditor still needs to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk and determining the extent to which he or she will use the work of others. If companies want to optimize auditor reliance on management testing, they will still need to align with the auditors' standards of testing and documentation.

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, we still struggle to get full credit for these controls in reducing 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.

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 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.

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 reducing the required 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 auditors the flexibility to focus on only **changes** in controls. This would mean changing the expectation that each year's audit stands on its own and allow for benchmarking or rotation of testing 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 any testing of that control, particularly for lower risk controls. Also, the auditors could limit the scope of their walkthroughs to only the changes.

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. We support the separate statement allowing reliance upon a broader group of individuals determined to be competent and objective for testing internal controls.

In addition in paragraph 40, it suggests the auditor should either perform the walkthroughs himself or herself or supervise the work of others who provide direct assistance. We draw a major distinction between supervise versus direct the work of others. We believe the term supervise is interpreted by the auditors too stringently and would involve extensive work by the auditors when they have already determined the individuals to be competent and objective. For example, we would suggest the auditors be allowed to direct the work of others performing walkthroughs on behalf of the auditors through guidance and oversight but not require detailed supervision of all their activities.

Multiple-location changes

We believe that the shift from a quantitative approach 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.

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 somewhat 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. We recognize the strong sentiments and sensitivity around the detection of fraud; however, we draw a major distinction between insignificant expense report exceptions compared to an intentional manipulation of financial statements. It may also be appropriate to define the specific types of fraud that should be considered to be an indicator of a material weakness (i.e. management fraud – senior management intentional manipulation of financial statements, versus employee fraud – inappropriate expense reporting). 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.

With all the buzz about auditors focusing more on fraud, it would be helpful if the proposed standard provided more guidance on what is expected of the auditor rather than allowing them to be more conservative in this area as opposed to the risk assessment focus for the audit of internal control over financial reporting to identify material misstatements. We would not support periodic forensic auditing to detect material misstatements due to fraud.

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 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 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.

Scaling the Audit for Smaller Companies

We agree the proposed standard has allowed the auditor to use more judgment through the top-down, risk-based approach. This should also allow the auditor to tailor his/her approach to plan and perform the audit based on risk and complexity of the organization. We do not believe it is necessary to call out the scalability under a separate heading within the proposed standard and suggest no distinction be drawn between the accelerated filer and non-accelerated filer. This information and guidance clearly falls under the role of risk assessment. In addition, we would suggest footnote 6 to the proposed standard be eliminated.

Effective date

We hope that we have clearly communicated our strong support for the proposed standards. So that we can 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 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.

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

Sincerely,

Arnold C. Hanish
Executive Director and Chief Accounting Officer
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February 26, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 021

Enbridge Inc. is pleased to provide comments in regard to the proposal to supercede Audit Standard No. 2.

Our Experience To Date

Enbridge Inc. sponsors and manages three different NYSE registrants subject to Sarbanes Oxley (SOx) legislation. Enbridge Inc.'s affiliates, Enbridge Energy Partners, L.L.C. and Enbridge Energy Management L.P., are domestic filers and were first required to certify with their fiscal year-ending December 31, 2004. As a foreign private issuer, Enbridge Inc. first certified with its fiscal year-ending December 31, 2006. As such, a large proportion of the Enbridge group of companies has had over three years of experience with SOx 404 legislation and Auditing Standard No. 2 (AS2). Although we have seen some improvement in cost and effort over the past three years, we continue to experience challenges in achieving substantial benefits from the compliance process. Both management and external auditor efforts remain excessive, as the risk-based focused guidance has not been implemented as anticipated. By not focusing on areas of high risk, management feels that the effort expended on low risk areas is not the intent of SOx 404 legislation, and is unlikely to help reducing the likelihood of a material misstatement.

We believe that the PCAOB file reviews being experienced by the external auditor community are not consistent with the spirit of the guidance. The interpretation of "more than remote likelihood" has resulted in much lower materiality for testing and evaluation of controls from that used previously in the financial statement audit. This results in significantly more details and extent of documentation requirements, which has decreased the extent of professional judgment the external auditors are willing to use, in their evaluation of both management's assessment of the effectiveness of controls and their own evaluation of the controls. Hence, management's efforts must be extensive to be relied on by the external auditor, and the external auditor's efforts need to be extensive to support their assurance opinion. The reliability of financial reporting is not enhanced by the extent of the procedures performed.

Comments on Auditing Standard No. 5

Enbridge views the proposed Auditing Standard No. 5 (AS5) as favorable, specifically with respect to:

- Eliminating the requirement for the auditor to report on management's assessment,
- Using the work of others, eliminating the principal evidence provision and testing of the control environment,
- Focusing on entity-level controls first, then addressing transactional or downstream controls in areas of higher risk,
- Selecting locations based on assessed risk,
- Using knowledge gained in prior audits,
- Performing management assessments and external audits to detect only material weaknesses, based on risk assessment,
- Revising definitions of 'material weakness' and 'significant deficiency',
- The allowing of flexibility in the application of professional judgment.

We believe that the scalable concept contained in paragraphs 9 to 12 of PCAOB AS5 should also apply to small/remote divisions/locations of large filers, where management daily interaction should be an acceptable monitoring control.

Application of AS5 Going Forward

Enbridge sees some challenges in applying the new Standard (AS5) going forward:

- Differences in approach between management and external auditor with respect to materiality may impact scoping, extent of testing, and the eventual evaluation of deficiencies.
- SAB 108 guidance may cause confusion for both management and the external auditor as to materiality.
- The principal audit evidence requirement is eliminated, so it is unclear as to the extent of testing required on the part of the external auditor to ensure high-risk areas are covered. This may also cause confusion for management and the external auditor as to evidence requirements.
- Management and the external auditors may have different testing approaches, which may result in excessive testing. Reduction in external audit fees may not be realized from increased reliance on the work of others, in the assessment of entity level controls first, and the elimination of the auditor opinion of management's assessment.
- Specific definition of "reasonable possibility" versus "more than remote likelihood" is required to ensure deficiency evaluation criteria, and resulting testing materiality levels can be established and applied quickly.

- The requirement for the external auditor to apply an integrated audit approach may tie management's approach to the external auditors' more than anticipated.

Although the proposed changes are favorable, we believe that these changes may not result in a reduction in external audit fees for the first two years after the adoption of AS5, and may in fact increase during this period as the changes may result in considerable re-engineering in the planning, risk analysis, and eventual work undertaken by the external auditor. Additionally, we are doubtful that the external auditor will meaningfully change its approach and extent of work until it sees tangible specific confirmation from the PCAOB in regard to file reviews expectations or receive PCAOB file review feedback on audit files created after AS5 is adopted.

Conclusions

Enbridge views the proposed Audit Standard No. 5 as favorable and would recommend that the PCAOB adopt it, but clarify perceived inconsistencies with the SEC guidance and publish file reviews expectations to external auditors as quickly as possible to ensure external auditors have confidence in implementing AS5 during the current year.

Sincerely,

Stephen J. Wuori
Executive Vice President,
Chief Financial Officer
& Corporate Development
Enbridge Inc.

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February 26, 2007

Mr. J. Gordon Seymour
General Counsel and Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006-2803

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

Dear Mr. Seymour:

Ernst & Young LLP is pleased to comment on the PCAOB's proposed auditing standard on auditing internal control over financial reporting (the "Proposed Standard") and related other proposals. We strongly agree with the Board's observations that auditing and reporting on internal control over financial reporting has produced significant benefits and protections to investors by fostering greater focus on corporate governance, enhanced audit committee oversight, improvements in the quality and efficiency of important corporate processes and controls, higher quality financial reporting, and enhanced transparency.

In our view, the continued provision of a single standard for conducting an audit of internal control over financial reporting that requires auditors to annually obtain reasonable assurance about the design and operating effectiveness of internal controls is the right result for investors, companies, and the capital markets. We believe the Proposed Standard is scalable for audits of companies of all sizes and do not believe a different set of requirements for audits of smaller public companies is in the public interest. The Proposed Standard will help auditors of accelerated filers that already have been through the most challenging aspects of initial Section 404 implementation to further improve their processes. Additionally, the Proposed Standard will be particularly helpful to the auditors of those issuers that have not yet implemented Section 404.

We support the Board's goals to better align the auditor's efforts in performing audits of internal control over financial reporting with the significant benefits they have been shown to provide, while maintaining the integrity of the overall audit process. We support the Board's objectives of focusing the auditor on the matters most important to internal control, eliminating unnecessary procedures, providing auditors the opportunity to incorporate knowledge obtained during past audits, and simplifying and shortening the standard.

We appreciate that the Proposed Standard is more principles-based and provides for wider use of professional judgment. We believe this will permit auditors to focus on matters most important to a company's internal control over financial reporting and its financial statements and to tailor the audits to the particular circumstances. This will significantly aid the auditor's ability to scale the audit to reflect the size and complexity of the company.

Several areas of the Proposed Standard provide for broader use of professional judgment, ranging from assessment of risk and the effect on the auditor's scope and testing to the evaluation of control deficiencies. A natural outcome of principles-based auditing standards that provides for wider use of professional judgment will be that auditing firms and individual auditors may not always interpret and apply such standards uniformly or agree on how they should be applied in a particular circumstance. Accordingly, we strongly believe that PCAOB inspectors must come to respect the range of possible judgments that auditing firms and individual auditors may appropriately make under principles-based standards and the alternative and equally acceptable approaches and methods they may choose to employ. Constructive discussions and challenges as to the scope and nature of procedures chosen are always an appropriate and needed part of the inspection process, but the inspector's judgment cannot be viewed as usurping that of the auditor as long as the principles outlined in the auditing standards have been complied with in a reasonable and good faith manner.

The following are summary comments regarding certain technical aspects of the Board's proposals.

Addressing Efficiency in the Performance of an Integrated Audit
The Proposed Standard has several provisions that address audit efficiency. We are committed to the objective of conducting an efficient as well as effective audit, but we are very concerned that the inclusion in an auditing standard of provisions relating to efficiency, including presumptively mandatory performance requirements such as the one in paragraph 3 that "the auditor *should* (emphasis added) select for testing only those controls that are important to the auditor's conclusion …," may detract from the overarching objective of the standard, which is to provide guidance for auditors for performing a high quality audit. Under the Proposed Standard, an auditor might perform audit procedures that the auditor believed were appropriate in the circumstances because they were relevant to the overall scope and objective of the audit. But he or she could nonetheless violate PCAOB auditing standards because, in the view of others, the approach he or she took was not the most efficient testing approach possible.

We are concerned that as drafted the Proposed Standard could be viewed by some as making efficiency as important a goal as audit effectiveness. We believe that would not be in the public interest. While efficiency is certainly important and we are committed to it in our work, performing a highly effective audit is paramount and essential to meeting the needs of investors and the markets. We suggest that the PCAOB make revisions in the final standard to make it clear that first and foremost the auditor must be concerned with effectiveness as the measure of audit quality. Part of the message must also be that if auditors faithfully follow the principles in the Proposed Standard and execute a highly effective audit, they will not be deemed to have violated PCAOB auditing standards if someone after the fact believes a more efficient approach might have been taken. We are unaware of any prior actions by auditing standard setters in the U.S. or internationally to describe the maximum amount of work that an auditor should perform without risking a violation of professional standards that could result in sanctions or litigation.

Management's Assessment
We encourage the Board to acknowledge in the final standard the significant effect that the nature and quality of management's assessment can have on the scope of the integrated audit, including a direct bearing on the auditor's consideration and use of the work of others. We also encourage the Board to acknowledge in the final standard that, because of this important effect, the auditor will need to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which he or she will use the work of others.

We believe it is important not to understate the effect that meaningful collaboration between management and auditors has on the efficient conduct of an audit. We believe management is generally interested in determining both how to complete its assessment and how the auditor completes its audit of internal control over financial reporting in a quality, yet cost-effective manner. In following the SEC proposed guidance for its assessment, management could face a number of decisions among competing cost-efficient approaches. For example, management may need to decide whether to gather evidence through self-assessment by those responsible for the design and operation of the controls, or instead gather evidence through re-performance of controls by more competent and objective internal audit personnel, with the latter alternative potentially affording the auditor the ability to use the work to a greater degree.

Considering the Effect of Company-Level Controls
We agree that an evaluation of company-level controls is an important part of a top-down, risk-based approach and should occur early in the audit. However, we are concerned that the Proposed Standard potentially overstates the frequency with which company-level controls can be directly linked to relevant assertions to address the risk of material misstatements in the financial statements. In our view, the final standard should acknowledge that in many circumstances company-level controls only indirectly relate to relevant assertions and do not operate in a manner that would be sufficient to address the risk of material misstatement to specific accounts and disclosures in the financial statements. If the Board believes company-level controls can more frequently be linked to relevant assertions, we would welcome examples that illustrate the linkage and the benefit that could be derived from them in determining the nature, timing, and extent of testing of lower-level controls.

Risk Assessments
We support the inclusion of a core principle that a direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention the auditor should devote to that area. However, we are concerned that the Proposed Standard implies that risk needs to be assessed and documented at multiple levels, including a formal assessment of risk at the control level.

Auditors are not currently required to assess risk at the control level for audits of financial statements, so we are unclear as to the need for, or the benefit of, this additional layer of risk assessment for the audit of internal control over financial reporting in an integrated audit. Similar to other auditing firms, we require a control risk assessment at the assertion level, which, in our view, provides the focus for evaluating whether identified controls adequately address the risk of material misstatement of the financial statements. We also believe that an assertion-level risk assessment provides an appropriate basis for considering an effective and efficient strategy for testing controls. Therefore, we believe that a requirement to assess risk at the control level is unnecessary and would not improve audit quality. In addition, we strongly believe the effort and documentation required to make and support a formal assessment of risk at this level would be labor-intensive, potentially costly and incremental to the effort that was required by PCAOB Auditing Standard No. 2 (AS2).

Using the Work of Others
We believe the Proposed Standard on auditing internal control over financial reporting removes the barriers that previously existed in AS2 to the effective use of the work of internal auditors and others by eliminating the principal evidence provision and providing that auditors can supervise the work of others who provide direct assistance to the auditor in the performance of a walkthrough. We believe that it is unnecessary to supersede AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, with the separate proposed standard on considering and using the work of others. We believe AU section 322 continues to provide relevant guidance to auditors and therefore recommend that it be retained. However, the Board should consider two conforming amendments to AU section 322 to (i) clarify that the auditor may use of the work of internal auditors in conducting an audit of internal control over financial reporting, and (ii) allow the auditor to use the work of management and others in assessing control risk for the audit of the financial statements.

In our view, with the conforming amendments suggested above, AU section 322 would provide an appropriate single framework for considering the use of the work of others in both the audit of the financial statements and the audit of internal control over financial reporting. Accordingly, we do not believe that the separate proposed auditing standard is necessary. It is our belief that the proposed standard expands the definition of relevant activities to include tests providing evidence about potential misstatements of the company's financial statements performed by those not acting in an internal audit capacity, which we believe could lead to the inappropriate use of the work of others in a manner that could reduce audit quality.

In the attachment to this letter, we also have included our responses to each of the Board's discussion questions either individually or in summary form related to specific topics.

We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Very truly yours,

Ernst & Young LLP

A. Focusing the Audit on the Matters Most Important to Internal Control

1. Directing the Auditor's Attention Towards the Most Important Controls

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

We believe that the Proposed Standard clearly describes how to use a top-down approach. We also believe the Staff's efforts to reorganize the standard to follow the sequential flow of an audit is helpful. However, we believe the Proposed Standard should provide a more balanced discussion of the potential link of company-level controls to relevant assertions and their effect on controls at the process, transaction, or application level.

We believe that the Proposed Standard suggests a stronger link between company-level controls and the nature, timing, and extent of the auditor's tests of controls that operate at the process, transaction, or application level than has been observed in practice over the years. Moreover, we believe that misperceptions could be prevented if it were made clear within the final standard how the varying types of company-level controls would be expected to influence testing of other controls.

While we agree that company-level controls vary in precision, we are concerned that the Proposed Standard leaves the impression that all the categories of company-level controls listed in paragraph 18 can be directly linked to relevant assertions or would be effective as monitoring controls in identifying possible breakdowns in lower-level controls. In our view, the final standard should acknowledge that in many circumstances the categories of company-level controls listed in the Proposed Standard only indirectly relate to relevant assertions and do not operate in a manner that would be sufficient to address the risk of material misstatement to specific accounts and disclosures in the financial statements. In our experience, company-level controls frequently do not directly link to relevant assertions, and it is difficult to reflect their indirect benefit in designing the nature, timing and extent of tests of process, application, or transaction level controls. If the Board believes the categories of company-level controls listed in the Proposed Standard can be linked more frequently to relevant assertions, we would welcome examples that illustrate the linkage and the benefit that could be derived from them in determining the nature, timing, and extent of testing of lower-level controls.

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

We believe the Proposed Standard appropriately emphasizes the importance of identifying and testing controls designed to prevent or detect fraud. However, we believe the understanding of a company's fraud programs and controls can best be leveraged when it is undertaken early in a top-down approach to the integrated audit. Accordingly, we recommend bringing paragraph 45 of the Proposed Standard forward to the "Identifying Company-Level Controls" section of the standard. We believe this change in the final standard also would help to clarify that fraud programs and controls are inter-related with the overall system of internal control over financial reporting.

We observe that the Proposed Standard has broadened the definition of company-level controls to include controls over management override without providing any further direction. Accordingly, we believe the Proposed Standard would benefit from an expanded discussion of the evaluation of the risk of management override and company-level controls. This expanded discussion could include, among other things, the auditor's evaluation of the risk of management override (i.e., incentives or pressures, opportunities, and rationalizations) and the types of actions generally taken by management in response to the risk of management override (i.e., controls or other actions taken by the company in response to identified risks).

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

Yes. In our experience, a top-down approach aids the auditor in identifying controls important to the audit. However, auditors might conclude differently as to the relative importance of individual controls or the combination of controls to test to address identified risks.

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?*

See response to question 1. We agree that an evaluation of company-level controls is an important part of a top-down, risk-based approach and should occur early in the audit. However, we believe the Proposed Standard should provide a more balanced discussion of the potential link of company-level controls to relevant assertions and their effect on controls at the process, transaction, or application level. In our experience, company-level controls in most instances do not directly link to relevant assertions, and certainly not with the regularity that might be inferred from the language in the Proposed Standard.

2. Emphasizing the Importance of Risk Assessment

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?*

We continue to be supportive of the Board's May 16, 2005 guidance and concur with the inclusion of the core principles of such guidance in the Proposed Standard, including the notation that a direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention the auditor should devote to that area.

However, we believe the Proposed Standard should clarify the risk assessments expected to be made and documented within the top-down approach. Specifically, we are concerned that the Proposed Standard implies that risk needs to be assessed and documented at multiple levels, which might result in confusion and create specific performance requirements resulting in unnecessary additional effort. We are particularly concerned about the requirement to make a formal assessment of risk at the control level. Auditors are not currently required to assess risk at the control level for audits of financial statements, so we are unclear as to the need for, or the benefit of, this additional layer of risk assessment for the audit of internal control over financial reporting in an integrated audit. Similar to other auditing firms, we require a control risk assessment at the assertion level (after determining and documenting for each control whether it is effective), which, in our view, provides the focus for evaluating whether identified controls adequately address the risk of material misstatement of the financial statements. We also believe that an assertion-level risk assessment provides an appropriate basis for considering an effective and efficient strategy for testing controls. Therefore, we believe that a requirement to assess risk at the control level is unnecessary and would not improve audit quality.

We strongly believe the effort and documentation required to make and support a formal assessment of risk at the control level would be labor-intensive, potentially costly and incremental to the effort that was required by AS2. We further believe the nature, timing, and extent of testing of the controls selected for testing that is documented in the audit program implicitly documents the auditor's consideration of the risk factors associated with each respective control.

Additionally, certain references throughout the Proposed Standard have the potential to create confusion for auditors. For example, paragraph 3 and paragraphs 41 through 44 of the Proposed Standard indicate the risk of misstatement should be considered for each relevant assertion. Paragraph 8 uses the terms "degree of risk" and "a particular area of the company's internal control," while paragraph 51 requires that for each control selected for testing, an assessment be made of "the risk that the control might not be effective and if not effective, the risk that a material weakness would result" and references the "risk associated with a control." We urge the Board to more clearly distinguish the various risk assessments described in the final standard and to clarify the role of each in an audit that is both top-down and risk-based.

While we believe we understand the Board's intention, we believe that the statement in paragraph 8 of the Proposed Standard that "the auditor should focus the majority of his or her attention on the areas of greatest risk to substantially decrease the opportunity for a material weakness to go undetected" is problematic and needs to be revised. Taken literally, an auditor could be determined to be in violation of professional standards if in the conduct of an audit the audit engagement team spent more than 50% of the total engagement time on areas of the audit that were not "of greatest risk." As drafted, the Proposed Standard would establish a requirement for audits that 51% or more of the engagement hours be spent on areas of greatest risk and 49% or less of the engagement hours on all other areas of the audit. We do not believe this was the Board's intention and recommend removal of the words "the majority of" from this sentence.

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

We agree with the general principle that a correlation should exist between the risk of a material weakness if a control failed to operate effectively and the amount of audit evidence needed to support the operating effectiveness of that control. Accordingly, we believe the auditor can vary the nature, timing, and extent of testing of controls based upon the consideration of various risk factors, including those outlined in paragraphs 52 and 66 of the Proposed Standard. In addition to these risk factors, we also believe the auditor should consider the importance of a control in determining the appropriate testing strategy for that control. This consideration includes whether the control addresses multiple "what could go wrong" questions for a single assertion or addresses multiple assertions related to one or more significant accounts or disclosures. In these situations, we generally do not believe that the performance of a walkthrough alone would be sufficient to test the operating effectiveness of the control. On the other hand, in circumstances where a control exists within a lower-risk area, is deemed to be low risk based on the factors in paragraphs 52 and 66 of the Proposed Standard, and was tested and determined to be effective in prior years, the performance of a walkthrough might be sufficient to test the design and operating effectiveness of the control. Overall, we would not expect that auditors will frequently conclude in many areas of the audit that only a walkthrough is sufficient for concluding on the design and operating effectiveness of controls.

3. Revising the Definitions of Significant Deficiency and Material Weakness

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?*

In our view, the proposed definition of "significant" could be applied in practice, but would require the use of judgment in determining whether a control deficiency relates to matters that are important enough to merit attention by those responsible for oversight of the company's financial reporting. We agree with the use of judgment in determining significance in this context, but it is uncertain how this change will affect the number of significant deficiencies communicated as a result of the integrated audit.

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?*

Because the audit of internal control and the audit of the financial statements are integrated activities, we are not surprised that a large number of material weaknesses reported to date were identified when material misstatements were detected during the audit. However, we do not believe that the underlying control deficiencies contributing to these material weaknesses necessarily suggests that the material weakness existed, or could have been detected, at an earlier date.

We agree that investors are better served by early identification of material weaknesses that have not yet resulted in misstatements. We believe the focus of the Proposed Standard on evaluating the control environment, anti-fraud programs and controls, and the period-end financial reporting process are appropriate measures to aid auditors in earlier identification of material weaknesses, even in the absence of material misstatements. However, such procedures alone would not improve the earlier identification of material weaknesses.

We believe that management and auditors must pay appropriate attention to controls at the process, transaction or application level, and the benefits of an effective system of internal control over financial reporting in preventing and detecting material misstatements, including those related to fraud. Root-cause analysis of exceptions identified in control testing also can lead to earlier identification of material weaknesses. We have a general concern that any significant reductions in the interactions with process owners through process, transaction or application level control testing potentially could adversely affect the early identification of deficiencies and thus the ability of management to take action to prevent material weaknesses in advance of an actual material misstatement.

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?*

It is difficult to predict whether the proposed changes to the definitions will have a measurable reduction in the amount of auditor effort in analyzing deficiencies. We believe that auditors already are, in effect, applying the "reasonable possibility" threshold in their evaluation of deficiencies because the Board's November 30, 2005 Report on the Initial Implementation of Auditing Standard No. 2 indicated that "more than remote" had the same meaning as "at least reasonably possible." However, paragraph 70 of the Proposed Standard states the auditor must evaluate the severity of each control deficiency that comes to his or her attention, so auditors will need to apply at least some degree of effort and judgment when analyzing each deficiency that has been identifed.

4. Revising the Strong Indicators of a Material Weakness

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 our view, each of these situations requires an analysis of the specific facts and circumstances. We believe that our audit engagement teams presently are basing determinations of whether or not material weaknesses exist based on the specific facts and circumstances. It has been our experience, however, that a material weakness often is found to exist when one of these strong indicators is present. We believe the list of strong indicators in both AS2 and the Proposed Standard are appropriate and our experience has demonstrated that these conditions are strong indicators of a material weakness for a good reason, i.e., in most cases the underlying control deficiency or deficiencies rise to the level of a material weakness when evaluated under the likelihood and magnitude framework. However, we believe removing the presumption that the circumstances described are indicative of at least a significant deficiency helps to eliminate the view expressed by some that auditors are too quick to conclude that a material weakness exists. We expect that auditors will continue to apply their professional judgment in evaluating the specific facts and circumstances, and in certain situations might conclude that no control deficiency exists.

5. Clarifying the Role of Materiality in the Audit

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

No.

6. Clarifying the Role of Interim Materiality in the Audit

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?

We strongly urge the Board to remove the reference to interim financial statements in the definitions of significant deficiency and material weakness. The reference to interim financial statements apparently continues to cause confusion for some regarding the scope of an integrated audit. Additionally, the auditor is unable to evaluate relevant factors (especially qualitative factors) about the potential effect of control deficiencies on interim financial statements because the auditor did not audit those statements and therefore does not have the knowledge that would have been gained from those audits. For these reasons, the reference to interim financial statements is potentially misleading to investors and should be eliminated.

However, we do not believe that the scope of integrated audits would be affected if the reference to interim materiality were removed from the deficiency definitions, because scope is determined with respect to the full-year, annual financial statements.

B. Eliminating Unnecessary Procedures

1. Removing the Requirement to Evaluate Management's Process

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

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's 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 support the removal of the requirement for the auditor to provide a separate opinion on management's assessment. We are aware that the issuance of this separate opinion has been incorrectly interpreted by some parties as the expression of an opinion on management's assessment process, rather than its intended purpose of acknowledging whether or not the auditor is in agreement with management's assertion about the effectiveness of the company's internal control over financial reporting. Therefore, we believe that providing an opinion only on the effectiveness of internal control will more clearly communicate the scope and results of the auditor's work. However, while potentially less confusing, we do not believe that eliminating the auditor's separate opinion on management's assessment will have a measurable reduction in audit effort. We do not believe that our audit engagement teams currently are spending significant incremental time and effort evaluating management's assessment process.

We observe that paragraph 1 and the introductory paragraph of the illustrative report in paragraph 96 of the Proposed Standard indicate the auditor is auditing management's assessment. We believe these references might continue to suggest the auditor is auditing management's assessment process and urge the Board to add a footnote to the final standard to explain why this reference is necessary in the introductory paragraph of the auditor's report on internal control over financial reporting. We believe this additional clarification would help to avoid any inference that the auditor is auditing management's assessment process.

On page 16 of the Board's proposal release, it states "Under the proposed standard, an auditor still would need to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which he or she will use the work of others." We strongly agree with the Board's statement and believe that the auditor's responsibility to obtain an understanding of management's process should be included in the final standard as part of planning the audit. We believe the auditor can perform an effective audit of internal control without evaluating management's assessment process, but the quality of management's process has a direct bearing on the auditor's risk assessments and his or her consideration and use of the work of others.

We also believe the Board should consider including in the Proposed Standard a discussion of the auditor's responsibilities if the auditor believes that management's assessment is so deficient that, in the auditor's judgment, it does not meet the requirements under the Sarbanes-Oxley Act of 2002 and the SEC's rules and regulations for implementing Section 404 of the Act.

2. Permitting Consideration of Knowledge Obtained During Previous Audits

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

We believe the Proposed Standard appropriately incorporates the consideration of cumulative knowledge obtained through past audits through the inclusion of paragraphs 65 through 69 under the section "Special Considerations for Subsequent Years' Audits." However, we also believe that this knowledge is only one of many considerations that weigh into a risk assessment. Accordingly, we encourage the Board to consider a minor revision to paragraph 65 to state "the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting as a part of the decision-making process for determining the nature, timing and extent of testing necessary."

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?

Refer to our response to question 6.

3. Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage

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?

We believe a risk-based approach for the scoping of a multi-location engagement that relies on auditor judgment is consistent with the overall direction of the Proposed Standard and is fundamentally sound. However, elimination of all of the guidelines currently in AS2 might provide the perception that the auditor should, in all instances, being doing less work. We recommend that the Board describe in the final standard the risk factors the auditor should consider in determining the locations or business units that present specific risks and therefore should be included in the scope of the audit. Among other factors, the relative size of the location or business unit, its history of unusual or complex transactions, prior audit findings, the risk of fraud, and management's own assessment of potential risk are important factors the auditor might consider to guide his or her professional judgment.

4. Removing the Barriers to Using the Work of Others

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?

As stated in our summary comments, we are supportive of the Board's efforts to remove barriers to the appropriate use of the work of others in integrated audits. However, we believe that aspects of the Board's Proposed Standard on considering and using the work of others pose the potential unintended consequence of undermining audit quality. The Proposed Standard expands the definition of relevant activities to include tests providing evidence about potential misstatements of the company's financial statements performed by those not acting in an internal audit capacity, which we believe could lead to the inappropriate use of the work of others and reduce audit quality. Another potential unintended consequence of the proposed requirements is to increase the effort by auditors to seek, and then to document, activities by others that eventually have no significant effect on the scope of the auditors' work.

Therefore we believe the Board should not issue a new, separate standard for using the work of others. Alternatively, we believe that eliminating the principal evidence provision in AS2 and specifying that auditors may supervise the work of others who provide direct assistance to the auditor in the performance of a walkthrough, among other changes to the Proposed Standard, and retaining AU section 322, with certain conforming amendments, would better meet the Board's objectives, while at the same time not reducing audit quality or efficiency.

We further believe that this alternative would benefit auditors of foreign private issuers that are required to report under both International Standards on Auditing (ISAs) and PCAOB standards. We are concerned about any course of action that could potentially create confusion for auditors of foreign private issuers with respect to their consideration of the work of others. ISA 610, *The Auditor's Consideration of the Internal Audit Function*, describes the requirement for the auditor to obtain an understanding of the internal audit function and consider whether the activities of the internal audit function are relevant to planning and performing the audit. In our view, these requirements are consistent with extant AU section 322. We therefore believe that retaining AU section 322, with certain conforming amendments, would promote harmonization of the ISAs and PCAOB auditing standards and help to avoid any confusion about requirements for auditors reporting under both sets of standards.

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?*

This question is answered as part of our response to Question 19.

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

As discussed above, we believe a new standard on considering and using the work of others is unnecessary and that the Proposed Standard on auditing internal control, along with conforming amendments to AU section 322, are appropriate. We do not believe that the proposed requirements for the auditor to understand in greater detail the relevant activities performed by others will improve audit quality to any appreciable degree, yet potentially will add incremental documentation efforts.

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

No. We support the Board's removal of the term "principal evidence" but recommend that the Board make appropriate conforming amendments to AU section 326, *Evidential Matter*, to indicate that the auditor must obtain sufficient competent evidence in support of his or her opinion in an audit of internal control over financial reporting.

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 framework for evaluating the competence and objectivity of the persons performing the testing included in the Proposed Standard on considering and using the work of others is similar to the framework provided in AU section 322. We are supportive of conforming amendments, as necessary, to AU section 322 to reflect this framework.

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

This question is answered as part of our response to Question 23.

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 the broad inclusion of this factor may entail additional documentation requirements with little other practical effect. We believe this additional consideration regarding objectivity is likely to have a low level of significance except in the rare circumstances where compensation arrangements are determined by the subject matter being tested (e.g., compensation arrangements for the individual are based upon growth in revenues, with revenues as the subject matter) or the outcome of the testing procedures (e.g., compensation arrangements for the individual are based on there being no or few deficiencies).

5. Recalibrating the Walkthrough Requirements

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

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?

Based on our experience, a change in the requirement to perform a walkthrough only with respect to each significant process, as opposed to each major class of transactions, is not likely to significantly reduce the number of walkthroughs being performed in these areas. Further, while some routine classes of transactions typically relate to the same significant process, these routine classes of transactions often have significantly different risks. As a result, we believe the actual reduction in the number of walkthroughs to be completed under the Proposed Standard is not likely to represent a significant percentage of the walkthroughs currently being performed.

We are supportive of the proposal allowing for the use of the work of others when they provide direct assistance in performing walkthroughs. However, it has been our experience that few companies have performed walkthroughs as part of management’s assessment of internal control over financial reporting. Accordingly, in many cases the resources necessary to provide direct assistance to the auditor in the performance of walkthroughs will be incremental to a company’s existing resources and planned efforts.

C. Scaling the Audit for Smaller Companies

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?*

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

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?*

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

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 are strongly supportive of the Board's efforts to address the unique challenges faced by smaller public companies. We agree that the auditor should evaluate the size and complexity when planning and performing the audit of internal control, and believe that such evaluations are regularly being made in practice now for audits of smaller companies. Evaluations of size and complexity affect materiality and scoping decisions, including the determination of significant accounts and relevant assertions and multi-location scoping decisions; the types of controls that are identified; and the nature, timing, and extent of the auditor's testing procedures. Additionally, we believe the attributes common to smaller and less complex companies listed in the Proposed Standard are appropriate and further believe that paragraph 12 of the Proposed Standard appropriately describes the aspects of the audit that might be affected.

We do not believe the market capitalization and revenue thresholds by themselves are determinative in evaluating risk and complexity in planning an integrated audit. We believe that the evaluation of size and complexity should be considered in light of each company's individual facts and circumstances. In our view, the thresholds in the note to paragraph 9 of the Proposed Standard focus only on size without regard to complexity, thereby implying that the audit could be scaled simply based on quantitative characteristics. We do not believe these simple quantitative thresholds should drive the auditor's performance requirements, but rather a risk assessment that reflects the uniqueness of each company and determines the tailored scope of each audit.

Further, we strongly believe that the applicability of the performance requirements in paragraphs 9 through 12 of the Proposed Standard under the caption "scaling the audit for smaller companies" should be clarified. The performance requirements should only be applicable to those companies meeting the definition of "smaller companies," as the caption titling suggests, and as provided in the footnote to the Note to paragraph 9. Requiring auditors to consider the performance requirements of paragraphs 9 through 12 for every audit would create unnecessary and incremental audit effort for the significant majority of accelerated and large accelerated filers.

We also strongly believe the inclusion of the specific performance requirement in paragraph 9 that the auditor “document how the size and complexity of the company affected the audit” is unnecessary, and will create an unnecessary documentation requirement if left without modification. Paragraph 9 already states the auditor is required to evaluate the size and complexity of the company and that such evaluation should have a pervasive effect on the audit. Therefore, documenting the specific effects would seem to be an exercise with little, if any, value, but one that would require unnecessary time and effort. Should this specific documentation requirement be retained, we believe the requirement should only be applicable for those companies meeting the definition of “smaller companies” referred to in paragraph 9. Additionally, if retained, we believe the final standard needs to be much clearer as to the expectations for how an auditor documents how size and complexity affected an audit.

Finally, we are very supportive of the PCAOB’s efforts to develop further guidance for the performance of audits of smaller companies.

D. Simplifying the Requirements

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?*

No. We believe the requirements of proposed rule 3525 are sufficient as drafted.

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?*

In our experience, significant planning efforts for integrated audits and management assessments occur in the first and second quarters of the fiscal year for a majority of accelerated filers. Accordingly, we recommend that the Board not make the final proposals mandatory for calendar 2007 audits. However, we believe early adoption should be permitted.

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February 26, 2007

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
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Dear Sir or Madam:

Rulemaking Docket 22 -- *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements*, PCAOB Release No. 2006-007, and related proposals.

The Ethics Resource Center (ERC) is a private, non-profit organization devoted to independent research and the advancement of high ethical standards and practices in public and private institutions. For 85 years, the ERC has worked closely with businesses to foster a strong ethics culture and high standards of business behavior based on ethical values.

It is with this experience in mind that we submit this comment letter to the Public Company Accounting Oversight Board (PCAOB). The Sarbanes Oxley Act and its Section 404 provisions have resulted in increased investor confidence in public companies and an enhanced focus on the promotion of a corporate culture committed to ethical conduct in the workplace. Implementation of Section 404, in particular, has resulted in an overall improved control environment that recognizes the importance of strong governance at the top of, and throughout, public companies. We support changes that will increase efficiency in implementation, but believe that any effort to control costs should not take away from activity that encourages a workplace that puts integrity first.

We support annual management evaluation and auditor attestation; anything less could open the door to increased risk of unethical behavior in years not subject to the assessment and audit. We also support the notion of increasing efficiency by scaling the audit to reflect the unique attributes of issuers, but recognize that size alone should not be a determinant of the level or nature of evaluation and testing.

Our most recent National Business Ethics Survey (NBES), conducted in 2005 before many of the provisions of the Act and Section 404 were broadly implemented, revealed the following. This data is instructive as the PCAOB contemplates changes that could loosen management's evaluation and auditor attestation at this time. The NBES identifies trends in organizational ethics from the perspective of our nation's workforce, using a statistically valid sample of the U.S. employed population.

- Nearly 45 percent of employees in small- to medium-sized organizations (500 employees or less) observed some type of misconduct each year.
- Some five percent of employees at companies of all size observed financial fraud.
- Only 58 percent of companies across the United States had strong ethical cultures in which employees believed that ethical conduct really matters.
- When employees perceived that their leaders were truly committed to ethical principles, rather than being driven by compliance alone, misconduct was reduced by as much as 50 percent.

The ERC believes that effective internal control over financial reporting is linked to building a strong ethical culture, but the actions of leadership matter even more. Meaningful effectiveness-testing helps assure both investors and the financial marketplace that management is discouraged from overriding controls that are well-designed or taking short-cuts to reduce costs alone. It is a critical step in encouraging a "tone at the top" that is so fundamental to ethical behavior and business integrity.

We would be happy to comment further or provide additional research findings to the PCAOB if desired, and we are pleased to have the opportunity to provide our ethics perspective to the rulemaking process.

Sincerely,

Patricia J. Harned

Patricia J. Harned, Ph.D.
President

February 26, 2007

To: Public Company Accounting Oversight Board

From: Mike Ettredge, University of Kansas
Karla Johnstone, University of Wisconsin
Mary Stone, University of Alabama
Qian Wang, University of Kansas

Subject: Comment related to PCAOB Rulemaking Docket Matter No. 021

This letter discusses evidence from our working paper, "Compliance with Auditor Change Disclosure Requirements: Theory and Empirical Tests," that we think is relevant to addressing the following questions raised in PCAOB Release No. 2006-007. (A copy of the paper is attached.)

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

Q. 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?

Q. 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?

Our research addresses the question: Why do managers comply or fail to comply with disclosure requirements? If compliance with disclosure requirements is one of the outcomes of adequate control over financial reporting, which we think it is, the results of our study may provide insights useful to the Board. Our study develops a conceptual model that recognizes three disclosure outcomes: compliance, intentional noncompliance, and accidental noncompliance. The model relates these outcomes to (1) a company's long-term disclosure compliance infrastructure, which includes monitoring and corporate governance mechanisms that are determined by the company's long-term disclosure incentives and resources available to develop infrastructure, and (2) disclosure disincentives that arise when disclosure of bad news is required. We test the model using data gathered from recently released SEC staff letters identifying omissions in mandatory auditor change disclosures. These letters provide a unique opportunity to test our model because they identify omissions of required auditor change disclosures for which there are only two explanations for noncompliance: management deliberately failed to make the disclosure or management did not understand its disclosure obligations. The first constitutes intentional noncompliance and the second constitutes accidental noncompliance, which could occur if a company had not invested enough in compliance infrastructure, including personnel.

The results of tests of our model indicate that compliance is associated with compliance infrastructure and disincentives to disclose bad news. They also provide evidence relevant to understanding the role of company size in fostering compliance. Fear of accidental compliance is one of the reasons managers of small companies argue against subjecting their companies to internal control reporting and accounting standards requiring investment in compliance infrastructure. The arguments of some advocates of size-scaled regulation and accounting alternatives assert that company size is the primary factor to be considered. Our empirical results indicate that the availability of resources and corporate governance affect compliance but that, taken alone, size *does not* necessarily explain disclosure compliance. Based on our findings and understanding of the literature related to the effects of size on corporate reporting, we encourage the

PCAOB to gather additional evidence on the factors that lead to the desired outcomes of adequate control over financial reporting before acquiescing to calls for size-based regulation.

Attachment

Compliance with Auditor Change Disclosure Requirements: Theory and Empirical Tests

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January 2007

We appreciate the comments and suggestions provided by workshop participants at the University of Alabama, University of Kansas, and University of Wisconsin-Madison.

Compliance with Auditor Change Disclosure Requirements: Theory and Empirical Tests

Summary: We address an important but previously ignored question: Why do managers comply or fail to comply with disclosure requirements? We develop a conceptual model that recognizes three disclosure outcomes: compliance, intentional noncompliance, and accidental noncompliance. Our model relates these disclosure outcomes to (1) a company's disclosure compliance infrastructure, which includes monitoring and corporate governance mechanisms that are determined by the company's long-term disclosure incentives and resources to develop the infrastructure, and (2) disclosure disincentives that arise when disclosure of bad news is required. Tests of the conceptual model using data gathered from recently released SEC staff letters identifying omissions in mandatory auditor change disclosures support the importance of compliance infrastructure and disincentives to disclose bad news. Some evidence also supports the roles of incentives and resources in development of investment in compliance infrastructure. Further, our empirical findings provide evidence of the need for regulatory monitoring of disclosure requirements, and provide evidence that company size is a weak indicator of the quality of a company's compliance infrastructure or the likelihood it will comply with disclosure requirements. Finally, our model provides a framework for conceptualizing and testing other management disclosure compliance decisions.

Keywords: Compliance, SEC staff comment letters, mandatory disclosure, auditor change.

Data Availability: Contact the lead author for a list of sample companies.

Compliance with Auditor Change Disclosure Requirements: Theory and Empirical Tests

I. INTRODUCTION

This study provides a conceptual model of management's decision about whether to comply with mandatory disclosure requirements, and tests the model using data gathered from recently released Securities and Exchange Commission (SEC) staff letters identifying omissions in required auditor change disclosures. Our inquiry is motivated by Sarbanes-Oxley's mandate to increase efforts to ensure compliance with accounting and reporting requirements (KPMG International 2004, 2005), by highly publicized assertions that small businesses lack the accounting skill and resources needed to comply with complex disclosure requirements (SEC Advisory Committee on Smaller Public Companies 2006), and by the paucity of research on factors affecting disclosure compliance.

Disclosure compliance connotes timely filing of periodic reports (Forms 10-Q or 10-QSB; 10-K or 10-KSB) and current reports (Forms 8-K) and, within those reports, providing the various information items that the SEC or other regulators specify must be disclosed. Thus defined, disclosure compliance differs from constructs such as earnings quality (Dechow and Schrand 2004) and balance sheet conservatism (Penman and Zhang 2002). Those constructs refer to characteristics of information that has been disclosed, whereas disclosure compliance deals with the decision to disclose or refrain from disclosing specific items of required information in a timely matter. The constructs can be further distinguished because earnings quality and balance sheet conservatism deal with amounts that have been recognized in the financial statements, while disclosure compliance covers a broader and expanding set of information, including disclosure of non-financial information.[1]

Our compliance model reflects three disclosure outcomes: compliance, intentional noncompliance, and accidental noncompliance. Compliance can be motivated by management's desire to provide value-relevant information that may reduce the cost of financial capital, or to develop a reputation for transparency that can enhance the value of managers' human capital. Intentional noncompliance is a manifestation of managerial opportunism and might have the purpose of withholding or delaying the release of bad news. The possibility of accidental noncompliance resulting from lack of awareness or understanding of disclosure requirements has been acknowledged only recently as an unintended consequence of the number and complexity of accounting and disclosure requirements (e.g., Herz 2005). Unlike intentional noncompliance, accidental noncompliance cannot be explained solely by managers' incentives to reveal or conceal information. Our model posits that the incidence of accidental noncompliance is affected by a company's compliance infrastructure, which includes corporate governance, and is determined by the company's incentives and resources to create compliance infrastructure.

Managers' incentives to avoid both intentional and accidental noncompliance reflect the probability of detection, and regulatory or private penalties when detected. The probability of detection by a private party, and the capital market penalty (loss of firm value and managerial reputation), are positively associated with incentives for private information search, with the chance of detection being greater for companies with large analyst followings and those traded on major exchanges. Possible penalties include the costs of litigation, loss of managerial reputation, and increases in cost of capital. The magnitude of penalties depends on what nondisclosure signals to investors and lenders. The revelation of nondisclosures, whether detected by regulators or employees, analysts or other private parties, can trigger both regulatory and capital market penalties.

The SEC comment letters we study, which were publicly disclosed beginning in May 2005, provide a unique opportunity to test our model because they identify omissions of required auditor change disclosures for which there are only two explanations for noncompliance: management deliberately failed to make the disclosure or management did not understand its disclosure obligations. The first constitutes intentional noncompliance, and the second constitutes accidental noncompliance. The auditor change disclosure requirements call for statements of fact; no estimation of amount or judgment of materiality is required. The compliance decision does, however, involve disclosure of information that investors would view as bad news that potentially could decrease firm value (e.g., auditor resignation)[2], or that management may not be aware it is responsible for disclosing in a timely manner. The possibility that management is unaware of its responsibility is substantial because auditor changes occur infrequently rather than routinely. Further, noncompliance with Form 8-K filing deadlines might occur because the time for filing was shortened from five business days to four business days effective August 23, 2004 (SEC 2004a).

We use regression models to estimate associations proposed in the conceptual model, discussed in the next section. We investigate whether proxies for incentives to develop disclosure compliance infrastructure, and resources available to develop infrastructure, are associated with proxies for extent of infrastructure. We also investigate whether disclosure compliance infrastructure and disincentives for compliance are associated with compliance status. We provide additional insights and assess the robustness of our model by employing alternative specifications of the dependent variable that capture timeliness of filings rather than completeness of content.

Our study contributes to the literature in at least four ways. First, it is the only paper of which we are aware that develops and tests a theory of compliance with mandatory disclosure requirements. A number of studies develop and test explanations for *discretionary* disclosures (e.g., Healy and Palepu 2001; Graham et al. 2005), and a few deal with compliance with SEC filing deadlines (e.g., Schwartz and Soo 1996; Ettredge et al. 2007). Studies of why managers fail to comply with seemingly straight-forward content disclosure requirements are missing. This is surprising given that the SEC arguably mandates timely and complete disclosure of the information deemed *most relevant* to investors, while the SEC leaves decisions on certain company-specific information to the discretion of managers. Identifying the factors that affect compliance is the first step to determining ways to increase compliance. Our conceptual model provides a framework for mapping disclosure incentives and infrastructure into disclosure outcomes: compliance, intentional noncompliance, and accidental noncompliance. We believe that the model provides an initial framework that can be modified for conceptualizing and testing other management disclosure compliance decisions.

A second contribution relates to the role of company size in fostering compliance. Fear of accidental noncompliance is purported to be one of the reasons managers of small companies argue stridently against making their companies subject to internal control reporting and accounting standards requiring investment in compliance infrastructure that they are unable or unwilling to make.[3] The arguments of advocates of size-scaled regulation and accounting alternatives assert that company size is the primary factor to be considered. Our empirical results indicate that the availability of resources and corporate governance affect compliance but that, taken alone, size *does not* necessarily explain disclosure compliance. This implies that the SEC and other standard setters should gather additional evidence before acquiescing to demands for size-based regulations.

The third contribution involves our use of SEC staff comment letters to test the model of disclosure compliance. To our knowledge, this is the first academic paper to draw on this data source. Because of our research objective, we use only letters relating to auditor changes. Other, more recently posted, letters address a variety of accounting and disclosure compliance issues that also deserve investigation.[4] The availability of such information may make it easier for academic researchers to address policy-related issues while there still is time for the evidence to be considered in policy debates.

The paper's fourth contribution is the distinction it makes between intentional and accidental noncompliance. We provide evidence that managers *intentionally* omit auditor change disclosure items that previous research indicates are viewed as negative news by investors. Our findings suggest that managers behave opportunistically in determining how to comply with mandated disclosure requirements. Our evidence complements evidence provided by studies reviewed in Healy and Palepu (2001) that managers behave opportunistically in making *discretionary* accounting choices. It also provides a justification for regulatory monitoring of mandatory disclosures.

The next section of the paper presents our conceptual model. The remaining sections describe the SEC staff comment letter database, state hypotheses, describe the sample and research methods, report results, summarize, and conclude.

II. CONCEPTUAL MODEL OF DISCLOSURE COMPLIANCE

In this section we provide a conceptual model of disclosure compliance (see Figure 1). The general construct to be explained is a company's compliance status. The primary proxy for noncompliant status is company receipt of an SEC staff letter. Receipt of a letter depends upon, first, the existence of noncompliance and, second, upon the extent of SEC staff scrutiny of filings (i.e., the probability of detection). Figure 1 indicates that noncompliance with disclosure requirements can be either accidental or intentional. Accidental noncompliance could arise from resource constraints and associated ignorance or misunderstanding of regulatory requirements. Alternatively, noncompliance could arise from disclosure disincentives, and could be intended to conceal specific unfavorable information from the public (i.e., intentional noncompliance). Below, we describe the explanatory constructs in the model: disclosure compliance infrastructure, incentives and disincentives associated with compliance, and resources available for investing in compliance infrastructure. Proxies for constructs are discussed subsequently.

[Insert Figure 1 about Here]

The model indicates that resources available for investing in disclosure compliance are positively associated with the level of disclosure compliance infrastructure. For example, companies that are large, or that are financially healthy, are likely in a good position to invest in infrastructure. In addition, the model indicates that incentives for investing in disclosure compliance infrastructure are positively associated with the level of infrastructure. We envision incentives for compliance as arising from scrutiny by market participants or other observers and regulators. For example, if a company faces scrutiny by analysts or is traded on a heavily regulated stock exchange, company management will likely be motivated to set up compliance infrastructure that associated observers would deem acceptable. In this way, managers can avoid market-based and regulatory penalties.

Disclosure compliance infrastructure is the set of policies, procedures, and personnel that the company establishes and/or hires to ensure disclosure compliance. As such, it is made up of components of the company's enterprise risk management process. The enterprise risk management process, as defined by The Committee of Sponsoring Organizations of the Treadway Commission (COSO), is designed to achieve (among other objectives) a *reporting* objective. COSO says this objective consists of "the reliability of the entity's reporting including both internal and external reporting of financial and non-financial information" (2004, 124). Thus, the disclosure compliance infrastructure is a *subset* of the company's investment in those components of the risk management process supporting this reporting objective. As such, greater investment in compliance infrastructure should be positively associated with compliance, and negatively associated with both accidental and intentional noncompliance.

In contrast to disclosure compliance infrastructure, the model proposes that disincentives for compliance have a positive association with intentional disclosure noncompliance, and should logically have no relationship with accidental noncompliance. We envision *disincentives* for compliance as arising from *particular* *items* of information that a company is required to disclose. Managers prefer not to disclose proprietary information that could benefit competitors (Verrecchia 2001). Managers might also prefer, if possible, to avoid disclosing specific items of negative information about auditor changes. We argue that managers will maintain a compliance infrastructure consistent with long-term incentives and resources, while trying to circumvent compliance in specific instances. These instances will often involve information having only short term implications and little chance of subsequent discovery (e.g., auditor resignation).[5]

In the next section we introduce the novel disclosure compliance data we employ to test our conceptual model. The data first became available in 2005, and consist of SEC staff comment letters sent to corporations that switched auditors. The letters assert that submitted Forms 8-K (item 4) do not contain all required disclosure items.

III. THE SEC COMMENT LETTER DATABASE AND FORM 8-K

SEC staff comment letters are important because they form one foundation for the SEC's enforcement process. SEC comment letters provide incentives for corporate managers and independent auditors to avoid unacceptable practices, and to prevent the violation of accounting principles or disclosure regulations. Each year the SEC staff (Divisions of Corporation Finance and Investment Management) reviews filed documents (such as registration statements relating to initial public offerings, 8-Ks, 10-Qs and 10-Ks), evaluates them for compliance with disclosure regulations, and sends comment letters to selected companies. SEC comment letters typically address areas in which the SEC staff believes that disclosure should be improved. A company can respond to a comment letter by making the SEC's recommended changes, by suggesting alternative approaches, or by presenting an argument that the current disclosure is appropriate. If the registrant's action or argument does not satisfy the SEC staff, the matter may be forwarded to the enforcement division, and might result in an enforcement action, such as the issuance of an Accounting and Auditing Enforcement Release (AAER).

In response to increased requests for disclosure of staff comment letters under the Freedom of Information Act, the SEC announced on June 24, 2004 (SEC 2004b) that it planned to begin publicly releasing its staff comment letters regarding company filings, as well as company responses to these letters. The SEC's objective is "to expand the transparency of the comment process so that [the] information is available to a broader audience" (SEC 2004b). The SEC began posting the comment letters at its EDGAR web site on May 12, 2005, and a large majority of the letters initially posted relate to Form 8-K Item 4 (reporting termination of association with an external auditor) matters, with particular focus on companies' failure to explain auditor changes or to address omissions in information relating to auditor changes (Martinek 2005).[6] We take advantage of this concentration of comment letters to test our conceptual model.

Regulation S-K, Item 304(a), requires that Form 8-K-4's report the termination of association with an external auditor, including information on (1) whether the former auditor was dismissed, resigned, or declined to stand for re-election, (2) whether the board of directors recommended or approved the decision to change auditors, (3) whether there were any disagreements with the former auditor, (4) whether there were any "reportable events", (5) whether the client consulted with a new auditor regarding application of accounting principles to a specified transaction, or regarding the type of audit opinion the client might receive, or about any disagreement or reportable event, and/or (6) whether the client provided the former auditor with a copy of the disclosures it intended to make in Form 8-K-4. Prior research documents the importance of 8-K-4 filings as a whole, and of some of the types of disclosure items listed above (DeFond et al. 1997; Krishnan and Krishnan 1997; Wells and Loudder 1997; Hackenbrack and Hogan 2002; Whisenant et al. 2003; Sankaraguruswamy and Whisenant 2004).

Importantly, information about the circumstances of an auditor change omitted from a Form 8-K will not necessarily come to light via some other means in the future. Suppose for example that a company submits an 8-K-4 stating that it “no longer is associated with” a former auditor when, in fact, the auditor resigned. There are two primary means by which the resignation might become public knowledge. First, SEC staff might notice that the 8-K-4 did not state, as required by Regulation S-K Item 304, whether the former accountant resigned, declined to stand for re-election or was dismissed. Second, the former auditor might notice the omission, and communicate it to the client in its letter commenting on the contents of the client’s 8-K-4. That letter, required by Regulation S-K Item 304(a)(3), should be included by the client in its 8-K-4 submission to the SEC. However, smaller firms auditing few public companies might not detect such an error and, if they did, the client might fail to include the auditor’s letter with the 8-K-4. If the omitted information does not come to the SEC staff’s attention when the initial 8-K-4 is filed, there is no subsequent event that will reveal the information to the public. Thus, the comment letters we study provide a unique opportunity to test our conceptual model, and the topics discussed in the comment letters are interesting and important themselves.

IV. HYPOTHESES

In this section we draw upon the conceptual model in Figure 1 to develop hypotheses about companies' compliance (or, conversely, noncompliance) with 8-K-4 disclosure requirements and filing deadlines, and we introduce proxies for explanatory constructs.

Availability of Resources

Our first hypothesis, stated in alternate form, is:

H1: Companies having greater available resources invest more in compliance infrastructure.

The SEC believes that smaller registrants lack personnel with expertise and experience in dealing with disclosure requirements. Evidence of this belief was provided by the SEC's formation, in March 2005, of an SEC Advisory Committee on Smaller Public Companies. The Advisory Committee recommended that smaller companies not be subject to further acceleration of Form 10-Q and 10-K filing dates, "because of the lack of capacity… of internal compliance personnel and external professional advisors to smaller public companies" (SEC Advisory Committee on Smaller Public Companies 2005). The SEC essentially argues that smaller companies are likely to have less disclosure compliance infrastructure than larger companies. Research indicates that internal control weakness, a likely manifestation of underinvestment in compliance infrastructure, is negatively associated with company size (Ge and McVay 2005). Smaller companies also are more likely to delay disclosure of auditor changes, leading to noncompliance with filing deadlines (Schwartz and Soo 1996).[7] Our proxy for company size is the natural log of market capitalization. We expect larger companies to invest more in compliance infrastructure.

The opportunity cost of investing in infrastructure varies systematically with company characteristics other than size. For example, the characteristics of high tech companies identified by Demers and Joo (2006) – heavy reliance on equity-financing, intense competition, and significant accounting losses resulting from high levels of research and development – are also characteristics that could increase the opportunity cost of investing in compliance infrastructure. Prior research on restatements and auditor litigation provides evidence that such companies are risky[8], may have under-invested in financial reporting controls, and have been targets of SEC scrutiny (e.g. Palmrose and Scholz 2004; Palmrose et al. 2004).[9] Therefore, we expect high tech companies to invest less in compliance infrastructure.

While healthy companies can afford to invest in disclosure compliance, financially stressed companies likely have to focus more on returning to profitability. Stressed companies also have fewer personnel resources to devote to compliance since managers, board members, and others arguably focus their efforts on survival rather than investing in compliance infrastructure. Our proxy for financial stress consists of the external auditor's decision to modify the audit report for 'going concern' reasons, and we expect that companies receiving such a report will invest less in compliance infrastructure.

Incentives for Compliance

Our second hypothesis, stated in alternate form, is:

H2: Companies having greater incentives for compliance invest more in compliance infrastructure.

Companies that rely more on external financing tend to disclose more voluntary information (Frankel et al. 1995). In some cases (segment reporting) they also disclose more or better required information (Ettredge et al. 2006). When companies are detected violating GAAP (as indicated by news reports, issuance of AAERs, or restatements of earnings) the cost of capital increases (Hribar and Jenkins 2004).[10] Arguably, these types of negative revelations are more detrimental to companies that are unable to finance growth internally. Therefore, we expect that companies relying more on external financing also have higher incentives for regulatory compliance, and therefore will invest more in compliance infrastructure.

Companies subject to greater scrutiny by sophisticated investors also should have higher incentives for compliance, since noncompliance is more likely to be detected and publicized in such cases (Piotroski and Roulstone 2004). Our proxies for private sector scrutiny include a dichotomous variable capturing whether a company is followed by analysts (IBES or Value Line coverage), and another capturing exchange membership. Companies followed by analysts clearly are subject to greater external scrutiny. Companies traded on major (national) exchanges tend to be subject to the full range of SEC filing requirements, and have stocks that are highly liquid and trade frequently. Companies listed on the major national exchanges therefore are subject to more scrutiny by sophisticated institutional investors. In addition, the major national exchanges have more stringent listing and maintenance requirements. We expect that companies followed by analysts, and listed on major exchanges, have higher incentives for regulatory compliance, and therefore will invest more in compliance infrastructure.

Compliance Infrastructure

Our third hypothesis, stated in alternate form, is:

H3: Investment in disclosure compliance infrastructure is negatively associated with noncompliance (receipt of an SEC staff letter).

A company's compliance infrastructure consists of long-term investments in personnel and procedures that ensure compliance. It also consists of the corporate governance mechanisms in place to monitor the design and use of the infrastructure. A company's investment in corporate governance provides an important subset of its disclosure compliance infrastructure. COSO (2004) notes that the board of directors is responsible for monitoring a company's risk control efforts, which include compliance efforts. The audit committee of the board has a direct role in ensuring the reliability of external reporting. Karamanou and Vafaes (2005, 453) state that "empirical evidence is broadly consistent with the notion that effective corporate governance is associated with higher financial disclosure policy." Research has established a direct positive relation between the independence of board members and practices consistent with high quality corporate governance (Weisenbach 1988, Brickely et al. 1994), and between audit committee characteristics and the effectiveness of monitoring financial reporting (Menon and Williams 1994; Abbott et al. 2004; Carcello and Neal 2003). Therefore, we employ measures of board independence and existence of an audit committee as proxies for compliance infrastructure. We expect greater levels of board independence, and existence of audit committees, to be negatively associated with receipt of an SEC staff letter.[11]

The external auditor is another important component of corporate governance and of compliance infrastructure. There is substantial evidence that audits by larger (Big 4) firms are of higher quality (see Francis 2004 for a review of this literature). The largest accounting firms should have greater knowledge regarding disclosure and filing requirements attending auditor changes, and we expect these audit firms to share such knowledge with their clients (Ettredge et al. 2001). Thus, we expect a negative relationship between a company having a departing Big 4 auditor and the likelihood that the company will receive an SEC staff letter.

Disincentives for Compliance

Before discussing the final explanatory construct (managers' disincentives to comply with disclosure requirements), we first explain why such disincentives exist in our particular research context. As mentioned previously, Regulation S-K, Item 304, requires that Form 8-K-4's report the termination of association with an external auditor, including information on (1) whether the former auditor was dismissed, resigned, or declined to stand for re-election, (2) whether or not the board of directors approved the decision to change auditors, (3) whether or not there were any disagreements with the former auditor, (4) whether or not there were any "reportable events", (5) whether or not the client consulted with a new auditor regarding application of accounting principles to a specified transaction, or regarding the type of audit opinion the client might receive, or about any disagreement or reportable event, and/or (6) whether or not the client provided the former auditor with a copy of the disclosures it intended to make in Form 8-K-4.

Research documents the types of companies making the foregoing disclosures and the market's reaction to those disclosures. For example, Schwartz and Soo's (1995) analysis of auditor changes by companies approaching bankruptcy shows that such companies experience more reporting problems, auditor resignations, and delayed disclosures of auditor changes. Additional analysis suggests that the reporting delays may reflect management's attempt to suppress the negative information being revealed by auditor change rather than by time constraints. Evidence of negative market reaction to SEC-mandated disclosures about the circumstances of auditor changes is provided in a number of studies. Wells and Loudder (1997), for example, document a negative price reaction to disclosures of auditor resignation. A negative price reaction may reflect the market's perception that auditor resignation is highly associated with litigation risk and is viewed as a warning signal about the quality of the company's financial reporting (Krishnan and Krishnan 1997). Disclosures of reportable events indicating problems with financial statement reliability are associated with negative stock price reactions, while those related only to internal control events are not (Whisenant et al. 2003). Smith (1988) provides additional evidence of negative market reaction to auditor change "bad news". Thus, there appear to be strong disincentives to providing required disclosures in the auditor change setting that we study.

Our fourth hypothesis investigates whether companies receiving an SEC staff letter (test companies) appear to omit information intentionally because managers view it as unfavorable to their companies. The hypothesis is:

H4: Auditor change circumstances that convey bad news to investors (i.e., disincentives for compliance) are positively associated with noncompliance (receipt of an SEC staff letter).

This hypothesis can be tested *within* the sample of test companies, which eliminates the need to control for systematic differences between test and control companies. Each of the 97 test companies omits one or more items of information from its initial 8-K-4. However, none of them omit all of the items. For any given item of information that should be disclosed in the 8-K-4, some test companies will have bad news to report, while others will not. Consider the following simple (and intentionally extreme) example. Clients are required to disclose whether they had a disagreement with their prior auditor. Suppose that 20 test companies had such a disagreement, while 77 did not. Suppose also that 30 companies omitted to disclose whether they had a disagreement. If these omissions were distributed randomly with respect to auditor disagreement status, we should observe about 6 of the 30 (= 30 x (20/97)) occurring among the 20 companies with a disagreement, and about 24 of the 30 (= 30 x (77/97)) occurring among the other 77 clients. However, a disagreement is likely worse news than no disagreement. Suppose instead that we observe that 20 out of 20 disagreement companies omitted to disclose, while 10 out of 77 other companies omitted to disclose. We would conclude that *omission* of information about the existence or nonexistence of auditor disagreement is not independent of the *content* of the information, and that the content being omitted is disproportionately bad news.

In addition to the within-test-sample procedure described above, we also create a bad news variable for inclusion in multivariate models. The variable, described in detail below, is equal to one if any circumstance of the auditor change is likely to be viewed as negative news by investors, and is equal to zero otherwise. We expect this variable to be positively associated with receipt of an SEC staff comment letter.

Compliance with 8-K Filing Deadlines

In addition to investigating whether our conceptual model explains company compliance with 8-K-4 content disclosure requirements, we also investigate whether the model explains compliance with Form 8-K filing deadlines. Our related hypotheses are parallel to H3 and H4 above, except for the nature of the compliance dependent variable:

> **H5:** Investment in disclosure compliance infrastructure is negatively associated with late filing, or delay in filing, of 8-K-4s.
>
> **H6:** Auditor change circumstances that convey bad news to investors (i.e., disincentives for compliance) are positively associated with late filing, or delay in filing, of 8-K-4s.

We employ two dependent variables to test H5 and H6. The first is a dichotomous variable equal to one if the 8-K-4 is filed late, and equal to zero otherwise.[12] Note that this variable does not relate to test versus control firm status. Some test firms might file on time, whereas some control firms might file late. We also investigate an alternative dependent variable consisting of the natural log of the 8-K-4 filing lag. The explanatory variables are the same as those used to test H3 and H4 above, plus a dichotomous variable capturing negative news in the 8-K-4. Schwartz and Soo (1996) previously studied determinants of filing deadline compliance for 8-Ks. Their strongest results are for company size, which is negatively associated both with noncompliance and with filing lag. Their weakest results are for negative news. In contrast, Smith (1988) concludes that "bad news" events likely *cause* delay of Form 8-K filings by a sample of companies that are not selected for financial distress. Neither study employs our variables representing board independence, audit committee existence, exchange membership, infrastructure, analyst following, or high tech industry membership. We expect all explanatory variables to have the same signs of association with filing date noncompliance (or lag) as with required content noncompliance (SEC staff letter status).

V. METHODS

Sample

The data for this study include the complete sample of companies receiving SEC staff comment letters on 8-K-4s posted at the EDGAR web site in May and June, 2005.[13] During this period, SEC staff issued letters to 105 non-financial companies on 8-K-4 issues. Complete financial and other data were available for 97 of those companies. We matched the companies receiving comment letters (test companies) with a group of control companies that also reported auditor changes via Form 8-K, but that did not receive comment letters. A matched control sample was used to reduce the cost of hand-gathering data on board independence, audit committee existence, and 8-K related information. Each test company was matched with the control company whose auditor change occurred closest (in time) to its own. This matching process controls for factors in the business and regulatory environment that might affect auditor change decisions, and that vary over time. The matching criterion is objective and does not require or allow any judgment in choice of control companies. In addition, the matching criterion does not eliminate any differences in test versus control firm characteristics, such as differences in company size or industry. Differences in these fundamental characteristics are the subjects of our hypotheses. Our final sample includes 194 companies. See Table 1 for a description of the sample attrition and for industry distribution of sample companies.

[Insert Table 1 about Here]

Variables

Proxies for Noncompliance and Filing Timeliness

The dependent variable used to test hypotheses related to noncompliance is *LETTER*, which equals one if the SEC issued a comment letter on a company's auditor-change Form 8-K, and equals zero otherwise. To conduct tests related to timeliness of filings, we use the variable *LATE*, which is equal to one if the 8-K-4 is filed late, and equals zero otherwise. We also use the variable *LnLAG*, which is the natural log of the company's Form 8-K-4 filing lag in days. See Table 2 for a listing of variable definitions and data sources.

[Insert Table 2 about Here]

Proxies for Availability of Resources for Disclosure Compliance

The SEC believes that smaller companies have weaker compliance infrastructures, so we expect that company size will be positively associated with compliance infrastructure. Our proxy for company size is *LnSIZE*, which equals the natural logarithm of the market value of equity.

Our next proxy for resource availability is high technology industry membership (*HITECH*). Consistent with Francis and Schipper (1999), we define a company as high tech if its 3-digit SIC code is 283, 357, 360, 361, 362, 363, 364, 365, 366, 367, 368, 481, 737 or 873. High tech companies exist in an intensely competitive environment that requires significant investment in creative people and research and development, so the opportunity cost of investing in compliance infrastructure is very high for these companies. Further, high tech companies are more likely to "encourage product innovation over compliance" Fleischer (2006, 18), and they have been the subject of a variety of restatements and litigation associated with noncompliance (e.g., Baldwin and Yoo 2005; Palmrose and Scholz 2004; Palmrose et al. 2004). Therefore, we predict that high technology companies will invest less in compliance infrastructure.

Our third proxy for resource availability is financial distress, which equals one if the company received a current year audit report modified for going concern reasons, and equals zero otherwise (*DISTRESS*). Financially distressed companies likely place a lower priority on investment in disclosure compliance because both monetary resources and managerial attention must be devoted to restoring profitability. As such, we expect that this variable will be negatively associated with compliance infrastructure.

Proxies for Incentives for Investment in Disclosure Compliance

Our first proxy for incentives to invest in disclosure compliance measures whether a company has sought, or will shortly seek, external financing (*EXTFIN*). We code the variable *EXTFIN* as equal to one if a company issued common stock, preferred stock, or long-term debt in the current year or the next year, and equal to zero otherwise. Companies subject to greater scrutiny by investors and regulators have more incentives to invest in compliance infrastructure, and greater incentives to comply. Companies that rely on external financing are more heavily monitored by investors, lenders, and other market participants (Jensen and Meckling 1976). These firms have market-based incentives to invest in infrastructure, so we expect *EXTFIN* to be positively associated with compliance infrastructure.

The second proxy for incentives to invest in disclosure compliance relates to the nature of the exchange on which the company's shares are traded. The disclosure and corporate governance requirements for companies trading on the major stock exchanges differ from those with prices quoted on the OTC Bulletin Board (OTCBB) or the Pink Sheets published by the National Quotation Bureau. The quotation services facilitate trading of the securities of very young companies as well as those of companies that have been de-listed from the other exchanges because of financial distress or other performance-related reasons. Because they are not subject to listing requirements, companies with prices quoted on the OTCBB or Pink Sheets are not required to have independent audit committees or meet other corporate governance requirements.[14] In general, the fiduciary responsibilities of large institutional investors result in investment policies that prohibit them from holding stocks of companies trading on the OTCBB or Pink Sheets. The listing requirements of the national exchanges provide a regulatory incentive to invest in compliance infrastructure. We define the variable *EXCHANGE* as equal to one for companies listed on the larger exchanges, and equal to zero for companies on the OTCBB or Pink Sheets. We expect *EXCHANGE* to be positively associated with compliance infrastructure.

The third proxy captures the extent of analyst coverage for the company's shares. We define the variable *ANALYSTS* as equal to one if a company is covered by the Value Line or IBES, and equal to zero otherwise. This variable captures market-based incentives to disclose, so we expect it to be positively associated with compliance infrastructure.

Proxies for Investment in Disclosure Compliance Infrastructure and Related Hypothesis-Testing Model

The first two proxies for investment in disclosure compliance infrastructure measure investment in, and quality of, corporate governance, including: (1) *BODINDPCT*, which equals the percentage of independent board of director members (number of independent board of directors divided by the total number of board members), and (2) *AUDCOM*, which equals one if the company has an audit committee[15], and equals zero otherwise. The third infrastructure proxy (*BIG4*) measures high-quality monitoring by external auditors, and equals one if the company is audited by a Big 4 audit firm prior to the auditor change, and equals zero otherwise. In addition, we include a summary measure of compliance infrastructure (*INFRASTR)*, which is the sum of the codes for *BIG4*, *AUDCOM* and *BODINDPC* (with the latter coded equal to one if *BODINDPC* is greater than the sample mean of 0.57, and coded equal to zero otherwise).

We use model (1) below to test H1 and H2. Based on H1, we expect the coefficient on a_1 to be positive, and the coefficients on a_2 and a_3 to be negative. Based on H2, we expect the coefficients on a_4, a_5, and a_6 to be positive.

$$INFRASTR = a_0 + a_1\ LnSIZE + a_2\ HITECH + a_3\ DISTRESS + a_4\ EXTFIN + a_5\ EXCHANGE + a_6\ ANALYSTS + \mathrm{u}. \quad (1)$$

Proxies for Disincentives for Compliance and Related Hypothesis-Testing Models

"Bad news" provides a disincentive for compliance. For each item of sensitive auditor change information discussed below, we determine the client's *actual* information state, and code an associated dichotomous variable to measure bad news. For test companies (i.e., those receiving an SEC staff comment letter), the actual states are determined by reading corrected 8-K-4s, not the initial (faulty) 8-K-4s.

The variable *RESIGN* equals one if the former auditor resigned the engagement or declined to continue providing service to the client, and equals zero otherwise. The variable *NOAPPROV* equals one if the decision to change auditors was *not* approved by the board of directors and equals zero otherwise. The variable *DISAGREE* equals one if there were any disagreements with the former auditor, and equals zero otherwise. The variable *EVENT* equals one if there were any “reportable events,” and equals zero otherwise.[16] The variable *PRIORGC* equals one if the last audit report before the auditor change included a going concern audit opinion, and equals zero otherwise. Finally, we construct a summary variable, *NEGNEWS*, which equals one if any of the above variables is coded one, and equals zero otherwise.

Our conceptual model asserts that compliance status is directly affected by compliance infrastructure (H3), and by disincentives for compliance (H4). The model for testing H3 and H4 is:

$$LETTER = a_0 + a_1\ INFRASTR + a_2\ NEGNEWS + \mathrm{u}. \qquad (2)$$

The first explanatory variable proxies for the quality of compliance infrastructure, and the second represents incentives not to comply. We expect coefficient a_1 to be negative because the likelihood of noncompliance should be higher with lower quality infrastructure. Coefficient a_2 should be positive because *NEGNEWS* provides incentives for intentional noncompliance.

In order to investigate whether our conceptual model explains timely compliance with the 8-K-4 filing deadline (H5), we alter model (2) by replacing the dependent variable *LETTER* with dependent variables *LATE* and *LnLAG*. In addition, we test H6 by retaining *NEGNEWS* in the model:

$$LATE/LnLAG = a_0 + a_1\, INFRASTR + a_2\, NEGNEWS + u. \qquad (3)$$

We expect the same coefficient signs for all explanatory variables in model (3) as in model (2). We expect that coefficient a_1 will be negative for H5 because of the anticipated negative association between investment in disclosure compliance infrastructure and late filing or filing lag. We anticipate that coefficient a_2 will be positive under H6 because we expect that auditor change circumstances conveying bad news will be positively associated with late filing or delay in filing. A positive coefficient will not imply that 8-K-4s are filed late intentionally since occurrence of the related events, especially auditor resignation, could lead to inadvertent filing delays.

Alternative Test for H4

In addition to testing H4 using the variable *NEGNEWS* in model (2) above, we test H4 using a within-test-sample procedure described previously. We expect that the proportion of test companies omitting specific disclosures will be greater for companies ultimately reporting (via the 8-K filing subsequent to the SEC letter) that the specific information omitted was negative. We use Chi-square and Fisher’s Exact tests to investigate whether omission of required disclosures is independent of the content of the omitted information. These tests do not involve a multivariate model.

VI. RESULTS

Descriptive Statistics: Differences in Means

Table 3 provides comparisons between test and control companies. The sample is optimized for detecting differences in *LETTER* status rather than differences in timeliness (*LATE* or *LnLAG*) status. Fifty percent of sample firms are coded one for *LETTER*, but only 28.9 percent are coded one for *LATE*, resulting in greater variability in the former. Table 3 indicates some significant differences between test and control companies, using two-tailed tests. Companies receiving comment letters have a higher proportion of high technology industry membership (42 percent versus 22 percent; $X^2 = 9.482$, $p = 0.003$). Test companies are more likely than control companies to have disagreements with departing auditors (4.1 percent versus 0.0 percent; $X^2 = 4.084$, $p = 0.043$). They also have a higher proportion of prior year (not current year) going-concern audit reports (42 percent versus 27 percent; $X^2 = 3.218$, $p = 0.024$). The summary "bad news" variable, *NEGNEWS*, is more likely to be coded as one for test companies (75 percent versus 58 percent; $X^2 = 6.686$, $p = 0.010$). There are few differences between test and control companies in terms of variables representing size and investment in quality corporate governance. Both groups have similar levels of board independence and audit committee existence. However, there is a significant difference between groups in terms of the use of Big 4 auditors, with just 34 percent of test companies using this class of auditors prior to their switches, compared to 51 percent of control companies ($X^2 = 5.408$, $p = 0.020$).

[Insert Table 3 about Here]

Descriptive Statistics: Correlations

Table 4 reports Pearson correlations among variables. The results show that companies are less likely to receive an SEC staff comment letter if they had a Big 4 auditor (r = -0.17, p = 0.020), and that they are more likely to receive a letter if they have bad news to report (r = 0.19, p = 0.010) or they are in a high technology industry (r = 0.22, p = 0.002). Companies are less likely to file their 8-K-4 late if they have stronger compliance infrastructure (*INFRASTR*: r = -0.25, p = 0.000), with similar results for the components of the *INFRASTR* variable (*BIG4*, *BODINDPC*, and *AUDCOM*). They are also less likely to file late if they are larger (r = -0.17, p = 0.017), and they are more likely to file late if they have bad news to report (r = 0.17, p = 0.016) or they are in financial *DISTRESS* (r = 0.25, p = 0.000). Similarly, companies have a shorter filing lag if they have stronger compliance infrastructure (*INFRASTR*: r = -0.23, p = 0.001), with similar results for the components of the *INFRASTR* variable (*BODINDPC* and *AUDCOM*). They also have a shorter filing lag if they are larger (r = -0.29, p = 0.000), and they are more likely to file late if they have bad news to report (r = 0.17, p = 0.021), or are in financial *DISTRESS* (r = 0.22, p = 0.002).

[Insert Table 4 about Here]

Regarding correlations among independent variables, the highest correlations appear between the summary *INFRASTR* variable and its components (*BIG4*, *BODINDPC*, and *AUDCOM*), but these variables never appear together in hypothesis-testing models, allaying concerns regarding collinearity. The only relatively high correlations among independent variables occur between *INFRASTR* and *EXCHANGE* (r = 0.60, p = 0.000), between *BODINDPC* and *AUDCOM* (r = 0.70, p = 0.000), and between *EXCHANGE* and *ANALYSTS* (r = 0.69, p = 0.000). Collinearity diagnostics completed in conjunction with subsequent hypothesis tests using linear regression models reveal little cause for concern, with the highest VIF equal to 2.397.

Test Results for Hypotheses H1 and H2

Table 5 reports results for model (1), and shows multivariate tests of H1 and H2. Recall from the conceptual model that compliance infrastructure is determined by resources available to invest (H1) and incentives to invest (H2). We first report our results using the summary dependent variable, *INFRASTR*, which is the sum of the codes for *BIG4*, *AUDCOM*, and *BODINDPC*, with the later coded one if the percentage of independent directors is greater than the sample mean of 0.57. The results for H1 show that, as expected, companies experiencing financial *DISTRESS* have lower investment in compliance infrastructure (t = -3.444, p = 0.001). *HITECH* is also a significant predictor of compliance infrastructure (t = 2.551, p = 0.012); contrary to prediction, however, the results show that *HITECH* is positively associated with investment in compliance infrastructure. In addition, the result for *LnSIZE* is not significant.[17]

[Insert Table 5 about Here]

Next, we report results using the component variables of *INFRASTR*: *BODINDPC*, *AUDCOM*, and *BIG4*. The results show that companies with higher market capitalization (*LnSIZE*) have more independent boards (t = 2.211, p = 0.014) and are less likely to have had a *BIG4* auditor (X^2 = 6.494, p = 0.005, see last column). *HITECH* companies have more independent boards (t = 3.841, p = 0.000) and are more likely to have an audit committee (X^2 = 3.874, p = 0.049). Finally, companies experiencing financial *DISTRESS* are less likely to have independent boards (t = -2.322, p = 0.011), are less likely to have an audit committee (X^2 = 10.403, p = 0.005), and are less likely to have had a *BIG4* auditor (X^2 = 6.728, p = 0.004). Taken together, the results for the summary measure of investment in compliance infrastructure, and the component measures, provide some support for the notion that resources available for investing in disclosure compliance are associated with the extent of disclosure compliance infrastructure.

Considering H2, the results for the summary dependent variable, *INFRASTR*, show that companies listed on the NYSE/AMEX or NASDAQ exchange are more likely to have higher investment in disclosure compliance infrastructure (t = 5.735, p = 0.000) than companies listed on less heavily regulated exchanges. In contrast to expectations, obtaining external financing (*EXTFIN*) and analyst coverage (*ANALYSTS*) are not associated with *INFRASTR*. Both *EXTFIN* and *ANALYSTS*, our proxies for market-based incentives, motivate companies to reduce their cost of capital by developing reputations for reliable disclosure, but do not require all companies to make a uniform set of disclosures. This is in contrast to the listing requirements of the major stock exchanges, which require all traded companies to adopt prescribed corporate governance practices and satisfy other requirements. Thus, regulatory incentives appear to have a greater effect on a company's compliance infrastructure than market-based incentives.[18]

Tests of H3 and H4

The conceptual model proposes that investment in disclosure compliance infrastructure will be negatively associated with noncompliance, i.e., receipt of an SEC staff comment letter (H3), and that auditor change circumstances that convey bad news to investors will be positively associated with noncompliance (H4). To test H3, we use the dependent variable *LETTER* (see Table 6). The results show that *INFRASTR* is not significantly associated with noncompliance, so H3 is not supported using this test. In contrast, companies conveying bad news (*NEGNEWS*) are more likely to be non-compliant ($t = 6.328$, $p = 0.005$), which supports H4.

[Insert Table 6 about Here]

To better understand the results for H3, we conduct supplemental tests using several alternative model specifications. First, we consider a model in which we include the variables predicting investment in compliance infrastructure (*LnSIZE*, *HITECH*, *DISTRESS*, *EXTFIN*, *EXCHANGE*, and *ANALYSTS*). Using this specification, we find the expected negative association between *INFRASTR* and noncompliance ($X^2 = 3.762$, $p = 0.026$), supporting H3. Thus, it appears that controlling for resources and incentives for investment in compliance infrastructure is important in understanding the relationship between infrastructure and compliance status. In another supplemental test, we analyze a model that includes the components of *INFRASTR* as alternative independent variables: *BIG4*, *BODINDPC*, and *AUDCOM*. The results show that having a *BIG4* auditor ($X^2 = 4.987$, $p = 0.013$) is negatively associated with noncompliance, which provides some understanding of the main factor driving support for H3. Finally, we test a model that includes both the infrastructure component variables (*BIG4*, *BODINDPC*, and *AUDCOM*), and the variables predicting investment in compliance infrastructure (*LnSIZE*, *HITECH*, *DISTRESS*, *EXTFIN*, *EXCHANGE*, and *ANALYSTS*). In this model, *BIG4* ($X^2 = 3.273$, $p = 0.035$) and *BODINDPC* ($X^2 = 4.136$, $p = 0.021$) are both negatively associated with noncompliance.

As a group, these models provide support for H3, with results revealing that having a Big 4 auditor and a more independent board are important in avoiding noncompliance with 8-K disclosure requirements. Other interesting results from these analyses include the positive association between *HITECH* and *LETTER* across two of the supplemental models, and the uniform lack of significance of *LnSIZE*. This latter finding has implications for regulators.

Alternative Test Results for H4

Across all four of the models that we use to test H3, we find robust results on the *NEGNEWS* variable, providing strong support for H4. We also provide an additional test of H4 by investigating whether companies that received comment letters might have intentionally omitted sensitive information from their disclosures. We report results of this analysis in Table 7, with Panel A reporting the main results (using test companies only), and Panel B reporting a sensitivity test that adds control companies to the main analysis. Considering the results in Panel A, we do not find (in contrast to expectation) that companies whose auditor resigned or declined to stand for re-election, *RESIGN*, were more likely to initially omit this information from their initial SEC filing.

[Insert Table 7 about Here]

The remaining Panel A results more strongly support our expectations, showing that other disclosure items are omitted when those items consist of bad news. Companies whose boards of directors did *not* approve their auditor changes, *NOAPPROV*, disproportionately do not disclose whether their boards approved changes. Companies *having* accounting disagreements with their auditors, *DISAGREE*, disproportionately do not disclose whether or not such disagreements exist. Companies *having* reportable events, *EVENT*, disproportionately do not disclose whether or not such events exist.

Companies previously *receiving* going concern opinions from their auditors, *PRIORGC*, disproportionately do not disclose whether or not such opinions were received.

To provide a summary test of H4, we employ *NEGNEWS* in Table 7 tests. Test companies disproportionately omit to disclose auditor change information that can be viewed as bad news (X^2 = 11.328, p = 0.001). The sensitivity results in Panel B are consistent with the Panel A results, but are statistically somewhat stronger. Overall, the results provide evidence consistent with the notion that managers *intentionally* omit sensitive information from their mandatory 8-K-4 disclosures, which supports H4.

Tests of H5 and H6

Our next set of hypotheses investigates whether investment in disclosure compliance infrastructure is negatively associated with late filing, or delay in filing, of 8-K-4's (H5) and whether auditor change circumstances that convey bad news to investors are positively associated with late filing, or delay in filing (H6). We report results in Table 8. The results show that companies with weaker compliance infrastructure are more likely to file *LATE* (X^2 = 11.480, p = 0.000), and that they have a longer filing lag (*LnLAG*) (t = -3.231, p = 0.000), supporting H5. Further, the results show that companies with bad news to report are more likely to file *LATE* (X^2 = 5.183, p = 0.016), and that they have a longer filing lag (*LnLAG*) (t = 2.232, p = 0.018), supporting H6.

[Insert Table 8 about Here]

We conduct supplemental tests of H5 and H6 to further explore these results. Specifically, we test models that include both the infrastructure component variables (*BIG4*, *BODINDPC*, and *AUDCOM*), and the variables predicting investment in compliance infrastructure (*LnSIZE*, *HITECH*, *DISTRESS*, *EXTFIN*, *EXCHANGE*, and

ANALYSTS). These results reveal that companies with an audit committee are less likely to file *LATE* (X^2 = 4.063, p = 0.022), and that they have a shorter filing lag (*LnLAG*) (t = -1.901, p = 0.030), while the other infrastructure component variables are insignificant. These results support the importance of audit committees as an integral component of corporate governance, an insight that our unique sample of companies enables us to provide. The results also reveal that *NEGNEWS* is consistently positive and significant in the supplemental models, illustrating that this result is not sensitive to alternative model specifications. *LnSize* is not associated with compliance with filing deadline (*LATE*) (X^2 = 1.437). It is, however, negatively associated with days delay in filing (*LnLAG*) (X^2 = -3.077). Finally, we note that *EXCHANGE* has an unexpected positive sign in both the *LATE* model (X^2 = 1.460, p = 0.023) and the *LnLAG* model (X^2 = 1.935, p = 0.054), suggesting that being listed on a national exchange results in less timely reporting, possibly due to the more-stringent filing requirements.

VII. LIMITATIONS, SUMMARY, AND CONCLUSIONS

Limitations

We acknowledge that there exist limitations to our analysis. First, we test our conceptual model in the specific context of auditor resignation reporting. The SEC is now making comment letters available in other reporting contexts, so an important extension of our paper could include testing the conceptual model in these contexts.[19] Second, the cost of hand-collecting some of the data necessary for our study is high. As such, our sample covers only May and June 2005. We could improve the power of our statistical tests by increasing our sample period, although we do note that our results are fairly strong even with this limited sample size.

Summary and Conclusions

Why do companies fail to comply with straight-forward disclosure requirements? Is it because management wants to avoid disclosing bad news or because the company's disclosure compliance infrastructure is weak? We address these questions by developing and testing a theory of disclosure compliance that distinguishes between intentional and accidental noncompliance. Our theory (Figure 1) posits that disclosure incentives and resource availability determine a company's disclosure compliance infrastructure, which is a mix of monitoring and corporate governance mechanisms. Lower quality infrastructure decreases the likelihood managers will be aware of and comply with requirements to disclose information they have no apparent reason to conceal (accidental noncompliance). It also decreases the likelihood management will disclose information it has incentives to conceal (intentional noncompliance). The strength of regulatory scrutiny determines the likelihood noncompliance will be detected.

We test the theory on a sample of companies complying or failing to comply with SEC requirements to disclose information about auditor changes and to make a timely filing of such disclosures. Compliance with auditor change disclosure requirements and filing deadlines are appropriate subjects for our inquiry because they require disclosures of facts, some of which may be viewed as bad news.

Our theory provides a framework researchers can develop further to study other compliance decisions. Our test results provide evidence relevant to answering the following policy-relevant questions.

Why do companies fail to comply with straight-forward disclosure requirements?

Most (75 percent) of the noncompliant companies concealed information about the circumstances of auditor change that if disclosed could decrease market value (intentional noncompliance). The remaining noncompliant companies did not conceal bad news but had lower quality disclosure compliance infrastructures than compliant companies. These companies were accidentally noncompliant. The potential for accidental noncompliance has been cited as a justification for simplifying accounting standards (Herz 2005). Our paper is the first to provide evidence that accidental noncompliance is negatively associated with lower quality infrastructure; and, in turn, to provide empirical support for the claim that higher quality infrastructure is positively associated with compliance. To the extent that improvements in internal control prompted by Sarbanes-Oxley improve the quality of companies' disclosure infrastructures they also should improve compliance, especially when management does not have bad news to conceal.

What determines the quality of a company's disclosure compliance infrastructure?

Companies with Big 4 auditors, a higher than average proportion of independent members of the board of directors, and an audit committee are deemed to have higher quality monitoring and corporate governance (e.g., Menon and Williams 1994; Carcello and Neal 2003), and, in turn, better infrastructure for ensuring compliance with accounting and disclosure requirements. The quality of a company's compliance infrastructure is determined by management's incentives to disclose and the resources available to invest in infrastructure. We find the regulatory incentives provided by exchange listing requirements have a greater positive effect on infrastructure than either market-based incentives or resources. This is consistent with the argument that regulation increases the overall level of disclosure.

Finally, our finding that size (the natural logarithm of market value of equity) explains neither quality of infrastructure nor likelihood of noncompliance raises questions about the merits of implementing proposals for size-based disclosure regulation.

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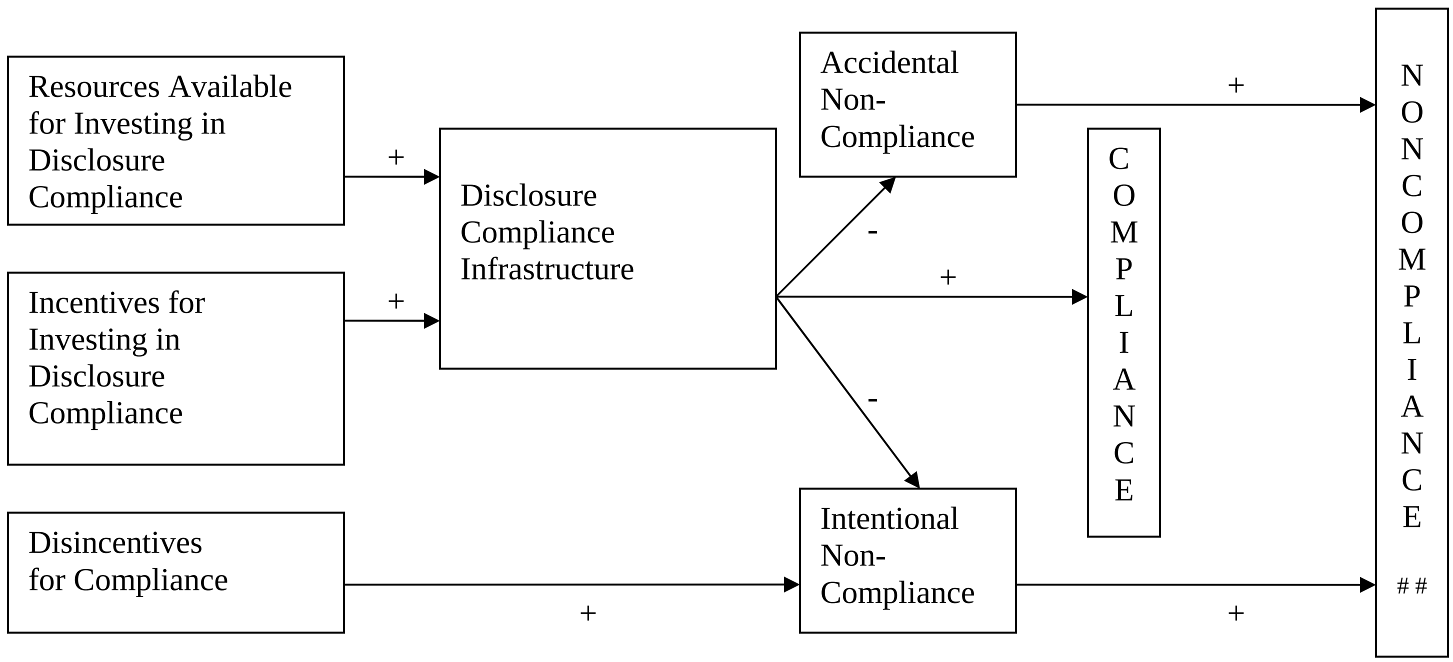
Figure 1
Conceptual Model of Disclosure Compliance



SEC *LETTER* status is the dependent variable used to proxy for noncompliance with required *content* of filings. *LETTER* is replaced by variables *LATE* and *LnLAG* to investigate *timeliness* of filings.

TABLE 1
Sample Size and Industry Breakdown

Panel A: Sample Attrition

	Test Companies	Control Companies
Initial sample of companies receiving comment letters from the SEC	105	0
Control companies	0	105
Missing data	8	0
Eliminated control company because associated test company had missing data		8
Total Final Sample Size	97	97

Panel B: Industry Distribution by SIC Codes

SIC Codes		N	%
01-09	Agric., Forestry, Fishing	0	0.0%
10-14	Mining	11	5.7%
15-17	Construction	4	2.1%
20-39	Manufacturing	82	42.3%
40-49	Transport., Communications	14	7.2%
50-51	Wholesale Trade	4	2.1%
52-59	Retail Trade	6	3.1%
60-69	Finance, Insurance, Real Est.	13	6.7%
70-89	Service	60	30.9%
	Total	194	100.0%

TABLE 2
Variable Definitions and Data Sources

Variable	Definition	Data Source
	Compliance Variables	
LETTER	= 1 if company received an SEC letter; 0 otherwise.	SEC, Edgar
LATE	= 1 if company filed its 8-K late; 0 otherwise.	8-K
LnLAG	= natural log of company's Form 8-K filing lag, in days.	8-K
	Resources for Investment in Compliance	
LnSIZE	= natural log of market value of equity	Compustat, 10-K
HITECH	= 1 if company is a member of a high tech industry; 0 otherwise. The high tech industries are defined as SIC codes 283, 357, 360, 361, 362, 363, 364, 365, 366, 367, 368, 481, 737 and 873.	Compustat, 10-K
DISTRESS	= 1 if current year auditor's opinion is 'going concern'; 0 otherwise.	Audit Analytics
	Incentives for Investment in Compliance	
EXTFIN	=1 if company issued common stock, preferred stock, or long-term debt in the current or next subsequent year.	Compustat, 10-K
EXCHANGE	= 1 if the company is listed on NYSE/AMEX or NASDAQ exchange; 0 for Bulletin Board or Pink Sheets.	Compustat, 10-K
ANALYSTS	= 1 if company is covered by ValueLine or IBES; 0 otherwise.	ValueLine, IBES
	Compliance Infrastructure	
BIG4	= 1 if company's departing auditor is Big 4; 0 otherwise.	8-K
BODINDPCT	= percent of members of company's board of directors who are described as independent in proxy statements.	DEF14A
AUDCOM	= 1 if company's board of directors has an audit committee; 0 otherwise.	DEF14A
INFRASTR	= sum of the codes for *BIG4*, *AUDCOM*, and *BONINDPC*, with the latter coded 1 if *BODINDPC* is greater than the mean of 0.57.	

(continued)

TABLE 2 (continued)

	Disincentives for Compliance (Bad News)	
RESIGN	= 1 if company's auditor resigned; 0 otherwise.	8-K or Corrected 8-K
NOAPPROV	= 1 if company's board did not approve the change; 0 otherwise.	8-K or Corrected 8-K
DISAGREE	= 1 if company had a disagreement with its auditor; 0 otherwise.	8-K or Corrected 8-K
EVENT	= 1 if company had a 'reportable event'; 0 otherwise.	8-K or Corrected 8-K
PRIORGC	= 1 if company received a 'going concern' opinion in the prior year; 0 otherwise.	8-K or Corrected 8-K
NEGNEWS	= 1 if any of the preceding five variables are coded 1; 0 otherwise. This is a summary variable capturing any kind of bad news.	See above

Data Source: 'corrected 8-K' applies only to test (SEC letter) companies. For control companies, the source is 8-Ks.

TABLE 3
Descriptive Statistics

	Mean (or proportion equal to 1)		**Chi-square/t-test two-tailed p-value**
Compliance Variables	Test Companies (*LETTER* = 1)	Control Companies (*LETTER* = 0)	
LETTER	1.000	0.000	N.A.
LATE	0.289	0.196	0.132
LnLAG	1.561	1.528	0.799
Resource Variables			
LnSIZE	15.194	14.257	0.283
HITECH	0.423	0.216	0.003***
DISTRESS	0.402	0.320	0.232
Incentive Variables			
EXTFIN	0.773	0.701	0.254
EXCHANGE	0.340	0.361	0.763
ANALYSTS	0.227	0.299	0.254
Infrastructure Variables			
BIG4	0.340	0.505	0.020**
BODINDPC	0.544	0.595	0.648
AUDCOM	0.650	0.680	0.648
INFRASTR	1.629	1.845	0.145
Disincentive Variables			
RESIGN	0.371	0.361	0.882
NOAPPROV	0.093	0.072	0.602
DISAGREE	0.041	0.000	0.043**
EVENT	0.124	0.082	0.345
PRIORGC	0.423	0.268	0.024**
NEGNEWS	0.753	0.577	0.010***

***, **, * Significant at the 0.01, 0.05, 0.10 level, respectively, two-tailed.
See Table 2 for variable definitions.

TABLE 4
Pearson Correlations

Variable	1.	2.	3.	4.	5.	6.	7.	8.	9.	10.	11.	12.	13.	14.
1. *LETTER*	1.00													
2. *LATE*	0.11	1.00												
3. *LnLAG*	0.02	0.59**	1.00											
Compliance Infrastructure Variables:														
4. *INFRASTR*	-0.09	-0.25**	-0.23**	1.000										
5. *BIG4*	-0.17*	-0.14*	-0.11	0.77**	1.00									
6. *BODINDPC*	-0.09	-0.26**	-0.25**	0.80**	0.43**	1.000								
7. *AUDCOM*	-0.03	-0.29**	-0.27**	0.86**	0.50**	0.70**	1.00							
Disincentive Variable:														
8. *NEGNEWS*	0.19*	0.17*	0.17*	-0.05	-0.06	-0.04	-0.09	1.00						
Resource Variables:														
9. *LnSIZE*	0.08	-0.17*	-0.29**	0.31**	0.10	0.34**	0.28**	-0.00	1.00					
10. *HITECH*	0.22**	-0.00	-0.06	0.26**	0.06	0.33**	0.23**	0.09	0.18*	1.00				
11. *DISTRESS*	0.09	0.25**	0.22**	-0.43**	-0.34**	-0.34**	-0.42**	0.22**	-0.21**	-0.17*	1.00			
Incentive Variables:														
12. *EXTFIN*	0.08	-0.07	-0.13	0.18*	0.13	0.16*	0.12	0.07	0.48**	0.13	-0.04	1.00		
13. *EXCHANGE*	-0.02	-0.06	-0.08	0.60**	0.51**	0.44**	0.50**	-0.10	0.39**	0.15*	-0.37**	0.24**	1.00	
14. *ANALYSTS*	-0.08	-0.12	-0.10	0.48**	0.41**	0.37**	0.40**	-0.07	0.41**	0.12	-0.38**	0.22**	0.69**	1.00

This table provides Pearson correlations between dependent variables and continuous explanatory variables. Spearman correlations yield similar results. N = 194. ** and * indicate significance at the 0.01 and 0.05 levels, respectively, two-tailed. See Table 2 for variable definitions.

TABLE 5
Models Investigating Determinants of Investment in Compliance Infrastructure

N=194

Regression Method		**OLS**	**OLS**	**Logit**	**Logit**
Dependent Variables	**Predicted Sign**	***INFRASTR***	***BODINDPC***	***AUDCOM***	***BIG4***
Resource Variables ***(H1)***					
LnSIZE	+	0.006 (0.446)	0.008 (2.211)**	0.016 (0.220)	-0.087 (6.494) ***
HITECH	-	0.361 (2.551)**	0.149 (3.841)***	0.894 (3.874)**	-0.111 (0.080)
DISTRESS	-	-0.510 (-3.444)***	-0.094 (-2.322)**	-1.233 (10.403)***	-1.063 (6.728) ***
Incentive Variables ***(H2)***					
EXTFIN	+	0.036 (0.216)	-0.023 (-0.489)	-0.104 (0.051)	0.624 (1.822)*
EXCHANGE	+	1.097 (5.735)***	0.156 (2.970)***	3.244 (9.252)***	1.998 (17.386) ***
ANALYSTS	+	0.145 (0.697)	0.028 (0.497)	1.712 (2.158)*	0.696 (1.662)*
Model p-value		0.000	0.000	0.000	0.000
Model R-square or Pseudo R-square		0.417	0.291	0.488	0.389

Data in tables represent the unstandardized regression coefficient and the t-value, or Wald chi-square. ***, **, and * represent significance at the 0.01, 0.05, 0.10 level, respectively. All p-values are one-tailed for coefficients having the expected signs, and are two-tailed otherwise. See Table 2 for variable definitions.

TABLE 6
Models Investigating Determinants of Compliance

N=194

		Primary Tests of H3 & H4	Supplemental Tests of H3 & H4		
Dependent Variable	**Predicted Sign**	***LETTER***	***LETTER***	***LETTER***	***LETTER***
Compliance Infrastructure Variables: H3					
INFRASTR	-	-0.150 (1.415)	-0.347 (3.762)**		
BIG4	-			-0.788 (4.987)**	-0.734 (3.273)**
BODINDPC	-			-0.707 (1.040)	-1.577 (4.136)**
AUDCOM	-			0.629 (1.970)	0.548 (1.272)
Disincentive Variable: H4					
NEGNEWS	+	0.789 (6.328)***	0.704 (4.373)**	0.821 (6.006)***	0.717 (4.396)**
Resource Variables					
LnSIZE	-		0.033 (1.092)		0.030 (0.812)
HITECH	+		1.123 (10.152)***		1.170 (10.250)***
DISTRESS	+		0.155 (0.173)		0.192 (0.252)
Incentive Variables					
EXTFIN	-		0.137 (0.118)		0.184 (0.198)
EXCHANGE	-		0.612 (1.487)		0.614 (1.482)
ANALYSTS	-		-0.675 (1.805)*		-0.618 (1.466)
Model Statistics					
Model p-value		0.017	0.002	0.008	0.001
Model R-square or Pseudo R-square		0.055	0.155	0.091	0.187

Data in tables represent the unstandardized regression coefficient and the t-value, or Wald chi-square. ***, **, and * indicate significance at the 0.01, 0.05, 0.10 level, respectively. All p-values are one-tailed for coefficients having the expected signs, and are two-tailed otherwise. See Table 2 for variable definitions.

TABLE 7
8-K Items Omitted by Companies Receiving a Comment Letter from the SEC

Panel A: Analysis using test companies only

Auditor Change Circumstances: 8-K-4 Disclosure Item	**Number Omitting Disclosure**	**Number Not Omitting Disclosure**	**Chi-square (one-tailed p-value)**	**Fisher's Exact Test (one-tailed p-value)**
RESIGN = 1	8	30	1.053	
RESIGN = 0	18	41	(0.153)	(0.215)
NOAPPROV = 1	6	3	26.978	
NOAPPROV = 0	6	82	(0.000)***	(0.000)***
DISAGREE = 1	3	1	3.554	
DISAGREE = 0	28	65	(0.030)**	(0.095)*
EVENT = 1	3	9	3.196	
EVENT = 0	7	78	(0.037)**	(0.106)
PRIORGC = 1	15	25	7.155	
PRIORGC = 0	8	49	(0.004)***	(0.008)***
NEGNEWS = 1	30	43	11.328	
NEGNEWS = 0	1	23	(0.001)***	(0.000)***

Panel B: Sensitivity test adding control companies

Auditor Change Circumstances: 8-K-4 Disclosure Item	**Number Omitting Disclosure**	**Number Not Omitting Disclosure**	**Chi-square (one-tailed p-value)**	**Fisher's Exact Test (one-tailed p-value)**
RESIGN = 1	8	67	0.788	
RESIGN = 0	18	101	(0.186)	(0.253)
NOAPPROV = 1	6	10	29.467	
NOAPPROV = 0	6	172	(0.000)***	(0.000)***
DISAGREE = 1	3	1	10.597	
DISAGREE = 0	28	162	(0.005)***	(0.013)**
EVENT = 1	3	17	4.421	
EVENT = 0	7	167	(0.017)**	(0.035)**
PRIORGC = 1	15	55	9.604	
PRIORGC = 0	8	116	(0.001)***	(0.002)***
NEGNEWS = 1	30	99	11.328	
NEGNEWS = 0	1	64	(0.001)***	(0.000)***

We rely on chi-square test results for most comparisons, but for comparisons involving five or fewer sample items in any partition (e.g. *DISAGREE* with N =3 and N = 1) we rely on Fisher's Exact Test. See Table 2 for variable definitions. ***, **, and * represent significance at the 0.01, 0.05, 0.10 level, respectively, in the hypothesized direction.

TABLE 8
Models Investigating Timeliness of Compliance

N=194

	Predicted Sign	Primary Tests of H5 & H6		Supplemental Tests of H5 & H6	
Dependent Variable:		***LATE***	***LnLAG***	***LATE***	***LnLAG***
Compliance Infrastructure Variables					
INFRASTR	-	-0.511 (11.480)***	-0.172 (-3.231)***		
BIG4	-			-0.177 (0.119)	-0.041 (-0.262)
BODINDPC	-			-0.995 (1.392)	-0.296 (-0.998)
AUDCOM	-			-1.198 (4.063)**	-0.355 (-1.901)**
Disincentive Variable					
NEGNEWS	+	0.954 (5.183)**	0.294 (2.232)**	0.780 (3.065)**	0.267 (2.035)**
Resource Variables					
LnSIZE	-			-0.046 (1.437)	-0.039 (-3.077)
HITECH	+			0.615 (1.921)*	0.087 (0.626)
DISTRESS	+			0.797 (3.229)**	0.218 (1.487)*
Incentive Variables					
EXTFIN	-			-0.226 (0.214)	-0.070 (-0.444)
EXCHANGE	-			1.460 (5.135)**	0.373 (1.935)*
ANALYSTS	-			-0.211 (0.114)	0.099 (0.505)
Model Statistics					
Model p-value		0.000	0.000	0.000	0.000
Model R-square or Pseudo R-square		0.134	0.068	0.236	0.141

Data in tables represent the unstandardized regression coefficient and the t-value, or Wald chi-square. ***, **, and * represent significance at the 0.01, 0.05, 0.10 level, respectively. All p-values are one-tailed for coefficients having the expected signs, and are two-tailed otherwise. See Table 2 for variable definitions.

ENDNOTES

[1] Examples of disclosures of non-financial information recently mandated by the SEC include disclosures of critical accounting policies and off-balance sheet arrangements.

[2] Studies providing evidence of negative market reaction to some auditor change disclosures include DeFond et al. (1997), Wells and Loudder (1997), Whisenant et al. (2003) and Sankaraguruswamy and Whisenant (2004). Additional motivation for concealing the circumstances of auditor change exists because omissions are unlikely to be detected subsequently. Subsequent audit reports will reveal the name of the new audit firm but will not disclose the circumstances of the auditor change (e.g., resignation versus dismissal).

[3] Arguments for scaled (size-based) securities regulation are provided by SEC Advisory Committee on Smaller Public Companies (2006). Issues related to private companies' ability to comply with Generally Accepted Accounting Principles are discussed in a joint FASB/AICPA proposal (2006) to improve financial reporting for private companies.

[4] Recently posted letters primarily discuss uncertain tax positions and segment disclosures.

[5] In contrast, it seems likely that specific items of *favorable* information that must be disclosed will not trigger circumvention of the disclosure compliance infrastructure.

[6] SEC staff members confirmed in telephone conversations that the SEC intentionally posted letters dealing with auditor change disclosures first, as a trial effort. They intend to expand the range of issues addressed by posted letters in the future.

[7] Conversely, the SEC believes that large filers can and should provide more disclosures, and file them more quickly. This belief underlies the SEC's designation of domestic companies that have a public float of at least $75 million as 'accelerated' filers. Public float is the market value of the issuer's non-affiliated voting and non-voting common equity. During the period studied, the SEC created a new category (large accelerated filers) that includes companies with a public float of $700 million (SEC 2005).

[8] For example, Pritchard et al. (2006) note that the high tech sector has been the most common target for class actions both before and after the Private Securities Reform Litigation Act.

[9] For example, Palmrose et al. (2004) indicate that 26 percent of their restatements were by high tech companies improperly accounting for in process research and development.

[10] Other consequences include: the reputation of managers and members of the board of directors is tarnished (Desai et al. 2006, Srinivasan 2005), the probability of litigation increases (Palmrose and Scholz 2004), and the price of corporate stock declines (Palmrose et al. 2004).

[11] An interesting feature of this study is that share prices for many of the companies in our sample are quoted on the OTC Bulletin Board or Pink Sheets. These companies are not subject to exchange listing requirements to have audit committees or to meet various other corporate governance requirements imposed by major exchanges. Inclusion of such companies in our sample allows us to investigate the effect of audit committee existence on disclosure compliance.

[12] As noted previously, SEC (2004a) requires all registrants in our sample period to file Form 8-Ks within four business days of a triggering event (i.e., there is no exemption for small entities).

[13] In some cases, the SEC posted companies' response letters at the web site without posting the SEC comment letters that provoked the responses. We include such companies in the sample since the contents of the original comment letters are evident from the responses.

[14] Quotations on the OTCBB are limited to the securities of issuers that are current in their reports filed with the SEC or other regulatory authority (NASD 1999).

[15]We code audit committee existence rather than percentage of independent audit committee members because our sample includes companies with shares prices quoted on the OTCBB and Pink Sheets that are not subject to exchange listing requirements and have not voluntarily created audit committees.

[16] Under Item 304 of Regulation S-K, reportable events include: (1) the auditor advised the client that internal controls are inadequate, (2) the auditor is unwilling to rely on management's

representations, or to be associated with the financial statements, (3) the auditor advised the client of the need to expand the scope of the audit, and/or (4) the auditor advised the client that information has come to light that materially affects the fairness or reliability of a prior audit report or of the current financial statements.

[17] Results are essentially the same if we calculate the *INFRASTR* using the median (rather than the mean) of *BODINDPC* as the cutoff for coding the variable equal to one. In addition, results are essentially the same if we calculate *LnSIZE* as the log of total assets.

[18] Considering results using the component variables of *INFRASTR*, we find that *EXCHANGE* is the only consistently significant predictor of *BODINDPC*, *AUDCOM*, or *BIG4*. The variables *EXTFIN* and *ANALYSTS* are only occasionally marginally significant.

[19] A study of SEC staff letters related to segment reporting is currently under way.

EALIC

European Association of Listed Companies AISBL-IVZW

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD
Office of the Secretary
1666 K Street, N.W.
Washington, D.C. 20006-2803
USA

BY ELECTRONIC MAIL

Brussels, 8 March 2007

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)

Ladies and Gentlemen,

EALIC is submitting this letter in response to the request of the Public Company Accounting Oversight Board (the "PCAOB") for comment on the PCAOB's auditing standard entitled "An Audit of Internal Control Over Financial Reporting that is Integrated With an Audit of Financial Statements" and a related proposed auditing standard entitled "Considering and Using the Work of Others in an Audit.".[1]

We strongly support the parallel efforts of the PCAOB and the Securities and Exchange Commission (the "Commission")[2] to better balance the benefits of reporting on and auditing ICFR against the cost and complexity of the process. In particular, we welcome the efforts of the PCAOB and the Commission to encourage auditors and management to use a top-down, risk-based approach to evaluating the effectiveness of ICFR. By focusing the evaluation and audit process on the risks that are most important to effective ICFR, we believe the PCAOB's proposed standard and the related Commission guidance have the potential to meaningfully improve the effectiveness and cost-efficiency of evaluations and audits of ICFR.

We also welcome the PCAOB's efforts to clarify the circumstances under which auditors can rely on the work of others when performing an audit. If properly implemented, we believe this guidance will help encourage auditors to make greater use of the work product produced by management in the course of its assessment, thereby reducing the need for duplicative testing. To further encourage auditors to make use of this flexibility, however, we encourage the PCAOB to include language in the release to specifically indicate that auditors should, whenever possible, endeavor to use the work performed by management during the course of its evaluation. In the absence of evidence that would call the objectivity or competence of a company's internal auditors into question, we believe the outside auditor should in almost all cases be willing to rely on tests performed by the company's internal audit department.

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

Secretary General
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EALIC

European Association of Listed Companies AISBL-IVZW

* * * * *

We appreciate this opportunity to provide you with our thoughts on the proposed interpretive guidance. Please do not hesitate to contact our organization if you have any questions or need any additional information.

Very truly yours,

Dorien FRANSENS
Secretary General

cc: Public Company Accounting Oversight Board
Hon. Mark W. Olson, Chairman
Hon. Kayla J. Gillan, Member
Hon. Daniel L. Goelzer, Member
Hon. Bill Gradison, Member
Hon. Charles D. Niemeier, Member

Securities and Exchange Commission
Hon. Christopher Cox, Chairman
Hon. Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner
Hon. Kathleen L. Casey, Commissioner
Hon. Annette L. Nazareth, Commissioner

Securities and Exchange Commission – Division of Corporation Finance
Mr. John W. White
Ms. Carol A. Stacey

Securities and Exchange Commission – Office of Chief Accountant
Mr. Conrad Hewitt

EALIC, the European Association of Listed Companies, promotes the common interests of European issuers on a European level. Its scope of activities includes the legal and regulatory framework specific to listed companies in general and to the issuing and trading of securities on European markets in particular. EALIC was incorporated in December 2002 as an international non-profit association. Its current member-base counts six national associations of listed companies, namely VEUO (Netherlands), ANSA and AFEP (France), ABSC-BVBV (Belgium), ASSONIME (Italy) and SEG (Poland). In addition, more than seventy public companies from the mentioned countries, as well as from Portugal and Spain, are direct members of our association. As such EALIC represents many hundreds of leading issuing companies to date.

Date
16 February 2007

Le Président

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Email: comments@pcaobus.org

Dear Ms Morris and Mr Seymour,

Securities and Exchange Commission Release on Management's Report on Internal Control over Financial Reporting

Public Company Accounting Oversight Board Proposed Auditing Standard on An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals

FEE (Fédération des Experts Comptables Européens – European Federation of Accountants) is the representative organisation for the accountancy profession in Europe. FEE's membership consists of 44 professional institutes of accountants from 32 countries. FEE Member Bodies are present in all 27 Member States of the European Union and they represent more than 500,000 accountants in Europe.

FEE is pleased to comment on:

- the Securities and Exchange Commission (SEC) Release Nos. 33-8762 and 34-5476 on Management's Report on Internal Control over Financial Reporting (the SEC's proposals); and
- the Public Company Accounting Oversight Board (PCAOB) Rulemaking Docket Matter No. 021 of 19 December 2006 – Proposed Auditing Standard on An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals (the PCAOB's proposed standard).

In the case of the PCAOB's document, FEE has only commented on the Proposed Auditing Standard in Appendix 1 of that document and not on the other appendices in the PCAOB's document.

FEE notes with interest the SEC's proposals and the PCAOB's proposed Auditing Standard in view of FEE's own substantial contribution to recent discussions in Europe over the future direction of requirements and guidance relating to risk management and internal control. In particular FEE:

- published in March 2005 its Discussion Paper "Risk Management and Internal Control in the EU"[1];

[1] http://www.fee.be/publications/default.asp?library_ref=4&content_ref=351

held a high level conference on 25 October 2005[2] (at which a senior staff member from the SEC spoke) on the issues raised by the Discussion Paper; and

- issued in May 2006 a Comment Paper "Analysis of Responses to the FEE Discussion Paper on Risk Management and Internal Control in the EU"[3].

We are supportive of the proposed objectives of the SEC and the PCAOB which we believe include:

- improving the effectiveness and efficiency with which management and auditors assess a company's internal control over financial reporting;
- adopting a top down, risk-based approach with emphasis on the control environment;
- providing flexibility in the approach to assessing internal control;
- increasing the focus on the exercise of judgement, rather than encouraging a check-list mentality; and
- considering issues related to the scalability of the requirements as applied to different companies.

Overall, whilst FEE considers the initiative of both the SEC and the PCOAB to be a step in the right direction, particularly the aim of providing high-level guidance to management which was previously a major omission, we have a number of concerns about the two documents and question whether the proposed objectives will actually be achieved in practice. Matters may not have been resolved and everything depends on how the words in the SEC's and PCAOB's documents affect the behaviour of people in registrants' management teams, audit firms and the regulatory agencies' inspection functions.

Overriding principles based on existing FEE policy

In preparing this response, we have applied three overriding principles which are based on FEE policy previously established in our Discussion Paper *Risk Management and Internal Control in the EU* and which FEE continues to fully support:

1. Internal control over financial reporting is primarily about the people at the top of a company who manage the business. The focus should be on management.

2. Whatever work auditors undertake, it must be performed within the context of the work that management undertakes and it should be aligned with that work and based on evidence of what management has done.

3. FEE supports the application Assurance Framework for Assurance Engagements of the International Auditing and Assurance Standards Board (IAASB) for any auditor involvement in respect of internal control over financial reporting.

Main Comments

1. One approach versus two separate exercises

The SEC's May 2005 guidance emphasises that management, not the auditor, is responsible for determining the appropriate nature and form of internal controls for the company as well as their evaluation methods and procedures. The work that auditors are required to undertake should be performed within the context of, and aligned to, the work that management undertakes.

Under the current proposals, both the auditor and management will undertake separate exercises to assess internal control over financial reporting using their own methodologies, guidance and frameworks. We think that the SEC and PCAOB proposals are at variance with our principles 1 and 2 noted above.

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[2] http://www.fee.be/news/default.asp?library_ref=2&content_ref=518
[3] http://www.fee.be/publications/default.asp?library_ref=4&content_ref=564

We believe that there should be one approach to internal control over financial reporting, not two separate exercises.

2. The elimination of the requirement on the auditor to evaluate management's process

We [strongly] approve of the SEC's and the PCAOB's objective of improving the effectiveness and efficiency with which management and auditors assess a company's internal control over financial reporting.

In attempting to bring about this objective, changes are proposed to the current requirements that the auditor form two opinions on internal control over financial reporting; the first being on management's work (process) and the second being the auditors' own assessment of the company's internal control over financial reporting. Whatever the words used in the documents for management's work – be it management's assessment or management process – the essential matter is that it is the work undertaken by management. We note that the SEC and the PCAOB both propose the elimination of the auditor's opinion on management's process – i.e. the work undertaken by management.

Our second principle, noted earlier in this letter, in practical terms means that whatever work the auditors undertake, it must be performed within the context of, and aligned to, the work that management undertakes and should be based on evidence of what management has done.

We note that, on page 52 of the SEC Proposed Release, the SEC states that it is "proposing to revise Rule 2-02(f) to require the auditor to express an opinion directly on the effectiveness of internal control over financial reporting" and goes on to state that "We believe this opinion necessarily conveys whether management's assessment is fairly stated."

It is questionable whether the above-quoted belief is well-founded. Section 404 (b) of the Sarbanes-Oxley Act states (our emphasis in italics) "Internal Control Evaluation And Reporting - With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues an audit report for the issuer shall attest to, and report on, *the assessment made by the management* of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement."

Additionally, we note that, on page 16 of the PCAOB Proposed Auditing Standard, the PCAOB "believes that the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process". However later on that page the PCAOB Proposed Auditing Standard notes that "an auditor still would need to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which he or she will use the work of others". These statements appear to contradict each other.

We believe that the removal of the requirement on the auditor to evaluate management's work/process does not follow our second principle noted above and in conjunction with our comments in the first section above (re 'one approach') we suggest that the wrong opinion has been proposed for elimination.

3. PCAOB regulatory and enforcement functions - lack of symmetry between them

The focus of the inspection reports published by the PCAOB on audit firms is on auditor shortcomings, inadequacies in audit work, on the *under-audit* of financial statements. The focus of the PCAOB Proposed Auditing Standard however, is on the prevention of the *over-audit* of internal control over financial reporting as evidenced by a significant number of notes referring to the fact that auditors ‘need not’ or are ‘not required to’ perform a particular procedure.

It is important that the PCAOB sends out a consistent message to auditors. Auditor behaviour is likely to be more sensitive to the approach taken by the PCAOB in its enforcement activities than it is to changes in auditing standards and it is therefore important that one reinforces the other.

If the enforcement approach focuses on detailed disclosure errors in published financial statements and compliance with the letter of standards rather than on the manner in which the audit was conducted and audit quality, and in particularly the quality of significant audit judgements, then changes to auditing standards will have a very limited effect on auditor behaviour.

The PCAOB Proposed Auditing Standard does not prevent auditors from ‘over-auditing’ in that it does not say that auditors must not perform a particular procedure. It is quite possible that auditors will continue to ‘over-audit’ despite the changes if their behaviour is being driven by an enforcement approach that encourages defensive auditing.

4. SEC’s guidance to management is rooted in an audit approach

It is the management of an organisation that is responsible for its internal control over financial reporting, and therefore the guidance should be user-friendly for them.

The SEC interpretive guidance included in the SEC Proposed Release is unlikely to resonate with management. The approach taken by the guidance, and the language used therein, is rooted in an auditors’ approach to internal control over financial reporting instead of language that may be better understood by management. For example, the proposed guidance makes reference to the ‘design’ and ‘operation’ of controls which is perceived as ‘auditor’ parlance

The PCAOB proposal makes reference to ‘identifying’ and ‘testing’ controls – language which is not used in the SEC guidance. It would be helpful that the terms are more aligned when discussing the same areas.

5. Potential implementation problems

The SEC’s Proposed Release anticipates cost savings, both for the entity directly and indirectly in respect of consulting and audit fees. For example, in removing the necessity for auditors to test management’s assessment process, the SEC hopes to eliminate unnecessary duplication of work. Whilst to some extent this is likely to be true, given that management’s assessment process constitutes an internal control over financial reporting from the auditor’s point of view, the auditor will not be able to discount the process entirely and thus cost savings may not be as great as anticipated.

The PCAOB proposed Auditing Standard is built upon the assumption that audit costs can be reduced. We are not sure that this can be the case in every audit and are concerned that entities may have overly optimistic expectations as to the magnitude of cost savings that can be achieved in practice. When, and only when, management has designed and is operating, an effective and well-documented system of internal controls (including documentation of management’s assessment) can audit costs be kept to a minimum.

Therefore, an impact assessment of the proposals is recommended to test in the field whether the anticipated cost savings will materialise in practice.

6. Consistency issues

We believe that it is important that both the SEC and the PCAOB documents are aligned and consistent within themselves. If they are not, this could cause confusion and may result in unintended consequences such as unnecessary costs.

As the documents currently stand, there are a number of inconsistencies both within each document and between the two documents. Although we only highlight two such matters, we are sure that other commentators will identify a number of other matters that will need to be rectified by the SEC and PCAOB working together.

Definition of material weakness

The SEC's definition of 'Material Weakness' (page 13) is:

A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's internal control over financial reporting.

The PCAOB defines 'Material Weakness' (paragraph A8) as:

A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.

We believe that a control deficiency, as part of the auditor's definition, can be wider than a deficiency in internal control over financial reporting, which forms part of the SEC's definition of a material weakness for management. We also note that the concept of prevention or detection on a timely basis is included in the SEC's definition of material weakness for management but not in the PCAOB's definition of material weakness for auditors. [Both of these differences violate FEE principle 2 as further detailed above.] On a matter as important as this, we suggest that the SEC and PCAOB adopt one definition of material weakness with primacy being given to the SEC. Having inconsistent definitions is problematical and unnecessary.

Controls with lower risk

There is an apparent discrepancy between the auditor's required treatment of controls regarded as having a lower risk in the PCAOB proposed AS 5 and that proposed in the SEC guidance for management. In the latter, for example on page 36, self-assessment may be used by management, whereas the auditor is not afforded similar treatment for controls regarded as having a lower risk in the proposed AS 5. Another such example is paragraph 36 on page A1 – 17 of the PCAOB document whereby the auditor should perform a walkthrough for each significant process. The SEC has not proposed a similarly stringent measure for management's assessment of internal control.

Questions asked by the SEC

We comment below on some of the questions posed by the SEC:

- Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process? Does the proposed guidance allow for management to conduct an efficient and effective evaluation? If not, why not?

  We refer you to our main comments number 1 on 'One approach versus two separate exercises', number 2 on 'The elimination of the requirement on the auditor to evaluate management's process, number 4 on 'SEC's guidance to management is rooted in an audit approach' and number 5 on 'Potential implementation problems'.

- Considering the PCAOB's proposed new 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, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to resolve the incompatibility?

  We refer you to our main comments number 6 on 'Consistency issues'.

Questions asked by the PCAOB

We have chosen to answer a selected number of the questions asked by the PCAOB – as detailed below:

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?

   We refer you to our main comments number 3 on 'PCAOB regulatory and enforcement functions – lack of symmetry between them.'

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

   We refer you to our main comments number 6 on 'Consistency issues' on controls with lower risk.

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 refer you to our main comments number 6 on 'Consistency issues' on definition of material weakness.

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

    We refer you to our main comments number 1 on 'One approach versus two separate exercises'.

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 refer you to our main comments number 2 on 'The elimination of the requirement on the auditor to evaluate management's process.

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 refer you to our main comments number 5 on 'Potential implementation problems'.

We would be pleased to discuss with you any aspect of this letter you may wish to raise with us and to send you copies of the two papers produced by FEE if these would be of interest to the SEC or PCAOB.

Yours sincerely,

Jacques Potdevin
President

FDIC
Federal Deposit Insurance Corporation
550 17th Street, NW, Washington, D.C. 20429-9990
Division of Supervision and Consumer Protection

March 29, 2007

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 2006-2803

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Board Members:

The staff of the Federal Deposit Insurance Corporation (FDIC), as the federal insurer of deposits in banks and thrift institutions, appreciates the efforts of the Public Company Accounting Oversight Board (PCAOB) and its staff in proposing an auditing standard, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements,* that would supersede the PCAOB's Auditing Standard No. 2 (AS 2).

The FDIC has a significant interest in the auditing standards issued by the PCAOB because they have direct impact on certain insured depository institutions that are subject to the FDIC's regulations. In general, Section 12(i) of the Securities Exchange Act of 1934 (Exchange Act) vests the FDIC with the powers, functions, and duties vested in the Securities and Exchange Commission (SEC) regarding insured state nonmember banks that have securities subject to the registration provisions of Sections 12(b) and 12(g) of the Exchange Act. These banks report to the FDIC pursuant to Part 335 of the FDIC's regulations. Part 335 generally incorporates through cross reference Exchange Act regulations of the SEC as those regulations are routinely issued, revised, and or updated by the SEC.

Additionally, under Section 36 of the Federal Deposit Insurance Act and its implementing regulation, 12 CFR Part 363 (Part 363), insured depository institutions with $500 million or more but less than $1 billion in total assets that are also public companies or subsidiaries of public companies that are required to comply with the provisions of Section 404 of the Sarbanes-Oxley Act must file a copy of the independent accountant's report on the audit of internal control over financial reporting that is required by Section 404 with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor. Furthermore, insured depository institutions with $1 billion or more in total assets, including those that are not public companies or subsidiaries of public companies, are required to file an independent accountant's attestation report concerning the institution's internal control over financial reporting as part of their Part 363 annual report. Institutions of this size that are also public companies or subsidiaries of public companies that are required to comply with the provisions of Section 404 must submit the independent accountant's report on the audit of internal control over financial reporting that is required by Section 404, either as part of the Part 363 annual report or separately as another report.

Based on our review of the PCAOB's guidance in the proposed auditing standard, we recommend that the PCAOB consider the following:

Reference to Regulatory Reports

Q&A 31 to AS 2 referred to the FDIC's Financial Institution Letter (FIL) 86-94, Additional Guidance Concerning Annual Audits, Audit Committees and Reporting Requirements. In that FIL, which addressed several issues related to compliance with Part 363 of the FDIC's regulations by insured depository institutions subject to Part 363, the FDIC indicated that financial reporting encompasses both financial statements prepared in accordance with generally accepted accounting principles and those prepared for regulatory reporting purposes. Q&A 31 provides guidance indicating that the auditor may expand his or her audit of internal control over financial reporting to include the controls over the regulatory report schedules equivalent to the basic financial statements and to modify the auditor's report accordingly. However, the proposed auditing standard does not provide similar guidance on regulatory reporting. The FDIC recommends that the PCAOB provide guidance comparable to that contained in Q&A 31 in the proposed auditing standard. In this regard, the FDIC suggests that paragraph C1 in Appendix C of the proposed auditing standard may be an appropriate place to provide this guidance.

Auditor's Report on Management's Assessment of the Effectiveness of Internal Control Over Financial Reporting

Since paragraph 94 of the proposed auditing standard does not specifically require the auditor's report on management's assessment to include a statement that the "accountant has audited management's assessment," the proposed auditing standard appears to be inconsistent with the SEC's corresponding proposal (Release No. 33-8762). In this regard, the SEC's proposed amendment to Rule 2-02(f) of Regulation S-X states in part:

> Every registered public accounting firm that issues or prepares an accountant's report for a registrant ... that is included in an annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) containing an assessment by management of the effectiveness of the registrant's internal control over financial reporting must attest to, and report on, such assessment. The attestation report on management's assessment of internal control over financial reporting shall be dated, signed manually, identify the period covered by the report, indicate that **the accountant has audited management's assessment**, and clearly state that the opinion of the accountant, either unqualified or adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting. ... The attestation report on management's assessment of internal control over financial reporting may be separate from the accountant's report. (Emphasis added.)

Nevertheless, the example of a combined report set forth in paragraph 96 of the proposed auditing standard specifically indicates that the accountant has "audited management's assessment." In contrast, the additional language set forth in paragraph 97 to be added to the auditor's report on the financial statements when the auditor chooses to issue a separate report on internal control states that the auditor also audited the registrant's "internal control over financial reporting," but does not indicate that the auditor audited management's assessment. The FDIC recommends that the staffs of the PCAOB and SEC take appropriate action to address these apparent inconsistencies in the required content of the auditor's report.

Proposed Rule 3525 – Audit Committee Pre-approval of Services Related to Internal Control Over Financial Reporting

The discussion in Section III of the preamble to the proposed auditing standard and the text of proposed Rule 3525 indicate that an auditor can perform certain non-audit services related to internal control over financial reporting, but the proposed rule does not include any examples of such services. Also, Section III of the preamble refers to the discussion in AS 2 regarding the application of principles of independence to internal control-related services. However, the discussion in Section III of the preamble indicates that the PCOAB has decided not to repeat that independence guidance in the proposed auditing standard or in a separate independence rule. In the absence of explanatory guidance, the proposed Rule 3525 seems to conflict with the SEC's auditor independence rules and its prohibition on certain non-audit services as more particularly set forth in Rule 2-01(c)(4) of Regulation S-X. The FDIC recommends that the PCAOB reconsider its decision not to provide the aforementioned independence guidance and provide guidance similar to paragraphs 32 to 35 of AS 2. The FDIC also recommends that the PCAOB provide examples of non-audit services related to internal control over financial reporting that, if performed by the registered accounting firm that performs the financial statement audit, would not impair the registered accounting firm's independence.

We would welcome the opportunity to discuss our comments with you further.

Sincerely,

Robert F. Storch

Robert F. Storch
Chief Accountant

cc: Mrs. Nancy M. Morris
Securities and Exchange Commission

financial executives international

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 L. Hinchman
Senior Vice President
Financial Executives International

financial executives international

committee on corporate reporting

February 26, 2007

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

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
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.

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.

From: John Dearie [mailto:John.Dearie@financialservicesforum.org]
Sent: Monday, February 26, 2007 5:12 PM
To: Comments
Subject: Comment Re: Proposed Auditing Standard - An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements

February 26, 2007

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

Re: Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements

This letter is submitted on behalf of the Financial Services Forum, a financial and economic policy organization comprising the chief executive officers of 21 of the largest and most diversified financial institutions with operations in the United States. The Forum works to promote policies that enhance savings and investment in the U.S. and that ensure an open, competitive, and sound global financial services marketplace. As a group, the Forum's member institutions employ more than 2 million people in 175 countries and hold combined assets of more than $16 trillion.

Please note that while we submit this letter on behalf of the Forum, the views expressed herein should not be taken to necessarily represent the specific positions of each institution comprising the Forum's membership, nor does this letter supplant other more specific comments that might be separately provided by the Forum's member institutions.

With this letter the Forum wishes to convey several important points: 1) our strong support for the enactment of the Sarbanes-Oxley Act of 2002; 2) the need for regulatory recalibration of certain aspects of the Act's implementation – particularly regarding internal controls for financial reporting, or Section 404; and, 3) the Forum's support for the new guidance proposed by the Public Company Accounting Oversight Board ("PCAOB"or "the Board") last December.

The foundation of any competitive capital market is investor confidence. When investors put their capital at risk by purchasing shares in a company or its debt securities, they must have faith that the company is telling the truth about its business and its finances. They must be sure that the company's financial statements have been prepared using high-quality accounting standards designed to accurately reflect the company's financial condition. If investors don't have that faith – or if their faith is undermined – investors will insist on a risk premium on their investment. The net effect of this "uncertainty" or "anxiety" premium is to raise the cost of capital, with clearly negative implications for business investment, risk-taking, innovation, productivity, and, therefore, job creation.

This scenario is of particular concern at a time when more than half of U.S. households own equities, and when investment decisions regarding the deployment of retirement funds are increasingly being delegated to individual beneficiaries. The number of American shareholders has risen from 30 million in 1980 to more than 84 million in 2002. And those individual investors – putting money into 401(k) pensions, mutual funds, and brokerage accounts – account for up to 80 percent of the new money flowing into U.S. stock markets.

Since the 1930s, the United States has required some of the most extensive financial disclosures, backed by one of the most robust enforcement regimes in the world. Such requirements entail substantial costs, particularly for foreign firms who must reconcile their financial statements to U.S. standards. But such costs are more than offset by the reduced cost of capital, the prestige, and other benefits that come with listing in the United States.

Unfortunately, in the boom years of the late 1990s too many forgot the critical importance of maintaining the confidence and trust of investors. As the dot-com bubble burst, a parade of corporate scandals began. Enron, WorldCom, Adelphia, Health South, Tyco, Global Crossing, Cedant, and others were accused of managerial fraud, accounting irregularities, and other governance abuses. While the vast majority of corporate officers are honest people who discharge their responsibilities with the highest ethical standards, it became apparent that some were employing questionable accounting practices and too often ethical corners were being cut.

The unfortunate effect of these scandals was to undermine investors' faith in the integrity and basic fairness of the world's greatest capital market. The subsequent drop in equity prices and the reluctance of investors to return to the markets once prices stabilized led to the loss of more than $7 trillion of equity value – nearly half of the markets' total capitalization.

The government's response came in 2002 when Congress passed and President Bush signed into law the Sarbanes-Oxley Act – the most significant piece of securities legislation passed since the Securities Acts of 1933 and 1934, the latter of which created the Securities and Exchange Commission. Sarbanes-Oxley created the PCAOB to oversee the audit profession, and created new rules to protect auditor independence. It addressed conflicts of interest faced by securities analysts, increased the penalties for financial fraud, and gave the SEC additional resources. The Act also instituted other important safeguards, such as requiring the chief executive and chief financial officers of issuing companies to personally certify the company's financial statements, and mandated that auditors certify the adequacy of the issuer's internal controls – the so-called Section 404 provision of the statute.

In assessing the effect of Sarbanes-Oxley, it must be acknowledge that since its passage investors – including millions of individual investors – have returned to the markets, pushing the major indices to multi-year highs and creating more than $5 trillion in additional equity value.

At the same time, other developments have established a worrisome pattern:

- In 2005, the United States accounted for 20 percent of worldwide IPO proceeds, down from 35 percent in 2001.

- In 2005, 23 of the 25 largest IPOs did <u>not</u> list in the United States.

- In 2000, nine out of every 10 dollars raised by foreign companies through new stock offerings were raised in the United States. In 2005, the reverse was true – nine out of every 10 dollars raised by foreign companies through new company listings occurred <u>outside</u> the Unites States, principally in Europe.

- A recent London Stock Exchange survey of 80 international companies that went public on its market found that of those that contemplated a U.S. listing, 90 percent decided that Sarbanes-Oxley made London more attractive.

Implementation of Sarbanes-Oxley is not uniquely responsible for this troubling trend. But given the evidence, it seems clear that, in addition to the acknowledged benefits of the Act, unintended consequences have undermined the attractiveness of the U.S. capital markets for many companies – both foreign and domestic.

It is entirely in keeping with the principles of our corporate governance standards to re-evaluate whether the rules and regulations written to implement those principles are effective and appropriate:

- Do the rules and regulations achieve the intended objectives?

- Do they impose an unnecessarily high or costly burden on regulated firms, particularly smaller businesses?

- Do the costs of meeting the requirements outstrip the acknowledged benefits of listing in the U.S. markets?

- Are there steps that can be taken to alleviate some of the burden and costs without undermining investor confidence?

These are reasonable, prudent questions to ask. And preserving a strong and vital capital market is too important to the future of the United States not to ask them.

For these important reasons, the Forum applauds the new guidance proposed by the Board on December 19, 2006. In issuing the new guidance, we believe that the Board has acted properly and within its statutorily defined authority. By clarifying regulatory notions of materiality, making implementation of Sarbanes-Oxley more top-down, risk-based, and scalable for smaller companies, and removing the requirement that auditors evaluate management's assessment process, the new guidance will focus auditors' attention, energy, and resources on those aspects of a company that pose the greatest risk of material error or fraud. These ideas will form the basis of a new accounting standard that will better serve the interests of investors, both large and small, and help achieve a more appropriate balance between the disclosure- and transparency-enhancing aspects of Sarbanes-Oxley and the priority of minimizing regulatory burden and compliance costs.

The Financial Services Forum appreciates the opportunity to submit this comment letter and looks forward to working with the Board and its staff to ensure the highest standards of corporate disclosure and accountability while keeping the United States the world's capital market of choice.

Donald L. Evans
Chief Executive Officer

Rob Nichols
President and Chief Operating Officer

cc: Mark W. Olson, Chairman
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
Bill Gradison, Member
Charles D. Niemeier, Member

THE FINANCIAL SERVICES ROUNDTABLE

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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. Goal of the Audit Should Be Clarified

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

[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

FROM THE DESK OF DAVID K. GOLBAHAR

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February 20, 2007

Office of the Secretary
Public Company Accounting Oversight Board
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* (PCAOB Release No. 2006-007, December 19, 2006)

Dear Mr. Secretary,

I appreciate this occasion to comment on the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements* (the "proposed standard"), for the Public Company Accounting Oversight Board (the "Board"). I would also like to extend my thanks and support to the Board for its efforts to better a standard that has helped restore confidence in our capital markets.

This letter addresses questions important to the standard. The questions follow the standard chronologically.

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

According to paragraph 16, the standard states, "A top-down approach begins at the financial statement level and company-level controls, and then works down to significant accounts and disclosures, relevant assertions, and significant processes." In my opinion, the detailed information provided in paragraphs 16 – 40 help auditors identify accounts and controls, but examples would help newer auditors understand specific accounts and situations that would result in audit efficiency. For example, footnotes directing readers to an appendix with situations would assist in understanding the standard clearly. While the standard should not be a substitute for an auditing text, it would also help lay readers understand what auditors do. This might help close the expectations gap between auditors and users of financial statements.

Furthermore, this section does not explicitly recommend auditors to look at the "tone-at-the-top," which arguably could be the most important indicator of how to direct the top-down approach in auditing. I recommend adding "tone-at-the-top" to paragraph 20.

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

After evaluating management's tone, the standard helps clarify to auditors what company-level controls to identify, but the eight bullets ("Company-level controls") under paragraph 20 are too vague for auditors to identify. Paragraph 19 through 22 provide more insight to the control environment and period-end financial reporting process, but after observing the history of enterprise risk management, I believe most auditors do not have a through understanding of a company's risk management process. It is a newer concept that many of the new hires in accounting firms are not familiar with, unless they specifically studied it in a course. Campus new hire training by the Big Four accounting firms do address it [however, it is found within most audit workbooks], and I believe it would benefit the accounting profession to address it within this auditing standard.

The top-down approach theoretically would focus the auditors to scrutinize the most important controls, but the auditors must understand risk management in order to do so.

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

Throughout the standard, "risk assessment" is used repeatedly to emphasize that auditing will occur on a risk-based approach. While auditors will now use their judgment to better audit companies, one must realize that our own risk equation [IR x DR x CR = AR] is subjective and requires that auditors maintain unbiased opinions and fairly determine the degree of risk present in an engagement. Risk assessment is appropriately incorporated with the standard, but it leaves a door open for potential abuse. As the Board and accounting professionals across the states have worked diligently to regain the public trust in our work, we must be careful not to lose it based on poor judgment.

In paragraphs 51 and 52, the standard adequately describes the correlation of risk and the necessity of evidence that needs to be collected. I would recommend a more complete list of risk factors that are associated with controls in a separate appendix, as needed.

I would like to reiterate my consensus with focusing auditors on a risk-based approach over a "check-list" compliance approach. The former efficiently helps auditors perform the necessary tests while keeping the broader purpose on the forefront of their minds. The latter might lead to an auditor getting lost in a flurry of detail, without the "big picture" in sight.

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

Walkthroughs in general are a great tool for auditors to gain an understanding of how the client's business operates internally. Paragraphs 36 through 40 help clarify to auditors what to look for and what questions to ask. However, I disagree that anyone other than the auditors should be allowed to perform a walkthrough. First, this poses as a liability risk in case an auditor is sued, and furthermore, it defeats the purpose of informing the auditor what happens while following a transaction. While I understand that an auditor may read a memo about a walkthrough, physically performing the requirements may result in a different perception of client's actions. Simply put, there is too much risk associated with a non-auditor performing the necessary work.

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

This third opinion in the opinion letter added more liability to auditors and additional audit work. I would argue that the opinions on the letter have helped establish trust in investors in our capital markets, but at the same time have also confused users of the financial statements. From my own understanding and brief survey results, most new auditors are unaware of how many opinions the opinion letter states.

The opinion on management's process is inherently tied to the auditor's opinion on internal control. This third opinion has created additional work, and its elimination would ease the amount of audit work and lower costs to the client. I believe the audit of internal controls allows auditors to gain a perspective on management's process. If auditors observe potential control failures, they disclose them and obviously assist the client to patch up any issues.

It is still necessary to issue an opinion on internal controls, but I know that in the future, with the trust of the public, auditors may return to the single opinion letter.

Question F. 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?

As a student in accounting for over four years, I was first surprised at the amount of opinions issued by firms, and then confused as to the wording of the opinion letter. My recommendation is to keep the letter as simple as possible to aid the users of the financial statements, notably the potential investors and stockholders. In a global environment, our wording must assist, not impair, those users. While the elimination of the third opinion may not directly result in a clearer document, it will reduce the amount of confusion, at the very least. Users may be confounded as to why there is an opinion on internal control *and* on management's assessment of those internal controls. Logically on the surface, the argument seems to be circular. One opinion on the financial statements and one on internal control facilitates the communication of the audit work.

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

Appendix B in the standard identifies the specific factors auditors should use in evaluating the competence and objectivity of others. Due to the nature of humans and their innate characteristics, scientists argue that we live in a culture that cheats. David Callahan and Steven Levitt have argued that in our society, individuals are acting in favor of themselves, and not the greater good. Therefore, it can be determined that not only individuals ("others") but also auditors have an incentive to cheat. First, there is no minimum required level to meet the competency qualification, and the objectivity of individuals is based on policies. As a future auditor, I would not feel comfortable using the works of others. I would conclude that the use of the works of others should be highly limited and possibly only used as guidance, but not as a substitute for audit work.

Please feel free to contact me regarding questions or comments regarding this comment letter. In conclusion, I would recommend that the SEC pass any guidance for companies that the Board passes for auditors simultaneously. I am proud to be a part of the forefront of accounting policy and again thank you for providing the opportunity to provide additional insight.

Respectfully submitted,

/s/ David Golbahar

David Golbahar

Graduate Student,
McIntire School of Commerce,
University of Virginia

From: Goldberg, Daniel [Daniel.Goldberg@tylertech.com]
Sent: Tuesday, January 23, 2007 2:29 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 021

I would like to submit the following comments/questions regarding Docket Matter No. 21.

In the Proposed Auditing Standard - Considering and Using the Work of Others in an Audit, paragraph 10 states, in regards to utilizing the work of others, the auditor should:

- Evaluate the nature of the subject matter tested by others;
- Evaluate the competence and objectivity of the individuals who performed the work; and
- Test some of the work performed by others to evaluate the quality and effectiveness of their work

I agree with need for the auditor's evaluation of the work performed; however I think the statement above is too general and can lead to some ambiguity in the interpretation. I believe the last bullet might lead external auditors to retest more than what might be deemed necessary for the auditor to gain comfort as to the quality and effectiveness of the work performed. I would suggest the Board eliminate this ambiguity by addressing the following concerns:

- Is there a way to specify how much of the work the auditor should retest to evaluate the quality and effectiveness of the work? Is it possible to state a percentage of items tested?
- Is there a way to state that this is not necessary throughout the entire year and that once the auditor is comfortable with the quality and effectiveness of the work performed, that continually performing this step is unnecessary?
- Can we capture knowledge that was learned during previous audits, as outlined in the proposed updates to AS No. 02? If the auditor is reasonable comfortable with the quality of the work performed one year, staffing has not changed and the process has not undergone significant changes, should we not be able to gain comfort in the quality and the effectiveness of the work completed without reperformance?

These comments are made on my personal behalf and do not and reflect my personal views only and not of my employer. Thanks

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Sarah E. Smith
Managing Director
Chief Accounting Officer

Goldman Sachs

February 26, 2007

Office of the Secretary
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1666 K Street, N.W.
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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 Proposals

Goldman Sachs supports the Public Company Accounting Oversight Board ("the Board") in its mission to oversee the auditing of public companies, protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports. Therefore, we appreciate the opportunity to comment on the above-referenced standard and proposals.

We support the Board's recent proposals and believe the revised auditing standard will "reinforce the Board's expectation that the integrated audit be conducted in the most efficient manner, while achieving the objectives of the standards" as stated by Chairman Olson. We support the proposed standard's goal of focusing the auditor on the matters most important to internal control on a risk weighted basis and eliminating unnecessary procedures. We believe the Board has also placed appropriate emphasis on the importance of leveraging a broader range of management efforts to maintain a rigorous internal control environment.

We have attached comments that may be helpful to the Board. It is our hope that the Board will consider these comments and finalize the proposed standard expeditiously to afford auditors and management the opportunity to take full advantage of the refinements during the 2007 financial reporting year.

Once again, we appreciate the opportunity to offer our views and we would be happy to meet with you to discuss them in greater detail.

Sincerely,

Sarah Smith

Sarah E. Smith
Chief Accounting Officer
(212) 902-5675

ATTACHMENT: Comments and Concerns

Considering and Using the Work of Others
We support the Board's acknowledgement of public concern regarding the cost and level of effort associated with implementation and on-going compliance with Sarbanes-Oxley Section 404. The proposed standard has addressed the most significant issues by eliminating the requirement of the auditor to evaluate management's process and allowing the auditor to use the work of others. As stated on page 21 of the proposed standard, "When the auditor duplicates high-quality, relevant work that already has been performed by competent and objective individuals, he or she risks increasing effort without enhancing quality." Additionally, by clearly stating that the auditor may use the work of competent and objective individuals to perform an integrated audit, the Board encourages management and the auditor to proactively consider opportunities to achieve efficiencies.

To further promote efficiency and coordination between the auditor and management, we recommend that the Board encourage auditors to engage management directly in identifying specific opportunities for leveraging work executed by or on behalf of management. In instances where the auditor determines he or she cannot rely on the work of management, the auditor should explain why the work could not be utilized, and what changes would be required to the design and execution of related work in the future that would allow use by the auditor in support of the opinion.

Company-Level Controls
Within the list of company-level controls (page A1-11); there is mention of the "controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs." While we agree that the audit committee's role is important in establishing and maintaining a strong control environment, we were surprised by the addition of the requirement to "assess the effectiveness of the audit committee" (A1-31) since this provision was not included in Auditing Standard No. 2. The primary criticism of this provision centered on the auditor's inability to offer an independent opinion of the audit committee since the auditor is hired by and reports into the audit committee. This fundamental issue does not seem to be addressed in the proposed standard.

Use of Benchmarking Audit Technique
Benchmarking of automated controls is a strategy employed by auditors to save time for both management and the auditor as long as there is evidence of proper access to applications, strong program change control, and the ability to verify that no significant changes have been made to the automated controls. We have had success with implementing this strategy and strongly encourage the Board require this for all audit engagements. We would recommend that the Board consider expanding this time-saving technique to other IT-related areas such as user entitlements and application general controls as long as management can display proper change control over these important areas. Considerable audit time is dedicated to IT-related areas and there needs to be a constructive dialogue between management and auditors to reduce complexities and burden related to auditing IT-related areas.

January 2, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 21
Proposed Auditing Standard – *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements And Related Other Proposals*
December 19, 2006

Dear Board Members,

I am submitting my comments to you regarding the above referenced Rulemaking Docket Matter. These are my personal comments and do not necessarily reflect those of my employer. You specifically asked respondents to answer thirty-four (34) questions. I begin with some observations on paragraphs 1 through 15 on page A1–4 to the top of page A1–11.

Par. 1. – The Public Company Accounting Oversight Board ("PCAOB" or "the Board") states the new standard "applies when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting...that is integrated with an audit of the financial statements." [Footnote and boldface type are eliminated.] This introductory paragraph seems to permit an auditor to bifurcate the audits. If the Board truly intends to *require* integration of an audit of internal control over financial statements with financial statement audit procedures, I recommend making a direct statement here. See my comments on paragraph 7 and question 19 below.

Par. 2. – This paragraph concludes with the statement, "A material weakness in internal control over financial reporting may exist even when financial statements are not materially misstated." Later in paragraph 72 on page A1–27, the Board states this again. To someone unfamiliar with auditing and the concept of "reasonable assurance," this must read like an oxymoron. "How," one may ask, "can there be a very serious problem with internal control over how the numbers are reported, but not a problem with the numbers that have been reported?" The Board mentions adjusting financial statement audit procedures beginning on the bottom of page A1–19 in paragraph 46. Let us consider basic safety standards to aid those who may not understand. One may remove oil soaked rags from a pile of paper not because there was a fire, but the *potential* of a fire exists. It appears that this is what the Board is promoting. Nonetheless, management and auditor will have to communicate. The imagination of the auditor will be assessed by management in these cases.

Par. 5. – Whether in this paragraph or another section to follow, I recommend discussion of how multiple locations may have different *specific* controls under a standard framework promulgated by the parent company (corporate headquarters). For example, a large company may provide this broad company-level control: "The VP Finance or Controller is the only person who may open a new bank account. Approval for the new account must be secured from Corporate Treasury." One business unit or division may have only one of those two titles. Therefore, they write their version of the control: "The Controller may open a new bank account when needed after receiving an approved 'Request for New Bank Account' form from the Corporate CFO." The Board may find it helpful to make this paragraph more robust directing the auditor to acquire and test the *local* framework as approved by the corporate powers that be.

Par. 7. – This paragraph is presently written as a *suggestion* by stating that the audit of internal control over financial reporting "should be integrated with" the financial statement audit. Appendix B provides more detailed guidance. I note that paragraph B1 starts with the phrase, "In an integrated audit of internal control over financial reporting and the financial statements..." This again leads to the possibility that these two audits may not be concurrent. See my reply to question 4.

Par. 8. – Integrating the audit guides the auditor in the reverse direction, too. The auditor must assess risk of misstatements on the financial statements. Therefore, the processes that yield the numbers and disclosures surrounding these risk points ought to lead the auditor to assess internal control risk accordingly. This means if Inventory is deemed to be high risk, perhaps more so given the particular client, the internal controls surrounding inventory need to get more attention. The Board hints that stronger internal control may reduce the risk of material misstatement in an area. What is being described here is how internal controls over financial reporting and the financial data produced are integrated by definition; a lattice if you will. Data is entered in the system after passing through a prescribed process. The natural extension of the process requires we retrieve that data to ensure it is accurate. Continuing with the example, a well-controlled process for inventory data input and usage reduces our risk of misstating inventory. The only exposure remaining is the process of inventory valuation. While circular in appearance, the auditor has gone from assessing the risk of a material misstatement of inventory to finding strong controls to reduce that risk. This in turn leads to reduced testing on the financial statement audit. The auditor may opt to spend more time on the internal control audit to ensure this. Overall, the amount spent may go down. If controls are weak, then the auditor needs to broaden procedures on the financial statement side, while spending *less* time on testing internal controls, which may not prevent misstatement of inventory.

Par. 9. – The Board presents this standard as benefiting smaller companies rather than all companies. Why ignore the "accelerated filers," who are ending the third year of compliance with Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX 404"). I agree with scaling the audit of internal control over financial reporting. I recommend that the Board make it clear that everything presented in this standard applies to integrated audits of all companies.

Par. 10. – The fifth bullet point is an indication of *increased* risk in my opinion. Managers with broad control may direct the auditor to assess the overall control environment and company-level controls in greater depth. The familiarity between senior management and company personnel, as mentioned in paragraph 11, may permit a manager to bypass a control–especially when unwritten–without being second guessed by the employee.

Par. 12. – The Board may find it helpful to include discussion in the first bullet point that the lack of client documentation will require the auditor to supplement with their own documentation of what was observed. This leads to more detailed walkthrough documentation. Segregation of duty issues are mentioned in bullet four. A division or business unit of a larger company may face a similar dilemma. In the fifth bullet point the Board writes of control performer competency. Suppose an auditor finds that a person in the accounting department actually has a degree in English (more likely in a small company). If the auditor feels this person is not competent to properly perform the internal controls under his or her purview, how can the auditor trust the numbers produced by the process? The auditor ought to expand testing in this area of the financial statement audit. If the numbers are deemed to be fairly accurate, would this rescind the auditor's premise of a lack of competency? I suggest it does. This premise nicely ties to the Board's later requirements presented in paragraphs 65 through 69. Finally, I suggest the Board add some reference to the use of spreadsheets in the sixth bullet point. Smaller companies may rely heavily on spreadsheets, even with very good software programs available. A small manufacturer may not have an integrated software package that handles job costing and the general ledger simultaneously. Data may have to be extracted from the job costing system, passed through a spreadsheet to yield journal entries, and then be input to the general ledger. The Board may not feel comfortable presenting guidance on how auditors ought to test software and spreadsheet packages. However, coordinating with another organization may be very helpful.

Directing the Auditor's Attention Towards the Most Important Controls

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

   The Board wisely presented detailed information in the order the Board wants the auditor to follow.

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

   Paragraph 31 on page A1–16 is a double-edged sword. To answer this question it clearly instructs the auditor to consider how misstatements occur, most likely due to fraud. See my response to question 3 below.

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

   I wrote above in my response to question 2 that paragraph 31 points the auditor in the direction of fraud detection by asking "what could go wrong?" It has been my experience that auditors asking this question quickly revert to a bottom-up approach. An auditor may want to know how a company prevents a false timesheet from being entered. If the auditor follows the top-down approach, he or she may discover that in order for a timesheet to be entered, the employee has to be entered by Human Resources and the payroll requirements must be entered by Payroll. To wrap the process up in a neat package, a computer-based timekeeping system may prevent an employee from charging an expense or project to which the employee is not assigned. This company-level set of controls mitigates the possibility of a false timesheet being entered especially when combined with supervisory review. It may be harder to prevent fraud where paper timecards may be in use, unless there are fewer employees in one location. Therefore, I recommend cautionary words here directing the auditor to develop tests for fraud and asking "What if" *after* the auditor makes an initial determination of what controls to test.

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?**

I recommend merging the first two sentences in paragraph 16, page A1–11, to read, "A top-down approach to select the controls to test begins at the financial statement level..." Throughout the proposed standard the Board employs the word "should" and does so here regarding the use of a top-down approach. "Should" is the past tense singular of "Shall," and it is also conditional. It is true that more current usage equates "should" with "must." I believe the Board ought to use the word "must" if that is the true intention, as you do in paragraph 19, page A1–12. Lastly, paragraph 22, page A1–13, may include a bullet on period-end due dates, *i.e.*, are they too aggressive leading to exhausted people trying to complete the numbers.

<u>Emphasizing the Importance of Risk Assessment</u>

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?**

On page A1–22, paragraph 53 is very important, and I agree with its premise. The conventional wisdom in place as of this writing is that just one exception causes the entire sample to be spoiled. For instance, if a control is to be tested with a sample of sixty (60) items, and tests are evenly spread throughout the year, if the sixtieth (60^{th}) item is an exception, a new "clean" sample of sixty (60) must be obtained. Perhaps the Board can include a brief discussion of acceptable deviation rates in statistical testing.

Inquiry regarding a control generally confirms what has been learned during the walkthrough. The Board may add to paragraph 55, page A1–22, that inquiry either confirms the control has not changed, or permits the auditor to update walkthrough documentation of a significant process.

Reperformance ought to be used only for high risk controls, especially where the auditor is uncertain as to the skills and competency of the control performer. Management can reduce costs using a similar approach. Would an auditor want to re-perform all bank reconciliations if the performer is deemed to be competent? Management may be able to avoid this as well. This is *not* to say that re-performing a sub-sample is not needed to ensure the reconciliation was correctly performed as presented in control documentation.

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

I advise altering the first sentence in paragraph 36 on page A1–17 to read, "The auditor ~~should~~ must perform a walkthrough for each significant process, and ought to consider performing a walkthrough of other processes to reduce or eliminate testing in those lower risk areas." I hope this sentence captures the Board's intention.

Revising the Definitions of Significant Deficiency and Material Weakness

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?

I am concerned that the use of the word "significant" to describe a process, an account, and a deficiency will be problematic to management, auditors, and courts. We start with a "significant process" to determine what areas provide us with "significant accounts." These numbers and related disclosures have controls surrounding them that management assesses and auditors may also test. Because the Board uses "significant" to describe these areas, and they are important enough to warrant all of this attention, to suggest that a "significant deficiency" ought to be noteworthy, but *not* a major (material) issue may be confusing. Professional judgment is gray enough. I recommend eliminating this middle class deficiency. A deficiency would then be either a "control deficiency" or a "material weakness." Materiality is a number derived by the auditor for both financial statement and internal control over financial statement reporting purposes, therefore less gray.

8. Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or 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?

I commented on paragraph 2 that auditing procedures on the financial statements and internal control over financial reporting form a lattice. I reiterate that one must ask oneself whether a material weakness exists if there is *no* material misstatement. This is especially true where compensating controls are in place. The auditor must document his or her opinion that a material misstatement can occur and communicate this to management. Referring to the example I used in my paragraph 2 comment, the auditor documents evidence that oil soaked rags create small amounts of heat–studies, insurance records, etc. When oil from the rag is absorbed by paper, the amount of heat needed to ignite the paper decreases. Therefore, while no fire has occurred as of this date, the company needs to remove the oily rag and paper to prevent a fire. In SOX 404 parlance, the company needs to match purchase orders, receiving reports and invoices prior to paying a vendor invoice.

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?

In theory the Board's decision to rely upon a definition that has been in the accounting and auditing domain ought to reduce the effort. If the Board eliminates the middle category as suggested in the response to question 7, this may further reduce the effort.

<u>Revising the Strong Indicators of a Material Weakness</u>

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?

It appears the Board will permit an auditor to conclude that no deficiency exists when the fourth bullet point of paragraph 79, page A1–30, exists. It may better serve users of the standard if this item is either placed in a separate paragraph or includes an introductory sentence specifically stating that the auditor may conclude no deficiency necessarily exists if this specific issue is found. In addition, one may argue that the second bullet may not necessarily lead to a deficiency, especially if management identified the misstatement through a new or improved internal control process. It could be that management opted to restate to be consistent with the current year's presentation, which would not necessarily be due to a change from one generally accepted accounting principle to another.

I believe that bullet points one and three are *prima facie* indicators of deficiency. If either of those exists both management and auditor ought to be instructed to report a material weakness.

Bullet point five may be a clear indication of deficiency *especially* for large, complex companies that ought to have an internal audit department. Smaller companies may not have the ability to employ internal audit staff. The Board may be aware that many companies have started to employ personnel strictly for SOX 404 compliance efforts in order to maintain internal audit staff independence. I recommend that the standard include consideration for the size and complexity of the company.

I suggest the Board either eliminate bullet point six or remove the language stating that only complex entities in regulated industries may be deficient due to regulatory compliance efforts. If, for example, a small regional airline company has trouble meeting Federal Aviation Administration ("FAA") requirements, it is more likely the FAA will impose sanctions against them–harming their financial performance. An airline may have a company-level control process regarding maintenance and inspections. One may argue that smaller companies may have a more difficult time meeting requirements, such as workers' compensation insurance, health benefits, sales tax remittance, etc. due to cash flow requirements.

In my response to question 7 above I mention the gray realm of professional judgment. I appreciate the Board's reluctance to impose requirements or draw a bright line for auditors to follow. Having reviewed external audit firms' reports from the Board for 2004 and 2005, it appears the number one issue raised is "insufficient evidence." This is a judgment area. At the time of the audit procedures, the auditor was satisfied with the evidence gathered. Upon further review, and I am assuming that it was PCAOB review because I do not have access to the correspondence, the evidence was deemed lacking. If it is hard enough to determine how much evidence is required to determine that accounts receivable is presented fairly in all material respects, then how can an auditor have confidence that deficiencies are properly categorized? I hope that the Board takes my advice to separate these items in paragraph 79, bottom of page A1–29 to the middle of page A1–32, into one group that may not be a deficiency and another group that are *de facto* deficiencies.

<u>Clarifying the Roles of Materiality and Interim Materiality in the Audit</u>

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

I like the Board's decision to directly tie materiality for financial statement audits to those of internal control over financial reporting. Any further attempt to define or clarify may create more questions.

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 of the scope of the audit?

I have suggested above that "significant deficiency" be removed. Therefore, reference to interim financial statements in the Board's proposed definition in paragraph A12 on page A1–48 would be moot. Regarding paragraph A8 on the previous page, until and unless the Security and Exchange Commission decides that interim (quarterly) financial statements do not expose a registrant and/or registrant's external auditor to legal action, the reference to interim statements ought to be maintained. Even a short-term impact on markets may have a negative affect on investors.

<u>Removing the Requirement to Evaluate Management's Process</u>

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

Absolutely! The requirement for the auditor to assess the competence and objectivity of the internal control over financial reporting tester, reviewer and/or SOX 404 project manager ought to cover this evaluation.

However, the Board counters this in the accompanying proposed standard *Considering and Using the Work of Others in an Audit*. Paragraph 10 of that proposed standard on page A2–5 includes three sub-paragraphs. The first two, a. and b., start with the word "Evaluate." Sub-paragraph c. directs the auditor to "[t]est some of the work performed by others to evaluate the quality and effectiveness of their work." [Underscore added.] The auditor must re-perform management's internal control testing under this guidance. It also depends on what the Board's definition of "some" is. Does the Board mean testing management's work only on high risk company-level controls? Is it the Board's intention to limit the auditor's testing to ten percent (10%) or twenty percent (20%) or twenty-five percent (25%)? The Board may not wish to publish such a bright line. The guidance ought to keep the percentage small (10% to 20%) given that there is a concurrent assessment of competence and objectivity.

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

If the auditor determines that management's personnel are either not competent or not objective to perform testing, the auditor will have to broaden his or her testing for both audits. To re-perform management's testing regardless of competence and objectivity of management personnel is a colossal waste of time and money.

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

I believe it will more clearly communicate the scope and results of the auditor's work. The process starts with the auditor determining the controls to test based upon the rubric presented on pages A1–11 to the top of page A1–20 in paragraphs 16 through 46. If the auditor observes that management has selected the same, or as much as ninety percent (90%) of the same controls to test, the auditor has an indication that management's assessment will be consistent with what the auditor now anticipates finding. With the requirement to assess competence and objectivity in place, the auditor ought to have a solid understanding of management's assessment process without repeating it. In actuality, this encourages *management* to hire competent personnel to perform SOX 404 work, and to compensate personnel in a way to enhance objectivity.

Permitting Consideration of Knowledge Obtained During Previous Audits

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

This proposed standard does appropriately incorporate the value of cumulative knowledge. Benchmarking automated controls will save time for the auditor and management. It will encourage companies to automate as many controls as possible. The Board's inclusion of guidance to the auditors to reflect on prior years' assessment of competency, objectivity, and risk is very helpful. *Can an auditor reduce tests on a high risk control if prior tests are clean without reducing risk to moderate or low?*

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?

Walkthrough procedures may provide sufficient evidence in highly automated areas, as well as processes with highly effective controls that have not been changed. I advise the Board to include wording to instruct the auditor to test high risk controls in these processes to ensure there was no change. One sample item from the population ought to suffice. In addition, by using acquired knowledge of the client's internal control over financial reporting, simple observation may be sufficient for certain controls. An example of this is general ledger account reconciliation, which follows.

The internal control states that the company reconciles balance sheet and related income statement accounts each month within five days of reporting to corporate headquarters (or small company equivalent, such as the Chief Financial Officer). In the past, the auditor has tested 60 such reconciliation packages and found no exceptions. To reduce time and cost the auditor asks management in writing if there have been any changes or enhancements to this process. Upon receiving the written reply from management that there are no changes or enhancements, the auditor looks at the reconciliation packages for the latest period-end in scope. Past experience guides the auditor in knowing what attributes ought to be observed without asking the client for population and copies of the sample. This will also reduce paper and storage costs. Management will store their documentation for future reference, and this will allow subsequent observation or testing if it ever becomes necessary if the auditor properly documents the items and attributes observed. (The auditor may wish to make one copy of this "sample" to include in the work papers. This is still a dramatic reduction in the amount of paper produced in the audit.)

<u>Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage</u>

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 benefits that can be realized with the proposed standard's risk-based approach combined with the proposal on using past experience are numerous. As an example, suppose the auditor obtains the budgets and goals for a large company's various business locations. The auditor sees that a seemingly small office is asked to produce gross profit of forty percent (40%) or more in a given year. This represents a large portion of the overall company's consolidated gross profit. Under AS No. 2's current "coverage approach," audit procedures on financial data and internal control over financial reporting may not have been done for this office. However, the auditor may feel the gross profit percentage to be fairly aggressive. Testing this location seems warranted. In addition, a business location where the local economy has sagged or where a very narrow segment has a high concentration of risk (key customers and/or vendors), more audit attention is needed.

Removing Barriers to Using the Work of Others

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?

This question reflects on my comment regarding paragraph 1 on page A2–3 of the proposed standard. The audits ought to be integrated. The only time that this would not occur is when two external audit firms are engaged as referred to in the note to paragraph 1. Specifically, a scenario where one firm audits internal control over financial reporting while a second audits the financial statement. Even here, however, the Board ought to encourage–even require–synergy between the two firms. For example, an agreement as to the level of materiality would have to be in place.

The fewer frameworks put in place, the better for all parties. By building scalability into the replacement for AS No. 2 the Board has addressed many of the fears smaller publicly traded companies face. I believe that most important facet to this process is integration of the two audits, and the Board ought to clearly require it.

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?

I believe the proposed definition does capture the correct scope of activities. However, the Board limits itself by stating, "Only tests that provide audit evidence may be considered relevant activities." A walkthrough performed by a competent and objective company employee may permit the auditor to rely upon that work for a low or moderate risk process (where the auditor uses three levels of risk). The auditor may also wish to rely upon flow charts of high risk processes to add to his or her walkthrough documentation.

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

I believe it will be helpful, provided those "others" are competent and objective. This can point the auditor towards troubled areas, reducing time spent before fieldwork commences.

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

If the Board truly wants auditors to utilize others' work, the principle evidence provision in paragraph 111 of AS No. 2 must be set aside. The auditor must be permitted to rely upon the evidence derived from others in order for this proposed new standard to work.

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 framework is good, in general. This sentence on page A2–6 in paragraph 13 confuses me: "...[T]he auditor should make judgments about the degree of competence and objectivity of the individuals rather than form an absolute conclusion about whether the individuals are competent and objective." Does the Board intend to remind the auditor that the perception of competence and objectivity may change over time? My comment on introduction paragraph 12 on page 3 of my comment letter provides an example of someone with a degree in English working in an accounting department. Given the guidance in paragraph 13 of this proposed standard, the auditor may at first feel the person has a low level of competence. As testing of controls this person performs progresses–and in light of using what is learned from prior years' work–the auditor may come to believe the person has a higher level of competence. The auditor may also add into the equation the apparent accuracy of the numbers produced by this person. We are still confronted with judgmental terms such as low and high levels.

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

The Board has identified the right factors for assessing competence and objectivity. Other factors I recommend are as follows. I believe the Board ought to include a note that those who perform tests may *not* be trained as auditors, nor even have experience in public accounting and auditing. This is acceptable provided these "testers" are first trained and supervised by an individual who is trained as an auditor–a Certified Public Accountant ("CPA") or Certified Internal Auditor ("CIA") with a current license. The external auditor may want to consider if management's "tester" is asked to test a control the auditor would not him or her self ask a junior member of the external audit team to perform. The theory is that the auditor is loath to ask this team member to perform a function, even though that person has taken courses and is preparing for licensure. How competent is management's "tester" by comparison?

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?

The Board may find it beneficial to include any plan based on company stock as impugning the objectivity whether it is "compensation" or not. This would include a savings plan that may be readily accessed. Conversely, a 401(k) plan that includes company stock may not be accessible until the "tester" reaches a certain age. If it is determined that the "tester" has arranged a loan from the plan, this ought to give pause to the auditor. If management borrows "testers" from within who *do* partake in a stock-based plan of any kind, the auditor may gain comfort if the person specifically hired to manage the SOX 404 project is well compensated in terms of salary *without partaking in* *a stock-based plan*, and holds a professional designation as described in my answer to question 24 above. If "testers" are specifically hired for SOX 404 work, they must not partake in stock-based plans.

Recalibrating the Walkthrough Requirements

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

The Board is attempting to point external auditors towards the top-down, risk-based approach. To this end it is appropriate to guide the auditor to walkthrough the significant processes. This ought to permit the auditor to calibrate his or her initial assessments. The auditor will be able to determine if management has covered all of the financial statement assertions adequately. If the auditor is concerned that another process may be significant afterwards, he or she may look towards management's walkthrough of that process (see my answer to question 27 below).

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 auditor may be able to utilize the work of an internal auditor and/or a person who is employed to perform SOX 404 compliance for the company. The auditor will assess both the competence and objectivity of those persons. I recommend that the Board stipulate that in order for the external auditor to be able to rely upon the walkthrough the person or persons performing or overseeing the work have a professional designation, such as a CPA or CIA.

Scaling the Audit for Smaller Companies

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?

Yes, the proposed standard does describe how auditors ought to scale the audit based upon a company's size and complexity. Smaller companies may not have either an internal audit department with time to perform SOX 404 testing, or the ability to hire personnel to perform this function. There may be a trade off on the external auditors' opportunity to use the work of others. One wonders if scalability is really a reallocation of focus. The auditor may find that more testing ought to be performed on period-end controls because of lacking of segregation of duties. Furthermore, the overall control environment may be "paternalistic" if the founder of the registered company is heavily involved in day-to-day operations. If this is the case and all decisions pass through this person (or family members) then the auditor may have to increase certain tests to gain comfort with the financial statements and internal controls over financial statement reporting.

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

One attribute that the Board ought to consider adding to paragraph 10 on page A1–8 of the proposed standard is "corporate governance." The auditor will have to assess the impact of a Chief Executive Officer who is also Chairman of the Board of Directors. In addition, I recommend that the Board add that the auditor consider if the company's Board of Directors includes family members and/or persons who have been "promoted" to board member. While reducing work for smaller companies is an admirable goal, it is my belief that greater risk exists in smaller companies.

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?

There is an opportunity for the external auditor to adjust the scale of all compliance audits in subsequent years if audit results indicate a healthy internal control environment and test results indicate effectively designed and operating internal controls.

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

I believe that the Board may do well to address scalability to *all* registrant companies, as I mention in my answer to question 30 above. A large company may have many more effective controls in design and operation than a smaller company. The Board ought to "reward" all companies by guiding external auditors to scale down their procedures as the risk of material misstatement is reduced.

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?

According to the footnote (6) on the bottom of page A1–7 there appears to be an emphasis on "aggregate worldwide market value." In order to promote comparability from year to year, I recommend that the Board use a threshold based on the *number* of shares issued and outstanding. The other criterion to consider is how many of those shares are actually publicly traded. Market forces may be too volatile to determine audit scale and scope over time.

Proposed Rule 3525 – *Audit Committee Pre-approval of Services Related to Internal Control*

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 Board's note inserted after paragraph (b) provides a clear case of where such work is not be permitted. It may be useful to require the auditor's submission to the audit committee include the auditor's written discussion why such non-audit service will *not* impair auditor independence. One may also make the argument that this correspondence be mentioned either in management's discussion and analysis ("MD&A"), even though MD&A is not within the scope of SOX 404, or in another disclosure (cash paid to the audit firm for non-audit services, for instance). Ultimately the investing public needs to be protected. Having knowledge that such services are being performed will aid investors in assessing the nature, timing and extent of future cash flows, which is the purpose of financial statements. How much cash is flowing to the external auditor? Is this "fee" enough of an enticement for the auditor to be persuaded in management's favor on significant issues?

Effective Date

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 the decision?

While bringing these new standards on line in 2007 would be fantastic, it is impractical because of the impact of tester objectivity. Many companies have stock plans as a benefit. Many persons may have to withdraw from those plans in order for external auditors to place more reliance on management's testing. This will also alter how those of us in SOX compliance are compensated. It would be unwise to offer a "bonus" to SOX compliance personnel to compensate for not being part of the stock-based plan determined by what would have been earned had they been a participating member. Accelerated filers, who are entering year four compliance efforts, will have to make the compensation adjustments. Competent persons will need to be found by smaller companies whose compliance efforts will be commencing in 2007.

This will also impact external audit firms. Firms will have to devise methods for assessing management's work (competence and objectivity), and/or the work of another external firm performing an audit. Each external firm will also have to adjust the audit teams' strategies to fully integrate the audits.

Unless the SEC can approve these standards before June 1, 2007, they ought to become effective for fiscal years ending on or after December 15, 2007.

In closing, an area of concern for both management and external auditors is documentation requirements. We generally copy original documents to include in work papers. With the introduction of software compliance tools, processes, individual controls, test plans, test results, and documents can be stored electronically. The Board may wish to address this technology within these proposed standards.

Respectfully submitted,

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February 26, 2007

Office of the Secretary
Public Company Accounting Oversight Board
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Via e-mail: comments@pcaobus.org

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*

Dear Board Members and Staff,

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("Board" or "PCAOB") proposed new auditing standard, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements,* (the "proposed standard", or "proposed AS5"). We respectfully submit, in Appendix A, our responses to your questions. Additional comments and suggestions are presented in Appendix B and C.

We are generally supportive of the PCAOB's proposals; however, we have two significant concerns:

1. The tone of the proposed standard appears to establish efficiency as an auditing standard. We recognize the need to perform audits that are both efficient and effective; however, efficiency should not be a factor in determining whether the auditor performed sufficient audit procedures, or whether the auditor has complied with PCAOB standards.

2. The new proposed standard, *Considering and Using the Work of Others in an Audit,* may be interpreted by some to remove auditor judgment from necessary determinations regarding this subject. We believe it is important for the auditor to be able to exercise judgment related to the use of the work of others. The existing auditing standard related to this topic—namely AU Section 322—is well understood by auditors and has operated effectively since its adoption in 1991. Accordingly, while the related guidance in the proposed AS5 is useful, we do not believe a new auditing standard covering the use of the work of others is necessary.

We would be pleased to discuss our comments with you. If you have any questions, please contact Mr. John L. Archambault, Managing Partner of Professional Standards, at (312) 602-8701, or Mr. R. Trent Gazzaway, Managing Partner of Corporate Governance, at
(704) 632-6834.

Very truly yours,

Grant Thornton LLP

Grant Thornton LLP

February 26, 2007

Appendix A – Responses to Questions

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

   Except as otherwise expressed herein, the proposed standard clearly articulates the need to use a top-down, risk-based approach to auditing internal control over financial reporting (ICFR). In addition, the proposed standard provides useful factors to consider in conducting such an audit. However, it is important to note that the variables influencing a top-down, risk-based approach are highly judgmental in nature and will vary from company to company. In addition, the top-down, risk-based approach will become more refined as auditors, as well as management, perform more evaluations of ICFR.

   The goal of encouraging auditors to use more judgment in their audits is laudable; however, the goal should not be achieved at the expense of audit quality. Additional guidance regarding how to apply judgment in a top-down, risk-based approach would help the consistency and quality of audits. The guidance could incorporate some of the concepts that currently exist in Auditing Standard (AS) No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, but have been removed from the proposed standard. The guidance could also incorporate much of the valuable guidance contained in the PCAOB Staff Question and Answer documents which may not already be incorporated into the proposed standard.

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 does place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud ("fraud controls"). As referenced in the proposed standard, this same emphasis is included in AU Section 316, *Consideration of Fraud in a Financial Statement Audit*.

   Paragraph 44 of AU Section 316 provides some guidance on the types of fraud controls, which include (a) specific controls designed to mitigate particular risks of fraud, such as controls to address certain assets susceptible to misappropriation, and (b) broader programs designed to prevent, deter and detect fraud, such as programs to promote a culture of honesty and ethical behavior. The final standard should be clear as to what constitutes fraud controls that should be covered by the evaluation of ICFR. It is our experience that nearly all controls have some role in the prevention or detection of fraud; however, there are very few controls that are specifically designed to prevent or detect fraud. Yet the words and prominence given to the concept of fraud controls in the proposed standard makes one believe there are many such controls.

   In addition, we believe it would be helpful to clearly articulate that the primary responsibility for the deterrence and detection of fraud rests with management, the audit committee and the board of directors.

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

   A top-down, risk-based approach, if properly and consistently applied, will appropriately focus the auditor's attention on the most important controls. However, as indicated in our response to the following question, the practical application of the concept of a "top-down, risk-based approach" is not consistently understood in the marketplace today. Many people believe the concept refers to the near-exclusive reliance on certain company-level controls—namely the monitoring of the results of operations and self-assessment activities. Both of these elements are important to an effective system of internal control; however, they rarely form adequate support on their own for management's or the auditor's conclusions regarding the effectiveness of ICFR.

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?

The proposed standard properly highlights the importance of company-level controls and their potential effect on the auditor's work. However, our experience has shown that companies rarely have company-level controls that operate at a sufficient level of precision to cause the auditor to reduce testing at the process level.

Page 6 of the release states: "In a top-down approach, if company-level controls are strong and link directly to the process-level controls, or if they are sufficiently precise to prevent or detect material misstatements to relevant assertions, the auditor will likely be able to reduce the testing of controls at the process level." The proposed standard should more clearly articulate what constitutes "link directly," "strong" and "sufficiently precise." Examples of company-level controls that do and do not meet those expectations should also be provided in the form of guidance.

As noted in our response to Question No. 3, many believe the term "company-level controls" refers to the near-exclusive reliance on controls to monitor results of operations and self-assessment activities. Monitoring the results of operations can sometimes indicate if a significant problem has occurred, but it cannot normally, on its own, provide reasonable assurance that such a problem could not occur and remain undetected. Likewise, self-assessments establish accountability and provide some evidence that controls are operating as intended, but they lack the necessary objectivity to provide all the support necessary over long periods of time. In reality, both elements more effectively provide interim support for a conclusion regarding control effectiveness between periodic, separate control evaluations. The length of time between, and the intensity of, these separate evaluations will be dependent on the level of risk and the strength of the evidence gathered during the interim periods.

Both the PCAOB and the SEC should clarify the benefits and limits of company-level controls in forming an opinion about the effectiveness of a system of internal control over financial reporting—recognizing that many risks are manifest at the transaction level and must be both controlled and evaluated at that level. To the extent that management effectively monitors important internal controls (consistent with the intent of the monitoring component of the COSO Framework[1]), those procedures may be the primary controls the auditor determines should be tested in connection with the audit of ICFR. This determination should be based on an appropriate risk assessment.

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?

The proposed standard appropriately highlights the importance of risk assessment and the relationship between risk and the evidence necessary to support an audit opinion. However, there is presently a lack of effective guidance, both in the proposed standard and in the marketplace, to support a consistently applied risk assessment methodology.

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[1] "COSO Framework" refers to the Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control – Integrated Framework* issued in 1992.

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

When the risk that a material weakness could exist in a particular area is assessed as unlikely, we agree that a walkthrough could be an appropriate response to the identified risk without further work. However, the term “lower-risk controls” will create confusion in some cases.

The term “lower-risk controls” is different for an audit of internal control versus a financial statement audit. In an audit of internal control, as the risk associated with a control decreases, the evidence to be obtained also decreases (paragraph 51 of the proposed standard). In an audit of financial statements, however, the lower the assessed control risk, the more testing would be required to support the control risk assessment. Obviously, “low control risk” differs from “lower-risk controls”; however, the potential for confusion remains.

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 term “significant” is generally understood, but still is not sufficiently defined to ensure that its use in practice will be consistent. Absent additional guidance, the change in the definition is very likely to increase the debate and tension between auditors and management regarding the classification of certain deficiencies, and will create a perception that the bar has been raised, when we understand such is not the intent. Further, we are not convinced that evaluations by auditors using the current terminology have been at a lower threshold than the Board intended. Stated differently, we believe that items previously reported as significant deficiencies would, and should, remain significant deficiencies under the proposed definition.

We suggest maintaining the existing definition and incorporating the guidance on this matter from the Staff Questions and Answers, which was helpful in clarifying the appropriate “threshold.” The PCAOB could also define “more than inconsequential” in much the way it has defined a significant misstatement: “A misstatement that is more than inconsequential is a misstatement that is less than material yet important enough to merit the attention by those responsible for oversight of the company’s financial reporting.” This would be consistent with the term’s current interpretation.

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?

Some commenters have concluded that too many material weaknesses are identified only after a problem has occurred, rather than before. These conclusions are generally based on analyses of the number of companies disclosing material weaknesses at the same time they disclose a restatement. However, it is important to note that the financial reporting profession, including the auditing profession, is still in the relatively early stages of assessing and auditing ICFR. The increased focus on the quality of the financial reporting process over the last few years has resulted in both the identification of material weaknesses and the identification of necessary restatements. As both companies and auditors become more adept at evaluating ICFR, we believe restatements will decline, and their respective abilities to proactively identify material weaknesses will increase, as will the efficiency with which they do so.

Further, the design and evaluation of internal control is based on reasonable assurance, not absolute assurance. The nature and extent of misstatements that could occur are virtually endless. Thus, a proper assessment of what reasonably could be misstated, how it could be misstated, and whether the identified controls would be effective leave open the possibility that material misstatements will occur even in companies for which controls are well designed and operating at a level of reasonable assurance.

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?

   Except as previously indicated with regard to using the term “significant” in lieu of “more than inconsequential,” the proposed changes to the definitions of significant deficiency and material weakness will improve the communication of deficiencies between auditors and management. This fact alone will improve the efficiency of the audit process. However, there must be a mutual understanding that the proposed changes will not dramatically affect the audit methodologies and scopes of auditors who previously interpreted the related definitions in accordance with the Staff Questions and Answers.

   The proposed change from the term “more than remote likelihood” to “reasonable possibility” merely formalizes guidance previously issued by the PCAOB[2]. Accordingly, any auditor that correctly interpreted the term “more the remote likelihood” will apply that same definition under the proposed standard.

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?

    The standard should allow that no material weakness exists when one of the strong indicators is present. We are not aware of any instances in which the presence of a strong indicator does not indicate at least a control deficiency. The strong indicators of significant deficiencies and material weaknesses present in AS No. 2 and the proposed standard provide consistency in the analysis and communication of some of the most significant forms of control deficiencies. It is important to recognize that there are rare instances in which these indicators may exist, and yet a reasonable person would conclude that no material weakness in fact exists. We agree with allowing judgment based on the circumstances of the engagement, but we believe the proposed standard should be clear that—when a “strong indicator” of a material weakness is present—there is a rebuttable presumption that a material weakness is present.

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

    Auditors should be able to apply the guidance provided in the proposed standard to achieve an effective audit while avoiding unnecessary testing. We would like to note, however, that throughout the proposed standard, there are requirements that seem to be based on the efficiency of the audit rather than its effectiveness. Although efficiency is necessary, it should not be a factor in determining whether the auditor performed sufficient audit procedures or whether the auditor has complied with PCAOB standards. Accordingly, we urge the Board to reconsider the use of the words “should” and “must” for appropriateness and necessity throughout the proposed standard where such terms might imply that the auditor should sacrifice necessary audit quality for the sake of efficiency.

    It is also worth noting that the success of improving efficiency while maintaining audit quality will occur only if the inspection process is consistent with the concepts in the proposed standard.

[2] See the November 30, 2005, PCAOB Report on AS2 Implementation, page 4.

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 reference to interim financial statements should be removed from the definition. The requirement under the Sarbanes-Oxley Act of 2002 ("SOX") is that management make an assertion, and that the external auditor audit, whether internal control over financial reporting is effective as of a specific day each year—the end of the most recent fiscal year of the issuer. The reference to the impact of deficiencies on interim financial statements is both confusing and inconsistent with the law.

While AICPA attestation standards in effect at the passage of SOX and the issuance of AS No. 2 allow for the option of reporting on controls that were in place during a specified period or on a specified date, the drafters of the law and standard clearly opted for the latter option. References to interim reporting suggest that the financial reporting process for interim financial statements is working at fiscal year-end, that interim financial statements are being prepared and filed with the U.S. Securities and Exchange Commission ("SEC") at fiscal year-end, and that the internal control over preparation of interim financial statements is in operation and subject to testing at fiscal year-end, when none of these things is true.

The removal of the reference to interim financial statements will improve the efficiency of communications between management and auditors regarding control deficiencies, but it will not impact the scope of the audit. Question #32 of the PCAOB's November 22, 2004, *Staff Question and Answer* document has already clarified that the reference to interim periods in the definition of significant deficiency and material weakness does not have any effect on either the scope or timing of the auditor's procedures in an audit of internal control over financial reporting.

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

We understand that some auditors were performing detailed testing solely to conclude on management's assessment process, with the assumption that the auditor's opinion related to management's process, not its assessment (or assertion). To the extent that auditors were conducting unnecessary tests on management's process under AS No. 2, the proposed revision will eliminate unnecessary audit work. However, we believe most auditors did not perform unnecessary testing on management's process and will not be eliminating audit work as a result of this specific change.

Further, the auditor must evaluate and test management's monitoring of controls in his or her audit of ICFR. Therefore, while an ineffective management process for assessing ICFR may no longer result in a disclaimer of opinion, the PCAOB (and the SEC) should clarify that an ineffective monitoring of controls would be a strong indicator that one or more material weaknesses in ICFR exist.

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

See our response to Question No. 13 above.

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 the existing opinion clearly articulates the results and scope of the auditor's work by expressing an opinion directly on the effectiveness of internal control and expressing an opinion on management's assessment (or assertion) about internal control effectiveness. The primary vehicle through which auditors formed an opinion on management's assessment was their audit of ICFR.

We acknowledge, however, that the revision to the reporting model will assist the individuals that previously misinterpreted the opinion on management's assessment.

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

The proposed standard does appropriately incorporate the value of cumulative knowledge. We agree with incorporating the guidance on benchmarking for automated application controls, which we believe has provided, and will continue to provide, for an effective and efficient audit.

It would be helpful, however, to clarify the guidance in paragraph 67 of the proposed standard, which states, "After taking into account the risk factors identified in paragraphs 52 and 66, the lower the risk associated with a control, the less evidence that the auditor needs to obtain in the subsequent year's audits." We believe this statement may be interpreted to permit rotational testing based on the assumption that controls were effective in the prior year, which would represent indirect reliance on the design and operating effectiveness of controls in prior years. If that is the PCAOB's intent, it should be clarified.

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 our response to Question No. 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?

We have previously commented on the need to modify the multi-location testing requirements, particularly relative to organizations that have a large number of homogeneous locations. Although the proposed standard allows for an appropriate risk-based focus on testing, the implications of eliminating completely the concept of coverage could have very serious negative consequences. The concept of coverage is fundamental to the evaluation of ICFR effectiveness. Other than Appendix B of AS No. 2, no guidance exists in this area.

Some may interpret the PCAOB's position on this matter as allowing an auditor to test locations representing less than 50% of a company's consolidated financial statements. Such an approach may be appropriate in limited circumstances, such as with an organization with a large number of homogeneous locations, but those instances would be rare. The proposed standard should make it clear that the auditor is responsible for conducting an audit of sufficient scope, and that coverage is often an appropriate consideration in the risk assessment process. It would also be helpful to incorporate, as guidance, the concepts in AS No. 2.

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?

Although a single framework for using the work of others could be appropriate for both an integrated audit and an audit of only financial statements, we do not believe the proposed standard, *Considering and Using the Work of Others in an Audit,* is necessary. Our specific concerns are expressed below and in our responses to Questions No. 20 to No. 25.

Existing AU Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, recognizes that, in accordance with The Institute of Internal Auditors'

Standards for the Professional Practice of Internal Auditing, internal auditing is an independent appraisal function that requires internal auditors to be independent of the activities they audit. In an integrated audit and an audit of only financial statements, AU Section 322 and the proposed standard are appropriate and clear.

However, the proposed standard expands the auditor's considerations to using the work of other company personnel, as well as third parties working under the direction of management or the audit committee. Ordinarily, such third parties represent members of the accounting and auditing profession, and they also adhere to certain professional and ethical standards relating to objectivity. Accordingly, the use of their work would be appropriate, mostly as it relates to ICFR. With regard to non-internal audit company personnel, however, it may be very difficult for the auditor to overcome the hurdle of objectivity. For such individuals, it would be helpful to clarify that this would include company personnel that perform functions similar to those of internal audit and that it would not include the work of non-internal audit company personnel performed in the ordinarily course of business.

Although AS No. 2 currently allows for the use of the work of others, which includes non-internal audit company personnel and third parties, we believe the standard has been broadened to not only consider their work as it relates to ICFR, but also their work as it relates to evidence (not direct evidence, as indicated in our response to Question No. 21) about potential misstatements. This broadening of the standard—combined with the removal of the principal evidence provision—could result in inappropriate use of the work of others, resulting in an ineffective audit. We believe it is important for the auditor to be able to exercise judgment related to the use of the work of others.

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?

The proposed definition of "relevant activities" is, for the most part, consistent with the description of relevant activities in AU Section 322 and, therefore, should be understood consistently by auditors. However, based on this question, the PCAOB's intent is unclear with regard to whether the definition encompasses activities that are part of the monitoring component of internal control. As indicated in our response to Question No. 4, many people believe that the monitoring component of internal control is limited to reviewing the results of operations and monitoring self-assessments. More guidance is needed in this area to better define what effective monitoring is, and how the auditor might use the work of others who perform effective monitoring.

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

Requiring the auditor to understand whether relevant activities performed by others identified control deficiencies, fraud or financial statement misstatements is appropriate and consistent with current practice. Such information assists the auditor in performing risk assessments and other audit procedures. However, the proposed definition modifies the level of evidence that AU Section 322 indicates a "relevant activity" would need to provide related to potential misstatements. AU Section 322.07 indicates that such activities provide "direct evidence" about potential misstatements, while the proposed standard only indicates the need for a relevant activity to provide "evidence." If the difference is intentional, the proposed standard should indicate the intended impact. If the difference is unintentional, the proposed standard should be conformed to the AU Section 322 definition.

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

    The principal evidence provision in AS No. 2 formally stated a concept that has always been true in auditing: namely, that the auditor's own work should form the primary basis for his or her opinion. This is similar to the concept in AU Section 543, *Part of Audit Performed by Other Independent Auditors*, where the auditor determines whether his or her own participation in the audit is sufficient to enable him or her to serve as the principal auditor and to report on the financial statements.

    We understand that the "principal evidence" language was removed out of concern that, as a result of its presence in AS No. 2, some auditors were not using enough of the work of others. However, elimination of the words implies elimination of the concept. Some companies may believe that the auditor could and should use much more, even a majority, of the work of others than what would be permitted under professional standards to support both the financial statement and internal control opinions.

    Accordingly, removing this language will cause additional tension and misperception in the marketplace. Although this exact language need not be used, the concept should be clear that, because the auditor is solely responsible for his or her opinion, his or her own work must be sufficient to enable him or her to report on the financial statements and on internal control. We believe the best approach in avoiding confusion is to retain the principal evidence provision that is in AS No. 2.

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 proposed standard provides an appropriate framework for evaluating the competence and objectivity of others. The proposed standard should also highlight that the substance of objectivity is often more important than the form. For example, a director of internal audit may report functionally to the audit committee, but may be significantly restricted in substance by management in terms of his or her ability to operate freely and properly. Conversely, an internal audit director may report functionally to the chief financial officer, yet have open and frequent access to the audit committee and have the necessary autonomy to properly perform internal audit duties. The proposed standard should highlight the importance of these judgments.

    Further, the guidance on evaluating objectivity is even more important with regard to company personnel (other than internal audit). It may help to provide an example of these individuals and how the auditor might deem them to be objective.

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

    See our response to Question No. 23.

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?

    How individuals are compensated often has a direct bearing on their objectivity. For example, it would be inappropriate for internal audit personnel to have a significant portion of their compensation linked to stock options or stock price. It is therefore appropriate to include compensation arrangements as a factor in evaluating objectivity, as long as allowances are made for reasonable compensation.

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

Walkthroughs provide the auditor with audit evidence to support his or her understanding of the process flow of transactions, the design of controls, and whether controls are in operation. Accordingly, it is appropriate to require a walkthrough only for all significant processes instead of for each major class of transactions. We believe this will reduce the number of walkthroughs, without impairing audit quality. It will not, and should not, impact the detail of walkthroughs that are performed.

We suggest, however, that the proposed standard incorporate, as guidance, the inquiries in AS No. 2 that could be performed during walkthrough procedures. This guidance would help maintain the quality of the walkthrough procedures.

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?

It is appropriate for the auditor to use others, such as internal audit or a similar compliance function, as direct assistance in performing walkthroughs as long as those individuals are competent, objective and directly supervised by the auditor.

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?

Paragraphs 9 through 12 of the proposed standard provide helpful guidance on matters relating to size and complexity that would ordinarily impact the auditor's risk assessments, overall audit strategy, and audit procedures to address specific risks. However, the tone of this guidance appears to favor less audit work for smaller companies rather than for companies with less risk. It is not always the case that smaller companies pose less risk, and in many instances, smaller companies pose greater risks.

Much of the guidance provided in these paragraphs could be equally applied to companies of all sizes and complexities. The matters discussed might have a pervasive effect on the audit or might impact only a particular area of the audit. It is critical that the proposed standard be revised to reflect this and also to focus on effectiveness rather than efficiency. Accordingly, we recommend removing the references (in paragraph 9 and in footnote 6 of the proposed standard) to the SEC's Advisory Committee on Smaller Public Companies' final report, which sets potentially unrealistic expectations regarding the audit effort required for companies of specific sizes.

We believe an audit guide would be the most appropriate form of guidance to discuss specific matters relating to size and complexity. An audit standard should contain only the basic principles for performing an effective audit. The top-down, risk-based approach is the basic principle that encompasses the concepts of size and complexity. This would be similar to the approach used by COSO. The COSO Framework contains the basic principles; the COSO Guidance for Smaller Public Companies then drills down on the application of the basic principles.

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

    See our response to Question No. 28 above.

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?

    See our response to Question No. 28 above.

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

    It is important that companies and auditors recognize that small is not necessarily equivalent to being low-risk. Small companies that enter into complex transactions must be prepared to account for them correctly. Likewise, the auditor needs to appropriately consider the element of complexity in his or her risk assessment process.

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?

    Establishing any set of thresholds for measuring the size of a company can never capture all the variables that might reasonably impact the auditor's methodology and the risks associated with the particular company. Over-emphasis of the threshold runs the risk of implying that the auditor should dramatically change the scope of his or her audit based on the tripping of some artificial triggers. Auditors should be encouraged to strongly consider such factors as market capitalization and total revenue in their risk assessments, but the establishment of a set of cutoff points will only add confusion to the risk assessment process. Therefore, as noted in our response to Question No. 28 above, we believe those references should be removed from the proposed standard.

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 proposed standard provides an effective list of information the auditor should provide to the audit committee during the pre-approval process.

34. How can the Board structure the effective date so as to best minimize disruption to ongoing 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 most part, the proposed standard incorporates previously issued guidance, which has already been adopted in many audit methodologies. Most audit firms have already completed modifications to their audit software, methodologies and training in preparation for the 2007 audit year. While it may be possible for some non-technical changes to be made at this point, such as the increased allowance for the use of the work of others, other changes may take more time. As such, it would be appropriate to make the final standards effective for audits of fiscal years ending on or after June 30, 2008, with early adoption permitted.

February 26, 2007

Appendix B – Specific Paragraph-level Comments

The following describes additional concerns and offers other comments and suggestions relating to specific paragraphs.

- **Paragraph 3 –** The last sentence of this paragraph indirectly implies that the auditor does not need to perform tests of controls himself or herself and could simply use the work of others to obtain evidence. Accordingly, in this sentence, we suggest replacing the "or" with an "and." In addition, we suggest deleting the word "only" in the Note to this paragraph. This term relates to audit efficiency, not effectiveness. It also causes confusion with regard to procedures performed for areas of low risk. Further, it is inconsistent with the language in paragraph 41.

- **Paragraphs 21 and 22 –** These paragraphs also refer to quarterly financial statements. We suggest the Board clarify the auditor's requirements in this area.

- **Paragraph 24 –** We do not agree with the Board's use of such phrases as "should start" in an auditing standard, as they go to efficiency and audit methodology and do not relate to the basic principles governing an audit.

- **Paragraph 58 –** This paragraph states, "The auditor's testing of the operating effectiveness of controls should occur at the time the controls are operating." We believe this should be revised, as it imposes a requirement to only test operating effectiveness when the controls are operating. Operating effectiveness could be tested at other times, provided there is documentary evidence of the control operation.

- **Paragraph 87 –** We suggest clarifying the Board's intent with regard to the use of the phrase "prior to the issuance of the auditor's report." To eliminate confusion, we suggest the Board use phrases such as "prior to the report date" or "prior to the report release date," as these terms are better understood in current practice.

- **Paragraph 94(c) –** It is unclear as to what is meant by an "identification of management's assessment" and how that differs from the language in (b), an "identification of management's conclusion." We believe the former might refer to the scope of internal control over financial reporting covered by management's assessment. However, some clarification on this point would be helpful.

- **Other –** As indicated in our letter, there are many requirements dealing with efficiency rather than effectiveness. In addition, there are certain other requirements that appear to be statements of fact rather than auditor actions. The specific paragraphs on which we believe the Board should focus for appropriateness include: paragraphs 8, 9, 10, 11, 12, 25, 27, 43, 56, 75, and B14. These paragraphs include matters that may be duplicated in, or covered by, other requirements. When considering these paragraphs, we urge the Board to consider the relationship to the documentation requirements in AS No. 3, *Audit Documentation*.

Appendix C – Other Recommendations

The following represent other recommendations. Unless otherwise indicated, suggested new language is shown in boldface; double strikethroughs suggest deletions.

- **Paragraph 7 –** We suggest the following revisions: "The audit of internal control over financial reporting ~~should~~ **must** be integrated with the audit of the financial statements. The objectives of the audits are not identical; however, ~~and~~ the auditor ~~must~~ **should** plan and perform the work to achieve the objectives of both audits."

- **Paragraph 17 –** We suggest the following revisions: **"**The auditor's evaluation of company-level controls can result in increasing or decreasing the testing that the auditor ~~otherwise would have performed~~ **performs** on controls at the process, transaction, or application levels."

- **Paragraph 30 –** Because this is a requirement, we suggest adding a footnote that would permit the auditor to use assertions that are similar to those listed. Certain auditors may have adopted the expanded list of assertions developed by the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants.

- **Paragraphs 47 and 48 –** In the first sentence of each of these paragraphs, we suggest replacing the word "test" with the word "evaluate."

- **Paragraph 51 –** In the first sentence, we suggest replacing the phrase "would result" with the term "exists."

- **Paragraph 62 (1st bullet) –** We suggest replacing the phrase "must be" with the word "are."

- **Paragraph 76 –** Compensating controls may or may not have been tested by the auditor. It would be helpful to clarify the auditor's requirements for testing compensating controls when trying to rule out whether the deficiency is a significant deficiency or a material weakness.

- **Paragraph 84(f) –** The audit of internal control over financial reporting is integrated with the audit of the financial statements. Accordingly, the representations regarding fraud should be consistent. Please consider whether modifications should be made to this paragraph or AU Section 333, *Management Representations.*

- **Paragraph 102 –** We believe the reference in the Note to paragraph 100 should be to paragraph 97 instead.

- **Paragraph 103 –** We believe the Note that is included in paragraph 102 would also apply to this paragraph.

- **Paragraph B4 –** We recommend conforming the second sentence to the first sentence in paragraph 3.

- **Paragraph B11 –** We suggest clarifying the auditor's requirement in the last sentence. The phrase "should inform" is unclear.

GREATER BOSTON CHAMBER
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February 21, 2007

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

Re: Docket Matter No. 021

To Whom It May Concern:

The Greater Boston Chamber of Commerce appreciates the publication of the Public Company Accounting Oversight Board (PCAOB) proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and hereby submits comments on this proposal. The Chamber support efforts on the part of PCAOB to help improve the reliability, efficiency and cost-effectiveness of audits conducted in connection with Section 404 compliance.

Sarbanes-Oxley has had a significant positive impact on corporate governance since its enactment, yet reform is still needed in the area of compliance with the internal control provisions of the Act. The provisions of the PCAOB proposed auditing standard, complemented by the Securities and Exchange Commission's proposed interpretive guidance for management, could contribute to a more top-down, risk based, scalable approach to evaluations and audits of internal control over financial reporting. Implementation of these proposals could substantially reduce undue expenses incurred and inefficiencies experienced in complying with Sarbanes-Oxley, while ensuring that auditors and management alike feel comfortable using good judgment and common sense without fear of liability.

Smaller public companies could particularly benefit from the scalability built into these proposals, enabling these innovative companies to focus more of their time and resources on creating jobs, attracting new capital, and driving the types of innovation that are fundamental to succeeding in the global marketplace. The Chamber believes these proposed reforms will yield benefits for public companies, investors and U.S. capital markets alike.

The Chamber is encouraged by the PCAOB's continuing efforts to enhance auditing standards and provide auditors and public companies with the necessary guidance and framework to improve corporate governance in a more efficient and cost-effective manner. Thank you for this opportunity to submit comments on this important economic issue.

Sincerely,

Paul Guzzi

Paul Guzzi
President and CEO

From: Larry Hightower, CPA [mailto:LHighto831@comcast.net]
Sent: Monday, February 26, 2007 5:08 PM
To: Comments
Subject: FW: PCAOB Rulemaking Docket Matter No. 021

From: Larry Hightower, CPA [mailto:LHighto831@comcast.net]
Sent: Monday, February 26, 2007 4:59 PM
To: 'comments@pcaobus.or'
Subject: PCAOB Rulemaking Docket Matter No. 021

Laura Phillips
Deputy Chief Auditor
Public Company Accounting Oversight Board
1666 K Street
Washington, D.C. 20006

SUBJECT: Comments on PCAOB Proposed Auditing Standard 5

Dear Ms. Phillips:

I have reviewed ***PCAOB Proposed Auditing Standard 5.*** Please review the following comments which are referenced to the noted subdivisions in the draft document. I hope that my comments contribute to the discussion, debate and release of a standard that promotes accurate, timely and transparent financial reports that allocate the most capital, at the best rates, to those firms that are adding genuine economic value to its beginning capitalization.
Very Truly Yours,

Larry Hightower, CPA
20217 Briarcliff
Detroit, Michigan 48221
(313) 345-3876

Comments on Public Company Accounting Oversight Board Proposed Auditing Standard 5

II. Significant Changes to the Standard (Page 4)

The Board decided to propose a new standard on auditing internal control rather than revise **PCAOB Auditing Standard 2**. Unless, **AS 2** was irretrievably flawed in all significant areas, it would have been better to revise **AS 2** to address legitimate concerns about auditing effectiveness, efficiency and cost.

2. **Emphasizing the Importance of Risk Assessment (Page 7 and 8)**

> In **Paragraph one**, under this caption, it is stated that "From the auditor's initial evaluation of material risk at the company level, the auditor should continually adjust his or her procedures to reflect information that the auditor has learned, including experiences from both the audit of internal control and the audit of the financial statements."

My question on the above excerpt is this: material to what? Can a “material weakness” be assessed at the company level? As I will discuss later, the word “material” implies a dollar threshold which further implies an assessment at the financial statement, account and transaction level.

In **Paragraph four**, the statement “In contrast, the proposed standard directs the auditor to consider the results of substantive audit procedures performed in the financial statement audit when determining the overall risk related to a control” appears to be backwards. The risk associated with a control determines the nature of substantive testing. In other words, the higher the level of risk associated with a control (i.e. lack of approvals of large expenditures could lead to errors or fraud), the more substantive testing that needs to be done to ensure that an account balance is accurate

Page 9 – In **Paragraph one**, the sentence “The Board believes that the existing framework in **AS No. 2**, which describes significant deficiencies and material weaknesses by reference to the likelihood and magnitude of a potential misstatement, is fundamentally sound” is probably the main reason for all of the confusion around this issue. For example, **Webster’s** Dictionary defines the adjective ***significant*** as “important’. Webster’s defines the word ***material*** as “having real importance or great consequences”.

So, it should be clear that significant deficiency and material weakness describe the same thing, even in the context of financial auditing. The Board needs to drop, not re-articulate the term ***significant deficiency***. The statement in **Paragraph two**, on **Page 10**, that “the Board is, therefore, proposing to re-articulate the definition of significant deficiency to better establish the threshold of what the Board believes is important enough to be identified as a significant deficiency” is a good example of why the term should be eliminated.

The issue is whether an examination of internal controls reveals deficiencies (i.e. lack of compliance, inadvertent or deliberate errors or omissions) that could impact financial statement accounts in a way that could influence the decisions of users. These would be material deficiencies. Drawing a non-existent distinction between significant deficiencies and material weaknesses is the source of the confusion.

If a “weakness” does not result or cannot result in a material misstatement, is really a material weakness? Also, if a control deficiency is significant (important), then, by definition, it’s material. If it’s not material, then it’s not significant.

Relative to the confusion over thresholds, accounting and audit professionals should not have to split these kinds of hairs (**Page 9, last two sentences in Paragraph two):** “The definitions in **AS 2** refer to a “more than remote likelihood of a misstatement occurring. In accordance with **FASB Statement No. 5**, the likelihood of an event is “more than remote” when it is either “reasonable possible” or “probable”. For example, if a potential misstatement is ***not remote***, then it must be either ***reasonably possible*** or ***probable.***

In the ***21st Century***, where statistical science is not only highly developed, but accessible to even the mathematically challenged via graphing calculators and easy to use PC based software, the Board should consider requiring that management establish and auditors attest to **subjective probabilities** that support the thresholds for the likelihood of material misstatements in financial statements. For example, note the following suggestions:

Remote	0 to 40%
Reasonable Possible	41 to 69
Probable	70 to 95%

These model subjective probabilities could be based on the opinions of experienced people in the company and supported by experts from other companies, industry experts, and other parties. The key point is management is forced to assign subjective probabilities to their estimates of the likelihood of future events that could have a material impact on financial statements.

1. **Removing the Requirement to Evaluate Management's Process (Page 15)**

The statement in **Paragraph two**, "Many commentators have expressed concern over these requirements. Some believe that, under **AS No. 2,** the auditor performs work unnecessary to achieve intended benefits by directly testing controls and evaluating management's evaluation process." My response to this statement is as follows:

The management of a company is responsible for internal control over corporate transactions and the related summary of these transactions in financial statements. Since SEC rules implementing Section 404 of the Act require management to evaluate and report on the effectiveness of internal control, the Act and the professional standards of the Board have to require auditors to examine and issue an opinion on management's review of internal control and the related statements of financial position, results of operations and cash flows.

For some strange reason, this discussion strongly implies that management's review and report on internal control has absolutely nothing to do with the production of financial statements. Unless I'm missing something, management's review of internal control should be the starting point for every annual audit. The auditor should review and test management's assessment of internal control and use the results as a basis for planning the audit.

Note: I have run out of time. I haven't finished my analysis of the AS 5 Proposal, but will send you what I have by the deadline. I will complete my analysis and send in the comments even though it will be after the deadline.

JOHN F. KERRY, MASSACHUSETTS, CHAIRMAN
OLYMPIA J. SNOWE, MAINE, RANKING MEMBER

CARL LEVIN, MICHIGAN
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MARK PRYOR, ARKANSAS
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CHRISTOPHER S. BOND, MISSOURI
NORM COLEMAN, MINNESOTA
DAVID VITTER, LOUISIANA
ELIZABETH DOLE, NORTH CAROLINA
JOHN THUNE, SOUTH DAKOTA
BOB CORKER, TENNESSEE
MICHAEL ENZI, WYOMING
JOHNNY ISAKSON, GEORGIA

NAOMI BAUM, DEMOCRATIC STAFF DIRECTOR
WALLACE HSUEH, REPUBLICAN STAFF DIRECTOR

United States Senate
COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP
WASHINGTON, DC 20510–6350

February 23, 2007

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

The Honorable Mark W. Olson
Chairman
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006

Dear Chairmen Cox and Olson:

Just a few years ago, the trust and confidence of the American people in their financial markets was seriously eroded by the emergence of a series of corporate accounting scandals. The Sarbanes-Oxley Act of 2002 helped restore confidence in our capital markets and increasing accountability to the corporate governance of public companies.

We support the efforts of the U.S. Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) to ease the regulatory burden of Section 404 of the Act by issuing new interpretative guidance on internal controls for small public companies. We believe these final proposals will help to reduce the costs, and the time, that small public companies spend complying with Sarbanes Oxley Act of 2002.

However, as these rules have not yet been finalized, we respectfully request that the implementation date of Section 404 for small public companies be delayed for up to one additional year from the date that both the SEC and the PCAOB issue their final Section 404 guidance. We believe this extension will provide small public companies the appropriate amount of time needed to comply with these new compliance and auditing standards.

If the SEC chooses to defer these implementation dates for an additional year, it is our understanding that calendar year filers would have until the 2008 annual report to file their management internal control reports and until the 2009 annual report to file the auditor's attestation report. This additional time would make it easier for many small businesses to make the transition to the new internal controls requirements.

Additionally, we also request that the SEC and PCAOB carefully consider all comments by small public companies, especially non-accelerated filers, before setting a final implementation date for the new auditing standards. We believe the comments made by small businesses concerning the proposed rules will give the SEC and the PCAOB the best guidance as to the amount of time non-accelerated filers will require to appropriately implement the new compliance and auditing standard.

In making these requests, we acknowledge the SEC's previous postponement of the date by which smaller public companies were required to comply with the Act's internal control reporting requirements. We believe this extension was wise and appreciate the SEC's willingness to respond to the needs of small issuers.

Small public companies are vital participants of U.S. capital markets as well as critical components of future economic growth and high-wage job creation. However, according to a recent United States Government Accounting Office study, the cost of compliance and the time needed for small public companies to comply with the Sarbanes-Oxley regulations has been disproportionately higher than for large public companies.

While most large companies are effectively dealing with Sarbanes-Oxley's changes, many small public companies continue to have difficulties in complying with the Act's moving auditing standards. Published reports show the number of restatements of financial results for large companies declined by approximately 20 percent in 2006. Inversely, small public companies, with assets of less than $75 million, saw the number of restatements increase by 42 percent in 2006. This increase demonstrates the additional costs and burdens small businesses face as they continue to update their internal control processes while they await the final SEC and PCAOB guidance governing these controls.

We urge the SEC to consider giving small public companies this much needed extension. We believe this process will help reduce the costs and increase the attractiveness for small public companies to participate in United States capital markets. Ultimately, our sensitivity to the needs and concerns of smaller public companies will help promote the strength of the U.S. economy and enable dynamic private firms to grow by helping them become thriving, innovative public companies.

Thank you in advance for your consideration of this request.

John F. Kerry
JOHN F. KERRY
Chair

Olympia J. Snowe
OLYMPIA J. SNOWE
Ranking Member

MICHAEL B. ENZI
WYOMING

United States Senate
WASHINGTON, DC 20510

January 17, 2007

The Honorable Mark W. Olson
Chairman
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006-2803

Dear Chairman Olson:

After the passage of the Sarbanes-Oxley Act (the "Act"), the American public has seen the enormous benefits achieved by renewed confidence in our markets. However, these benefits have carried a high price, and many companies have struggled to implement the provisions of the Act, especially Section 404. I have been vocal in the need for company and auditor guidance to help smooth the implementation of Section 404 and reduce costs. I am pleased that the Securities and Exchange Commission (the "SEC") and the Public Company Accounting Oversight Board (the "Board") listened when, late last year, they issued cooperative guidance to help lower the costs of the Act for public companies, especially small public companies.

The SEC and the Board face the tough challenge of balancing efficiency and reliability in company audits. In an effort to find this balance, I am pleased that the Board has decided to take another look at their auditor guidance to find new ways to reduce costs for large and small businesses. I have included more detailed comments on the Board's proposal below.

One of the most important revisions made by the Board, and one of the biggest potential cost-savers, is in the auditor's use of the work of others. This includes company management's own internal control evaluation, as well as past audits. Duplicating control evaluations despite low relative risk multiplies audit costs unnecessarily. Allowing auditors to evaluate and utilize past work would allow them to focus resources on high-risk areas and reduce costs.

One of the biggest ways the Board is promoting this new auditor culture is by removing the "Principle Evidence Provision" from the standard. This will encourage a more cumulative understanding of a company's financial health, as well as help integrate the financial statement audit and the internal control audit.

From an auditor's standpoint, a clear understanding of risk and the severity of a control deficiency is crucial to implementing a top-down audit approach. The Board is encouraging efficiency by clarifying and refining the definition of "material weakness" and "significant deficiency", as they do in Appendix 1, paragraphs 70-79 of the new standard. I have heard several examples of audit costs skyrocketing when auditors are unsure about material weaknesses and abandon a risk-based assessment to chase down problems that are neither significant nor material. These cases can be avoided when auditors are confident in their ability to target the most significant control deficiencies in a company.

The Board correctly recognizes that their changes to Auditing Standard No. 2 hold the most potential benefit for small companies. Since the drafting stages of the Sarbanes-Oxley Act, I have been concerned with the disproportionate impact the law would have on smaller public companies, and those attempting to access the public markets for the first time. In a Government Accountability Office (GAO) report requested by myself and Chairwoman Snowe, these concerns were proved to be well-founded. According to that report, small companies who had implemented section 404 in 2004 paid a median amount of $1.14 in audit fees for every $100 in revenues, compared to only $0.13 per $100 for larger companies. While some of this money was dedicated to the financial statement audit, the internal control audit undoubtedly consumed a large portion of this cost. There is a connection between the size of a company and the functioning of their internal controls and, as shown by this GAO report, small business auditors have not been quick to recognize these differences and modify the scope of their audits accordingly.

Despite these statistics, I am confident that small company audits will become more efficient than in the past due to the Board's emphasis on scalability for small companies. For example, the segregation of duties at a company with 10 employees is necessarily different than those of a 1,000 employee company. Management may be intimately involved in the day-to-day operations of a small company, yet past audits did not reflect that difference. It is crucial that auditors now recognize the unique operations of small business and adapt audits accordingly. It is the Board's responsibility to actively promote this change, even after the new guidance is adopted, to ensure that audit costs do not become prohibitively high for small business.

On a related note, I am pleased that the Board has decided to continue holding their Forums on Auditing in the Small Business Environment. The Board has an exemplary record of reaching out to the accounting community. These forums have helped accountants prepare for internal control audits as well as provided crucial input to the Board on their guidance. As most small business have yet to experience a Section 404 audit, the need for capable small business auditors will only increase as implementation continues.

I am hopeful that the Board's revisions to Auditing Standard No. 2 will significantly reduce costs for public companies, especially smaller public companies with limited resources and those preparing to go public. This is an evolving process, and full implementation has not yet been achieved. But the Sarbanes-Oxley Act has been crucial in protecting the confidence of our public markets, and I am dedicated to ensuring that the American markets remain the gold standard for the world.

Sincerely,

Michael B. Enzi

Michael B. Enzi
U.S. Senator

Philip Broadley
Chairman of The Hundred Group
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Laurence Pountney Hill
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The Hundred Group
of Finance Directors

February 26, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

We would like to thank the Public Company Accounting Oversight Board (the "**PCAOB**") for the opportunity to comment on the issues raised in its proposed Auditing Standards "An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and related other proposals" ("**AS5**") and "Considering and Using the Work of Others in an Audit" ("**AS6**") of December 19, 2006, and we applaud the PCAOB's efforts to facilitate more streamlined compliance with Section 404 of the Sarbanes-Oxley Act of 2002 (the "**Act**") and the rules promulgated thereunder by the Securities and Exchange Commission (the "**Commission**").

By way of introduction, The Hundred Group of Finance Directors (the "**100 Group**") represents the finance directors of Britain's largest companies, mainly but not entirely drawn from the constituents of the FTSE 100 Index of the largest companies by market capitalisation listed on the London Stock Exchange. Almost 40 of our member companies are SEC registrants. We meet periodically to discuss issues affecting major corporations, and selectively respond to governmental and other consultation exercises where we believe that our role in companies and collective experience give us a particular insight into often complex matters.[1]

We acknowledge that Section 404 is designed to improve corporate governance, increase the quality of financial and other disclosure and instill investor confidence in the financial markets. Nevertheless, many market participants and commentators have observed the high cost and burden associated with its implementation. The Commission's "Staff Statement on Management's Report on Internal Control Over Financial Reporting" released on May 16, 2005 and the Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting of July 11, 2006 (the "**Concept Release**") were important steps in trying to ease the application of Section 404. Our group accepted the Commission's invitation to comment on the Concept Release and sent in a letter with our views on the questions posed by the Commission on September 15, 2006. The subsequent Commission release regarding "Management's Report on Internal Control Over Financial Reporting" (the

[1] While this letter expresses the views of The Hundred Group of Finance Directors as a whole, such views are not necessarily those of individual members or their respective employers.

"**Guidance"**) and AS5 and AS6 reflect a number of concerns and suggestions we voiced in our comments, and we applaud both the Commission and the PCAOB for their continuing efforts in this regard.

Following the publication of AS5, AS6 and the Guidance, a number of our member companies who are SEC registrants set out to consider the questions posed in both documents. A response prepared at a workshop was subsequently circulated to all members of the 100 Group who are SEC registrants for further comment. We have appended to this letter the 100 Group's response to the Commission concerning the Guidance. Our comments on AS5 and AS6 and responses to particular questions contained therein are set out below.

- We welcome the Guidance, which contains principle-based guidance for management to fully apply a top-down, risk-based approach to compliance with the Act, enabling management to exercise judgment and expertise in this regard. However, we are concerned that AS5 remains overly prescriptive and does not afford auditors sufficient flexibility to apply their professional judgment in the same fashion as the Guidance permits management to do in its assessment. The outcome of any such divergence between the Guidance and AS5 is likely to be a reduction in the alignment of management's and the auditors' own assessment processes, with a corresponding reduction of the potential benefit of the Guidance on the cost/benefit implications of complying with the Act. We therefore request and encourage the PCAOB to consider revising AS5 to be more principle based in nature and to avoid, where appropriate, prescriptive lists that the auditors "should" or "must" consider when conducting their assessment process.

- We recognize that the spirit of the Guidance and AS5 and AS6 is to reduce the high cost and burden currently incurred by registrants in complying with the Act. We consider the thrust of AS5 and AS6 is to offer potential reductions in those costs and burdens. For example we welcome:

  - the omission of the requirement from the new standard that "each year's audit must stand on its own" (paragraph 2 on page 19 of the Foreword to AS5),
  - the removal of the requirement for the auditor to test controls over a "large portion" of the company (paragraph 3 on page 20 of the Foreword to AS5), and
  - the removal of certain barriers to using the work of others (paragraph 4 on page 21 of the Foreword to AS5).

  However, we await demonstrable evidence of its application by auditors before drawing conclusions on whether an actual reduction in cost and burden will be achieved. As such, we encourage the PCAOB in its inspections of audit firms to consider, as a key performance indicator, the extent to which each audit firm has exploited the opportunities for cost savings and efficiency improvements contained in AS5 and AS6.

- We note the removal of the requirement for auditors to opine on management's evaluation process in complying with the Act, as cited in paragraph B1 on page 14 and at the top of page 17 of the Foreword to AS5, as well as the continued requirement for auditors to opine on the effectiveness of internal control over financial reporting ("**ICFR**") based on their own assessments. We have noted in our response to the Commission that we consider this proposal does not offer the most cost effective outcome in compliance with the Act, believing instead that a requirement for the auditor to provide only an opinion on management's assessment process would produce the most cost effective solution.

- If the current proposal to remove the requirement for auditors to opine on management's evaluation process is adopted, the requirement should be supported by the application of a principle-based, top-down and risk-based framework that permits the auditors to apply professional judgment in the performance of a truly integrated audit of ICFR and the financial statements. As such, we would await the final versions of AS5 and AS6, and also evidence of their application by auditors, before we could conclude on the extent to which retaining the requirement for auditors to opine on the effectiveness of ICFR would reduce the cost and burden to registrants of complying with the Act.

- We welcome the increased flexibility offered in AS6 to auditors to use the work of others in arriving at their own assessment on the effectiveness of ICFR. We request consideration as to whether it would be appropriate for management and the auditors to rely simultaneously upon the work of others in instances where testing of the controls relied upon by the auditors is performed with the direct assistance of others, as permitted by paragraphs 20 and 21 on page A2-8 of AS6.

- There are several differences between the definitions and language used in AS5 and those contained within the Foreword; we expect the planned review processes will ensure the full burden-reducing spirit of the Foreword is reflected in the final form of AS5. For example, on page 12 the Foreword to AS5 permits the application of professional judgment by the auditors in their assessment of uncorrected significant deficiencies, whereas the discussion in paragraph 79 on page A1-29 of AS5 appears to remove their ability to apply that judgment.

- With regard to the use of company-level controls in a top-down approach, we request clarification that paragraphs 17 – 22 on pages A1-11 through A1-13 are for illustrative purposes only and do not constitute a mandatory list of items that <u>must</u> be covered during the audit (which again could be perceived as constraining the use of professional judgment by auditors). We also request that the PCAOB recognise that company-level controls assessed using the control framework adopted by management (and the auditor, as stipulated in paragraph 5 on page A1-5) should be selected based on the risk assessment of material misstatements. Furthermore, we request that the PCAOB acknowledge that the selection and application of different weightings of importance to specific entity-level controls will be unique to each organization and may even vary by location within an organization**.**

- In respect of paragraph 5 on page A1-5, we request that the PCAOB replace the word "should" with "must" in respect of auditors using the same control framework to perform the audit of ICFR as management does.

In addition to the general comments set forth above, we have also prepared responses to specific questions raised in the Foreword to AS5 and AS6 where we felt it appropriate to share our views with the PCAOB.

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

  Yes.

- **Question 7: Is the proposed definition of "significant" sufficiently descriptive to be applied in practice?**

  Yes.

  Does it appropriately describe the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency?

  Yes, but please note our reservations about paragraph 79 on page A1-29 of AS5 set out in the general comments above.

- **Question 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 proper application of these changes by both management and the auditor would result in a reduction in the amount of effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement.

  We encourage the PCOAB to refine the AS5 definitions of materiality to permit the use of more than one measure of materiality, such as in circumstances where there is a disproportionate relationship between a company's income statement and balance sheet.

- **Question 10: Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present?**

  Yes.

  Will this change improve practice by allowing the use of greater judgment?

  Yes.

  Will this change lead to inconsistency in the evaluation of deficiencies?

  We do not consider that the change will lead to an inconsistency in the evaluation of deficiencies. Instead, it should enable the application of expertise and professional judgment in assessing the individual circumstances that will apply in each evaluation.

- **Question 11: Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?**

  We encourage the PCAOB to clarify that the focus of effort and risk assessment is to identify material fraud or potential for material misstatement. The latter is emphasized in a number of places in both the Foreword to AS5 and AS5 itself. We encourage the PCAOB to state clearly that it is only material fraud that should be included in the risk assessment performed during the scoping and evaluation of ICFR.

- **Question 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?**

  Section 404 of the Sarbanes-Oxley Act requires an annual "as of" assessment. We therefore consider it inappropriate to review deficiencies using interim financial statements.

- **Question 13: Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?**

  We believe the potential does exist for some unnecessary audit work to be eliminated by this proposal. However, please see our comments in the general response above.

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

  Yes. However, please see our comments in the general response above.

- **Question 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?**

  As noted on page A-17 of the appended response to the Guidance, we understand the Commission's and the PCAOB's intention to be to remove the requirement for auditors to give an opinion on the effectiveness of management's evaluation of ICFR, but find the expression of this intent in AS5 and the Guidance to be confusing in certain respects. For example, the elimination of this requirement does not appear to be fully reflected in the example report on page A1-38 of AS5. If the current proposal for the role of the auditor is adopted in the final Guidance, we would request that the removal of the requirement for auditors to opine on management's assessment of ICFR in the Foreword to AS5 be clearly reflected in AS5 itself.

- **Question 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?**

  We welcome the removal of the requirement for auditors to test controls over a "large portion" of a company, and await demonstrable evidence of the application by auditors of a truly top-down, risk-based approach in determining the scope of testing in a multi-location engagement.

We request that the Note contained within paragraph B12 on page A1-51 be removed from AS5 as it could potentially encourage auditors to consider risk and materiality at a more stringent level to cover the possibility of material misstatement emerging through aggregation of a number of, in themselves, low-risk or immaterial business units or locations.

- **Questions 19 – 25**

  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?

  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?

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

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

  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?

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

  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?

With regard to questions 19-25, AS6 should positively encourage auditors to place reliance on the work of others, as this is the understanding we have derived from both the Foreword to AS5 and AS6 and the Guidance. Encouraging auditors to do this is likely to have a direct and positive impact on the cost and burden of compliance with the Act.

- **Questions 26 and 27**

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

> **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?**

With regard to questions 26 and 27, where testing of controls is performed under the direct assistance of others, as permitted by paragraphs 20 and 21 on page A2-8, we request clarity on whether simultaneous reliance may be placed on this work by management and auditors.

As consistency between the proposed auditing standards and the Guidance is of central importance, the responses we have provided above should be read in conjunction with the 100 Group's response to the Commission concerning the Guidance, a copy of which is attached hereto for your convenience.

Once again, we appreciate the opportunity to comment on AS5 and AS6, and hope that our comments will assist the PCAOB in evaluating the issues raised therein. We are also available to consult with the PCAOB concerning our comments.

Yours sincerely,

Philip Broadley
Chairman
The Hundred Group of Finance Directors

cc: Sebastian R. Sperber
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The Hundred Group
of Finance Directors

February 26, 2007

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number S7-24-06

Dear Ms. Morris:

We would like to thank the Securities and Exchange Commission (the "**Commission**") for the opportunity to comment on the issues raised in its proposed interpretative guidance, Management's Report on Internal Control Over Financial Reporting of December 20, 2006 (the "**Guidance**"), and we applaud the Commission's continuing efforts to facilitate compliance with Section 404 of the Sarbanes-Oxley Act of 2002 (the "**Act**") and the rules promulgated thereunder by the Commission (collectively, "**Section 404**").

By way of introduction, The Hundred Group of Finance Directors (the "**100 Group**") represents the finance directors of Britain's largest companies, mainly but not entirely drawn from the constituents of the FTSE 100 Index of the largest companies by market capitalisation listed on the London Stock Exchange. Almost 40 of our member companies are SEC registrants. We meet periodically to discuss issues affecting major corporations, and selectively respond to governmental and other consultation exercises where we believe that our role in companies and collective experience give us a particular insight into often complex matters.[1]

Following the publication of the Guidance, a number of our member companies who are SEC registrants set out to consider the questions posed in the Guidance. A response prepared at a workshop was subsequently circulated to all members of the 100 Group who are SEC registrants for further comment. The consensus views that emerged from this process are appended to this letter as Appendix A.

We acknowledge that Section 404 is designed to improve corporate governance, increase the quality of financial and other disclosure and instill investor confidence in the

[1] While this letter expresses the views of The Hundred Group of Finance Directors as a whole, such views are not necessarily those of individual members or their respective employers.

financial markets. Nevertheless, many market participants and commentators have observed the high cost and burden associated with its implementation. The "Staff Statement on Management's Report on Internal Control Over Financial Reporting" released on May 16, 2005 and the Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting of July 11, 2006 (the "**Concept Release**") were important steps in trying to ease the cost burden associated with the application of Section 404. Our group accepted the Commission's invitation to comment on the Concept Release and sent in a letter with our views on the questions posed by the Commission on September 15, 2006. The Guidance reflects a number of concerns and suggestions we voiced in our comments, and we applaud the Commission for its continuing efforts in this regard.

Consistent with our response to the Concept Release we recognise the value of the management attestation requirement, and the investor protection benefits generated by the enhanced requirements to assess the effectiveness of internal controls. We also recognise the deterrent effects of the additional civil and criminal penalties adopted in recent years for financial reporting failures.

However, in our response to the Concept Release we noted that the 100 Group did not have complete conviction that the application of the auditor attestation requirement in its current form was worth all of the cost and burden associated with it, due primarily to the duplication of effort by management and auditors in the documentation and testing of controls.

We consider there to be three options for the opinion of the auditor as regards internal control over financial reporting ("**ICFR**"):

1. Retain the current requirement for auditors to opine both on management's evaluation process and separately opine on their own assessment of the effectiveness of ICFR.

2. Require auditors to opine only on the effectiveness of ICFR, removing the requirement to opine on management's own evaluation process (as proposed in the Guidance).

3. Require the auditors to opine only on management's evaluation process, and not provide their own assessment of ICFR.

We consider that the first option does not provide an efficient or effective assessment process and has resulted in the cost and burden of compliance exceeding the benefits derived by registrants and the investor community.

The option proposed in the Guidance, as noted in 2 above, would afford management and the registrant's board an independent assessment of the effectiveness of ICFR, thus providing some additional comfort in the performance of their fiduciary duties in this regard. Investors may also take additional comfort from an independent assessment of ICFR. The requirement should also offer the potential to reduce some of the cost and burden of complying with the Act, if properly applied in a top-down, risk-based framework that is principle based and that permits the auditors to perform a truly integrated audit of ICFR and the financial statements.

We believe, however, that requiring auditors to opine only on management's own evaluation process (option 3 above) would result in the most cost effective outcome in complying with the Act, primarily through the removal of duplicative documentation and testing requirements on auditors and management. The maximum potential reduction in cost and burden from this option would be realised if auditors were afforded sufficient flexibility to apply professional judgment in the same fashion as the proposed Guidance permits management to do in its assessment process. We also consider that an assessment of management's own evaluation process and the conclusions from that work by the auditor would provide sufficient comfort to registrants and investors with regard to the effectiveness of ICFR. In conclusion, while we would like to reiterate our support for the Commission's efforts to reduce the costs and burdens associated with the Act, we believe that the cost/benefit implications of the Act are better served by requiring the auditor only to opine on management's own evaluation process. As such we would welcome the opportunity to participate in any cost/benefit analysis undertaken by the Commission before finalisation of these proposals.

In addition to the comments above, several general themes and principles run through our comments:

1. The 100 Group supports the thrust of the guidance contained in the Guidance and the goals the Commission is seeking to achieve through this guidance.

2. Consistency with prior Commission guidance and with the proposed PCAOB auditing standards is of critical importance, and we encourage the Commission to consolidate all the relevant releases and guidance into a single, consistent statement of interpretative guidance.

3. If the Commission adopts the current proposal on the role of the auditor in Section 404, the final guidance should clarify and affirm the Commission's and PCAOB's publicly stated goal of eliminating the requirement for auditors to provide an opinion on management's evaluation of internal control over financial reporting, as the Guidance and the related proposed auditing standards of the PCAOB currently contain ambiguities that might cause inconsistent application.

4. We request that the Commission immediately implement the final guidance contained within the Guidance, and give consideration to a retrospective application of the guidance to apply to accounting periods commencing on or after January 1, 2006.

Once again, we appreciate the opportunity to comment on the Guidance, and hope that our comments will assist the Commission in evaluating the issues raised therein. We are also available to consult with the Commission concerning our comments.

Yours sincerely,

Philip Broadley
Chairman
The Hundred Group of Finance Directors

cc: Sebastian R. Sperber
Cleary Gottlieb Steen & Hamilton LLP

Appendix A

Section I -- Responses to Questions Posed in Part III, "Proposed Interpretive Guidance" (pp. 49-51)

1. Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process? Does the proposed guidance allow for management to conduct an efficient and effective evaluation? If not, why not?

We welcome the Commission's proposed principle-based guidance (the "Guidance")**,** which substantially recognises the concerns raised by registrants about the need to permit management to apply their own top-down, risk-based approach to the evaluation of internal control over financial reporting ("ICFR")**.**

We also broadly support the proposed auditing standards replacing Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements" ("AS2") (we have commented on specific issues with the proposed standard in our responses below) and await demonstrable evidence of evolving practice of auditors applying a more effective and efficient integrated audit.

However, we have noted in the cover letter to this Appendix that we believe that the ambition of the Commission to reduce the cost and burdens of complying with the Act may be better served by requiring the auditor only to opine on management's evaluation process, and removing the requirement for the auditor to provide a completely separate assessment of ICFR. We believe that this requirement would remove duplicative documentation and testing procedures while maintaining the benefits of improved corporate governance and an independent assessment of ICFR.

Additionally, we encourage the Commission to keep under review any duplication of effort and cost imposed upon foreign registrants by like-for-like regulation in their local jurisdiction, with an eye towards removing duplicative U.S. requirements should local requirements achieve the same purpose.

We request that the Commission and the PCAOB confirm that firms and auditors can begin immediately to apply the final Guidance once issued and that the Commission and the PCAOB will, respectively, themselves apply the Guidance in evaluating filings made on or after January 1, 2006 and in inspections of audit firms. These measures are especially appropriate since several areas of the Guidance reflect that it was always the intention of the Commission and the PCAOB that both the Commission guidance and AS2 should be interpreted as is now set out in the Guidance.

2. Are there particular areas within the proposed interpretive guidance where further clarification is needed? If yes, what clarification is necessary?

In addition to our other recommendations made elsewhere herein, we recommend the paragraph on page 44 beginning "In evaluating the magnitude of the potential misstatement . . ." should clarify that due consideration should be given to the risk associated with a control deficiency, and that it is inappropriate simply to focus on the magnitude of the account affected by that control deficiency, as other controls may cover the affected account.

We also disagree with the presumption on pages 44 - 45 that "significant deficiencies that have been identified and remain unaddressed after some reasonable period of time" are a strong indicator of a material weakness. We welcome the application of professional judgement by auditors that can be applied in the consideration of unremediated significant deficiencies in the Foreword to the proposed new auditing standard, "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements" ("AS5"), and consider the same latitude should be afforded to management, which would be consistent with principle-based guidance and the Commission's definition of "reasonable assurance" (including footnote 38) on page 15.

3. Are there aspects of management's annual evaluation process that have not been addressed by the proposed interpretive guidance that commentators believe should be addressed by the Commission? If so, what are those areas and what type of guidance would be beneficial?

We request the Commission provide principle-based guidance on documentation and testing standards that will aid management's judgement in a top-down, risk-based approach that seeks to place reliance on IT application controls and/or IT dependent controls, recognising the difficulty registrants face with the documentation requirements (base-lining) for legacy systems and the ongoing maintenance of that documentation (to reflect changes to ICFR) to support an IT benchmarking testing strategy.

Benchmarking of IT application controls is recognised as being an opportunity to achieve efficiencies in the testing of automated controls. Despite guidance issued on May 16, 2005 by the PCAOB, there are inconsistent interpretations by external auditors as to the nature, extent and timing of benchmarking permitted by management and the benefit that will accrue to the current and future evaluations of ICFR. We request that the Commission provide principle-based guidance on the reliance that management can place on benchmarking of IT application controls to reduce the nature, extent and timing of testing and the evaluation of ICFR.

4. Do the topics addressed in the existing staff guidance (May 2005 Staff Guidance and Frequently Asked Questions (revised October 6, 2004)) continue to be relevant or should such guidance be retracted? If yes, which topics should be kept or retracted?

To avoid ambiguity and redundancy, we request the Commission take this opportunity to consolidate all prior guidance and answers to frequently asked questions provided to issuers into one interpretive guidance that is internally consistent.

5. Will the proposed guidance require unnecessary changes to evaluation processes that companies have already established? If yes please describe.

No. Principle-based guidance that permits the application of management's judgement is welcomed.

6. Considering the PCAOB's proposed new 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, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so what are those areas and how would you propose to resolve the incompatibility?

The Guidance affords management the flexibility to apply its own top-down, risk-based approach, enabling management to conduct efficient and effective evaluations. Nonetheless, we observe that there will continue to be dependencies between management's evaluation and that of the auditors and therefore a need to ensure alignment between the Guidance and AS5 and the other proposed new auditing standard, "Considering and Using the Work of Others in an Audit" ("AS6"). Examples of these dependencies include management structuring their work to ensure efficiency can be achieved by the auditors placing maximum reliance on management's scoping, documentation and testing. Accordingly, we encourage the Commission through its approval process of AS5 and AS6 to ensure that these auditing standards are made consistently principle based, affording auditors maximum flexibility to use professional judgement in the same fashion as the Guidance permits management to do in its assessment.

A further example of an area where a difference of opinion between management and the auditors could arise is the definition of what constitutes a risk of a material misstatement. This is likely to occur in companies where the balance sheet and income statement are significantly disproportionate and do not justify the application of a single measure of materiality, as is sometimes required by auditors. Using a single measure of materiality in such circumstances makes incompatibility with a risk-based approach more likely. Clarification on the use of multiple materiality levels pertinent to the circumstances of the company would also be welcomed.

We welcome the principle-based approach applied in the Foreword to AS5, but consider the actual language contained in the proposed standard not to fully reflect the intention of the Board of the PCAOB to revise AS2. For example, on page 12 the Foreword permits the application of professional judgement of the auditors in their assessment of uncorrected significant deficiencies, whereas page A1-30 appears to remove their ability to apply that judgement. There are several other similar examples among the definitions and language used in the proposed standard, and we expect the planned review processes will ensure the full spirit of the Foreword is reflected in AS5**.**

7. Are there any definitions included in the proposed interpretive guidance that are confusing or inappropriate and how would you change the definitions so identified?

We request that the Commission define the term "senior management" used on page 45 in the context of "Identification of fraud of any magnitude on the part of senior management". We consider the definition included in AS5 on page A1-30 to be consistent with principle-based guidance. Accordingly, if the words "the term 'senior management' includes the principal executive and financial officers signing the company's certifications as required under Section 302 of the Act as well as any other members of management who play a significant role in the company's financial reporting process" were incorporated as a footnote on page 45 this would clarify the scoping and evaluations required by management.

The Commission should incorporate a definition of "prudent official" in the Guidance**.**

8. Will the guidance for disclosures about material weaknesses result in sufficient information to investors and if not, how would you change the guidance?

Yes.

9. Should the guidance be issued as an interpretation or should it, or any part, be codified as a Commission rule?

Whether issued in the form of a Commission interpretation or Commission rule we would expect management to be able to rely upon the Guidance in conducting its assessments of internal control over financial reporting. We also strongly support the Commission's proposal to adopt the safe harbour for management conducting its annual evaluation in accordance with the proposed Guidance, and agree that embodying this safe harbour in Rules 13a-15(c) and 15d-15(c) through a rule amendment is appropriate.

10. Are there any considerations unique to the evaluation of ICFR by a foreign private issuer that should be addressed in the guidance? If yes, what are they?

We support the guidance in footnote 47 on page 21 that "Management of foreign private issuers that file financial statements prepared in accordance with home country generally accepted accounting principles or International Financial Reporting Standards with a reconciliation to U.S. GAAP should plan and conduct their evaluation process based on their primary financial statements (i.e., home country GAAP or IFRS) rather than the reconciliation to U.S. GAAP".

Any other issues for foreign private issuers have been reflected in our comments above.

Section 2 – Responses to Questions Posed in Part IV, "Proposed Rule Amendments" (pp. 52-54)

1. Should compliance with interpretive guidance, if issued in final form, be voluntary, as opposed to mandatory?

Compliance should be voluntary, not mandatory**.**

2. Is it necessary or useful to amend the rules if the proposed interpretive guidance is issued in final form, or are rule revisions unnecessary?

We support the proposed Guidance and the amendments to the Commission rules, subject to the requested clarification on the proposed rule alterations as discussed in our response to question 7 on page A-17 below.

3. Should the rules be amended in a different manner in view of the proposed interpretive guidance?

As noted above, we believe that a reduction in the cost and burdens of complying with the Act may be better served by a requirement for the auditor only to opine upon management's evaluation process. We would welcome the opportunity to participate in a cost/benefit analysis before the finalisation of the current proposal to have the auditor separately assess, and opine upon, the effectiveness of ICFR.

4. Is it appropriate to provide the proposed assurance in Rules 13a-15 and 15d-15 that an evaluation conducted in accordance with the interpretive guidance will satisfy the evaluation requirement in the rules?

Yes.

5. Does the proposed revision offer too much or too little assurance to management that it is conducting a satisfactory evaluation if it complies with the interpretive guidance?

We welcome the principle-based Guidance and consider it appropriate, subject to the observations made above. We encourage the Commission to continue to seek feedback from registrants, investors and auditors (through, for example, roundtable forums) and as appropriate provide additional guidance as practices evolve.

6. Are the proposed revisions to Exchange Act Rules 13a – 15(c) and 15d – 15 (c) sufficiently clear that management can conduct its evaluation using methods that differ from our interpretive guidance?

Yes.

7. Do the proposed revisions to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X effectively communicate the auditor's responsibility? Would another formulation better convey the auditor's role with respect to management's assessment and/or the auditor's reporting obligation?

Although in the cover letter to this Appendix and elsewhere in our responses we suggest an alternative approach to the one proposed by the Commission, we make the following comments that would apply if the Commission adopts its proposal as currently worded.

It is our understanding that the Commission's current proposal is to remove the requirement for auditors to give an opinion on the effectiveness of management's evaluation process, leaving the auditors to express an opinion directly on the effectiveness of internal control over financial reporting. We have reviewed the language in the proposed rule amendment and consider it to be confusing in certain respects. If the current proposals for the role of the auditor are adopted, we request clarification that all that is required is for the auditor to express an opinion on the effectiveness of ICFR, and that there is no requirement for them to audit, assess or evaluate management's evaluation and/or assessment process, and/or opine on that process.

We consider the PCAOB's Foreword to AS5 beginning on page 14, paragraph B, through page 17, which states that "the auditor can perform an effective audit of internal control without conducting an evaluation on the adequacy of management's evaluation process", to reflect the public statement made by the PCAOB on 19 December 2006 about "Remov[ing] the requirement to evaluate management's process", [1] as well as the Commission's proposal on page 52 of the Guidance "to require the auditor to express an opinion directly on the effectiveness of ICFR", rather than on management's assessment of ICFR. However, the elimination of this requirement does not appear to be fully reflected in the Commission's proposed rule amendments on pages 67 - 70 or in proposed standard AS5, including the example reports on page A1-38.

We agree with the assertion made in question 15 on page 18 of the Foreword to AS5 to the effect that "an opinion only on the effectiveness of internal control, and not on management's assessment, more clearly communicate[s] the scope and results of the auditor's work". Accordingly, were this proposal for the role of the auditor adopted, we would request the removal of all references in the Commission and PCAOB guidance, and the Rules relating to an "attestation report on management assessment of ICFR" and would recommend replacing this term with an "attestation report on ICFR". We also request that the words "attest to, and" be deleted from the first sentence of the proposed revision to S-X Rule 210.2-02(f) on page 68 of the Guidance and that the words "indicate that the accountant has audited management's assessment" be deleted from the second sentence of the same paragraph.

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[1] See http://www.pcaob.org/News_and_Events/News/2006/12-19.aspx.

8. Should we consider changes to the other definitions or rules in light of these proposed revisions?

Issuing the clarification requested in previous responses will require conforming changes elsewhere in the interpretive Guidance, proposed rule amendments and AS5.

9. The proposed revision to Rule-2-02(f) highlights that disclaimers by the auditor would only be appropriate in the rare circumstance of a scope limitation. Does this adequately convey the narrow circumstances under which an auditor may disclaim an opinion under our proposed rule? Would another formulation provide better guidance to auditors?

Yes, the example is sufficiently narrow.

Section 3 – Responses to Question Posed in Part VI, "Cost-Benefit Analysis" (p. 56)

By encouraging managers to rely on guidance that is less prescriptive and better aligned with the objectives of Section 404, the proposed rule should reduce management's effort relative to current practice under existing auditing standards. The expenditure of effort by audit firms also may decline, in response, relative to what would occur otherwise. We are thus soliciting comments on how the proposed guidance and the proposed new auditing standard will affect the expenditure of effort, and division of labor, between the managers and employees of public companies and their audit firms.

We would welcome the opportunity to participate in a cost/benefit analysis of the current proposals, particularly with regard to the current proposals for the future role of the auditor as relates to Section 404.

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February 23, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Board Members,

We appreciate your efforts to reduce the costs associated with compliance with the Sarbanes-Oxley Act of 2002 Section 404 (SOX 404), through PCAOB Release 2006-007. However, we believe that a proposal to improve the process of external auditors doing the work to allow them to express an opinion on the effectiveness of Internal Controls over Financial Reporting (ICFR) is just tinkering with a requirement we believe is redundant, not cost effective and does little if anything to improve results of public company management. We believe the proper action for the PCAOB is to:

- Limit the interpretation of the SOX legislation to require management to assess and report on the adequacy of ICFR and require external auditors attest to and report on the assessment made by management
- Eliminate the requirement of an external audit opinion on the effectiveness of ICFR.

SOX 404 has provided new regulations with the intention of protecting shareholders including items that address improving the clear responsibility for management over financial reporting and controls, improve the likelihood of discovery of and increase penalties for illegal activities. Among these are:

- Improved rules for external auditor independence and audit committee independence
- Certification of financial reports for a company by the CEO and CFO
- Management assessment and representation of the adequacy of ICFR and the requirement that external auditors attest to and report on the assessment made by management
- Significantly longer maximum jail sentences and larger fines for corporate executives who knowingly and willfully misstate financial statements
- Enhanced whistleblower protection

In addition to these and other requirements of public companies already in place prior to SOX 404, the PCAOB through AS2 has required an external audit opinion on the effectiveness of ICFR. Our experience is that our audit costs have more than doubled due to this requirement. This requirement entails significantly more work than would be required under a more precise interpretation of SOX 404(b) and is redundant with management's own assessment and it is management's job to make sure the controls are in place and effective.

The primary cause of the infamous public company disasters that brought on the SOX legislation was "colluding liars" running the companies. Without this type of leadership and behavior among the people running these companies, the probability of significant accounting fraud is very low. Less than 1% of companies have exhibited these types of behavior and yet costs are being imposed on all publicly traded companies.

We don't believe that an external audit of internal controls would have been effective at stopping "colluding liars" from their actions in the following examples:

- Enron used partnerships to hide the true performance of its business and enrich select officers.
- Adelphia used company money and debt to fund personal spending and investments of its officers (many of whom were from one immediate family).
- WorldCom intentionally violated accounting rules to treat expense items as capital to inflate its earnings.

In each of the above cases, the truth came out within a few years and in the Enron and WorldCom cases, internal personnel notified auditors or board members who were in a position to do something about it. The primary executives involved in these scandals have received substantial prison sentences (terms from five up to 25 years have been handed down).

In looking at the core reasons for SOX 404 legislation and any additional requirements the PCAOB chooses to impose, the actual effectiveness and cost of PCAOB imposed requirements needs to be checked against the issue they propose to fix. We believe requiring external auditors to express an opinion on the effectiveness of ICFR fails this review.

Also, if accounting rules are made more onerous than their value or competitive alternatives available in the capital markets, the PCAOB should expect companies to find ways to reduce those costs to remain globally competitive and improve the return to their shareholders. There are alternatives such as going private, selling to foreign companies, or listing on foreign exchanges. More companies will be driven to these alternatives. To expect anything different is to disregard economic reality and American ingenuity.

In a speech on February 9, SEC Commissioner Kathleen Casey said, "We need to fix 404. No other issue in recent times has come to symbolize regulation gone awry than this relatively modest-looking provision of the Sarbanes-Oxley Act. While the spirit and letter of the law never contemplated the costly and burdensome result that this provision has generated, the law's implementation undoubtedly facilitated such a result…In the end, however, I believe we will only be able to measure our success by whether our reforms are sufficient to alter the behavior our policies have driven." We agree with Commissioner Casey's assessment of the impact of SOX 404 and the need for changes in regulation that are sufficient to allow significant reduction in the efforts to comply with SOX 404 by public companies and their external auditors. We do not believe PCAOB Release 2006-007 provides enough change to pass that test.

In summary:

- SOX 404 legislation put in place multiple regulations intended to improve the control environment of publicly traded companies. This is in addition to the accounting and regulatory requirements in place prior to the SOX 404 legislation.
- The requirement that external auditors express an opinion on the effectiveness of ICFR is not required by the SOX 404 legislation, is the source of most of the increased audit costs associated with SOX 404 compliance and does little if anything to mitigate the root issues that precipitated the SOX 404 legislation.

We strongly urge the PCAOB to:

- Limit their interpretation of the SOX 404 legislation, which requires management to assess and report on the adequacy of ICFR and requires that external auditors attest to and report on the assessment made by management.
- Eliminate the requirement for external auditors to express an opinion on the effectiveness of ICFR.

Sincerely,

John A. Ingleman
Senior Vice President and
Chief Financial Officer

David P. Radloff
Vice President of Corporate Finance

INDEPENDENT COMMUNITY BANKERS of AMERICA

TERRY J. JORDE
Chairman
JAMES P. GHIGLIERI, JR.
Chairman-Elect
CYNTHIA BLANKENSHIP
Vice Chairman
KEN PARSONS, SR.
Treasurer
ROBERT C. FRICKE
Secretary
DAVID E. HAYES
Immediate Past Chairman
CAMDEN R. FINE
President and CEO

February 26. 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F. Street, NE
Washington, D.C. 20549-1090

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

Re: SEC File Number S7-24-06 and PCAOB Rulemaking Docket Number 021

Ladies and Gentlemen:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to offer comments in connection with the SEC's guidance under Section 404 of the Sarbanes-Oxley Act ("SEC Guidance") and the PCAOB's proposed auditing statement, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would supersede Auditing Standard Number 2 (referred to hereafter as Auditing Standard No. 5 or "AS5").

ICBA's Position

While the SEC guidance and proposed AS5 may curtail excessive testing of controls and reduce some of the unnecessary documentation required by SOX 404 audits, we still have doubts that it will reduce 404 audit costs, particularly for smaller public companies. ICBA recommends at

[1]*The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 265,000 Americans, ICBA members hold more than $876 billion in assets $692 billion in deposits, and more than $589 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

INDEPENDENT COMMUNITY BANKERS of AMERICA The Nation's Voice for Community Banks[sm]
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least another one year delay in the Section 404 due dates for non-accelerated filers so that calendar year filers will have until the due date for their 2008 annual report to file their management internal control reports and the due date for their 2009 annual report to file the auditor's attestation report. The additional one year delay would give the SEC and the PCAOB an opportunity to evaluate the cost effectiveness of their controls on accelerated filers and would also give the non-accelerated filers that have no experience with Section 404 additional time to understand and apply the new guidance and establish a new internal control framework.

To indicate that it is serious about reducing costs, ICBA also believes that the SEC should propose a quantitative benchmark or goal for the new standard that is tied to a reduction in overall SOX 404 audit costs. ICBA's specific recommendations regarding AS5 and the SEC include (1) making the SEC Guidance more specific, (2) defining terms such as "material deficiency" more clearly and (3) eliminating the "principal evidence" provision in AS2. While a risk-based and scalable AS2 may reduce some of the high costs of SOX Section 404, ICBA still advocates that smaller public companies should be partially or fully exempted from Section 404 in order to be competitive with larger companies and foreign competition.

General Comments Concerning AS5 and the SEC Guidance

We commend the SEC and the PCAOB for its attempt to create a scalable, top-down approach for SOX 404 audits. As noted in the release for the SEC Guidance, the SEC Advisory Committee on Smaller Public Companies raised a number of concerns regarding the ability of smaller companies to comply cost-effectively with the requirements of SOX 404. Some of the concerns stemmed from the implementation of AS2 and the fact that auditors were engaged in excessive testing of controls and requiring unnecessary documentation to comply with SOX 404.

While the SEC guidance and proposed AS5 may curtail excessive testing of controls and reduce some of the unnecessary documentation required by SOX 404 audits, we still have doubts that it will reduce 404 audit costs, particularly for smaller public companies. We note, for instance, that AS5 has not been field tested so that there is no evidence to suggest that, despite the proposed standard's focus on scalability and risk-based testing, that auditors will significantly change their audit procedures or reduce the time they take to perform a 404 audit.

ICBA recommends at least another one year delay in the Section 404 due dates for non-accelerated filers so that calendar year filers will have until the due date for their 2008 annual report to file their management internal control reports and the due date for their 2009 annual report to file the auditor's attestation report. The one-year delay would accomplish several things. First, it would give the SEC and the PCAOB an opportunity to evaluate the cost effectiveness of their controls on accelerated filers. If, for instance, the SEC Guidance and AS5 have little impact on SOX 404 audit costs for the 2007 and 2008 accelerated filers, then the SEC and the PCAOB will have time to revise the guidance and the new standard before it is fully implemented by the non-accelerated filers. Second, a one-year delay would also give the non-accelerated filers that have no experience with Section 404 additional time to understand and apply the new guidance and establish a new internal control framework.

ICBA also believes that the SEC and the PCAOB should propose a quantitative benchmark or goal for the new standard that is tied to a reduction in overall SOX 404 audit costs. For instance, the SEC should state that the goal is to reduce average internal control audit costs by a certain percentage—say 20%--with a commitment that if the revised standard does not meet that goal, then the standard will be revised further. It is too ambiguous for the SEC or the PCAOB to state that the goal is to increase the "cost effectiveness of the 404 audit" or "to reduce unnecessary audit procedures" particularly when there has been no field testing of the new standard and therefore no assurance that it will have any impact. A specific benchmark or goal would convey to the industry that the SEC and the PCAOB is serious about reducing the overall costs of SOX 404 and is committed to achieving that goal.

ICBA has other specific recommendations with regard to the SEC guidance and AS5. These include the following:

The SEC Guidance Should Be More Specific

The SEC states that the purpose of the new Guidance is not to prescribe any specific method or set of procedures for management to follow in performing its evaluation of internal controls. According to the SEC, this will give managers flexibility with regard to its evaluation. However, ICBA believes that the SEC Guidance is too broad and ambiguous. Since AS5 is more detailed and prescriptive, we are concerned that management will eventually turn to proposed AS5 as the guidebook for internal control evaluations and will eventually ignore the SEC Guidance altogether.

In the case of non-accelerated filers that have not begun their SOX 404 audits, the temptation will be for management to use the more specific and detailed AS5 for guidance rather than the SEC Guidance since it lays out more clearly what the auditors will expect in the way of an internal control framework. Over time, we predict that the SEC guidance will become less relevant to smaller public companies--exactly the scenario that the SEC wanted to avoid—and that management will rely more on their auditors to determine how a good internal control framework should be implemented.

ICBA recommends that the SEC Guidance should be more specific and include more illustrations of how the guidance should be implemented particularly for smaller public companies. For instance, AS5 indicates clearly how an auditor should assess a company's control environment but the SEC Guidance only makes a passing reference to it and does not provide any specific evaluation criteria or any information on what constitutes a poor control environment. AS5 lists a number of specific factors for identifying significant accounts but the SEC Guidance has no parallel guidance for management and has few illustrations to help managers identify significant accounts. AS5 sets forth certain specific points for auditors to consider in evaluating the effectiveness of IT systems for smaller companies whereas the SEC Guidance has no such comparable discussion of IT systems.

ICBA also recommends that there be a closer alignment between the broad and principle-based SEC Guidance and the more prescriptive AS5. Both management and the auditors should be able to look to both documents for a consistent and detailed approach to assessing internal controls. AS5 should focus on how to audit the company's internal controls whereas the SEC Guidance should concentrate on how an internal control framework should be established. If both documents are closely aligned and are detailed enough for users, then we will avoid the problem of one becoming less relevant than the other.

Defined Terms Need to be Clearer

While we agree that the SEC and the PCAOB have made some progress with clarifying some of the defined terms used in AS2, there is more room for improvement. Specifically, there is still confusion about what constitutes a "material weakness" and how management should identify material weaknesses. AS2 currently defines a material weakness as a control deficiency, or a combination of control deficiencies, that result in more than a remote likelihood that a material misstatement of the company's annual or interim financial statements will <u>not</u> be prevented or detected. In the proposed AS5 and SEC Guidance, the SEC and the PCAOB uses the same definition but substitutes "reasonable possibility" for "more than a remote chance."

While "reasonable possibility" is clearer than "more than a remote chance" and possibly raises the threshold to some degree, the definition still requires management and the auditors to prove a negative—that no material weaknesses exist—as opposed to affirmatively proving the effectiveness of internal controls. This negative approach--proving that no material weaknesses exist--places an enormous burden on auditors and management who must attest to the internal control financial reporting and encourages them to be very conservative with their testing and documentation.

ICBA believes that there should be a more precise definition of "material weakness" or "material deficiency" that is tied to the impact on a company's earnings. Last year, ICBA supported the COMPETE Act[2], introduced by Rep. Tom Feeney (R-Fla.), that directed the SEC and the PCAOB to use a 5% de minimus standard (e.g., 5% of profits) under AS2 for noting material deficiency. Furthermore, if management and the auditors must prove the negative--that there are no "material deficiencies" in their internal controls--then there should be greater clarity as to how companies both large and small can achieve that goal. The guidance should also indicate at what point a combination of control deficiencies gives rise to a material weakness. Illustrations of different control deficiencies that rise to a material weakness would be useful. Both the SEC Guidance and AS5 should be clear enough so that management does not have to consult with their auditors every time there is an issue about a "material deficiency."

There are other examples of defined terms that need to be clarified. For instance, the SEC Guidance indicates that management is required to assess whether a company's internal controls are effective in providing "reasonable assurance" regarding the reliability of financial reporting. "Reasonable assurance" is defined as assurance that would "satisfy prudent officials in the conduct of their own affairs." This definition is too vague. At a minimum, the SEC should provide illustrations so that companies have a clearer idea of what it means to be "reasonably assured." As mentioned above, the guidance should be clear enough that management does not have to constantly refer to experts (i.e., an outside auditor) to understand the definitions.

[2] HR 5404, known as the "Competitive and Open Markets that Protect and Enhance the Treatment of Entrepreneurs Act."

The "Principal Evidence" Provision in AS2 Should Be Eliminated

ICBA commends the PCAOB for proposing a new auditing standard, *Considering and Using the Work of Others in an Audit*, which would replace AU section 322 and provide direction to auditors for using the work of others in both the audit of internal control reporting and the audit of the financial statements. We agree that a single, unified framework for the auditor's use of the work of others would remove barriers to the integration of the internal control audit and the audit of financial statements. We understand that the new standard will replace the provisions in AS2 that dealt with using the working others.

We also applaud the PCAOB for eliminating (or not including in the new standard) the "principal evidence" provision in AS2 which required the auditor's own work to provide the principal evidence for the auditor's opinion. The "principal evidence" provision contributed to the high cost of SOX 404 audits because it was interpreted by many auditors to mean that under no circumstances could the auditor rely on the work of others. For instance, the work of internal auditors was often ignored by outside auditors because of the "principal evidence" provision in AS2.

ICBA recommends that the proposed new standard and SEC Guidance also address the use of bank examination reports when considering the work of others in an audit of internal controls. Bank examiners frequently check and report on internal controls as part of their safety and soundness examinations of financial institutions. These reports would provide valuable insight into a bank's internal controls and are performed by highly competent and objective examiners. ICBA believes that bank examination reports would be useful evidence for management when conducting an evaluation of internal controls.

The SEC Guidance Should Provide a Clear Safe Harbor for Management

As proposed, the SEC Guidance says that the proposed amendments to Rules 13a-15(c) and 15d-15(c) will make the SEC Guidance "similar" to a non-exclusive safe harbor. **ICBA recommends that the SEC provide a clear safe harbor for management under the Securities and Exchange Act of 1934 provided that management has complied with all aspects of the SEC Guidance**. A clear safe harbor would make it more likely that management will detect material weaknesses and disclose them since management will have some legal protection under the Exchange Act. Furthermore, management will be more likely to rely on its own interpretation of the guidance and not constantly seek advice from auditors.

The SEC rules contain a number of safe harbors that have been very successful, including Rule 144A under the Securities Act of 1933 which provides a safe harbor from registration for re-sales of privately placed securities to qualified institutional buyers and Regulation D, which is a safe harbor from registration for certain private placements of securities. In each case, these safe harbors have provided a clear way for parties to comply under the securities laws. The SEC should provide a clear safe harbor for management under the Exchange Act that provides legal protection similar to these other safe harbors.

Even With a Scalable AS5, ICBA Still Endorses a Small Company 404 Exemption

ICBA commends the SEC and the PCAOB for its endorsement of a scalable approach to SOX 404 audits. Proposed AS5, for instance, does include a section on scalability that includes a description of the attributes of smaller, less-complex companies that make them different from larger and more complex companies. That section also includes a discussion of six areas of the audit that are often affected by the attributes of smaller, less-complex companies. For each of these areas, the proposed standard describes the principles the auditor should apply in order to obtain sufficient competent evidence in a reasonable manner. We understand that this part of the proposed AS5 will provide the foundation for planned guidance on auditing internal control in smaller companies to be issued later this year.

While a risk-based and scalable new standard may reduce some of the high costs of SOX Section 404, ICBA still believes that smaller public companies should be partially or fully exempted from Section 404 in order to be competitive with larger companies and foreign competition. Even with a revised auditing standard, we believe that smaller public companies would still be subject to unnecessarily extensive auditing of detailed control processes under Section 404 by auditors excessively concerned about their liability and being second guessed by the PCAOB.

ICBA strongly endorses the primary recommendations of the SEC's Advisory Committee on Smaller Public Companies including (a) exempting micro-cap companies (with equity capitalizations of $128 million or less) that have revenue of less than $125 million from the internal control attestation requirements of SOX Section 404 and (b) exempting small-cap companies (with equity capitalizations of between $128 million and $787 million) that have revenue of less than $250 million from the external audit requirements of SOX Section 404. We agree with the Advisory Committee that with more limited resources, fewer internal personnel and less revenue with which to offset the costs of Section 404 compliance, both micro-cap and small-cap companies have been disproportionately impacted by the burdens associated with Section 404 compliance. We also agree that the benefits of documenting, testing and certifying the adequacy of internal controls, while of obvious importance for large companies, are of less value for micro-cap and small-cap companies, that rely to a greater degree on "tone at the top" and high-level monitoring controls, to influence accurate financial reporting.

The proportionately larger costs for smaller public companies to comply with Section 404 adversely affect their ability to compete with larger public companies and even with foreign competition. This reduction in the competitiveness of U.S. smaller public companies hurts their capital formation ability and, as a result, hurts the U.S. economy.

For community banks, Section 404 costs have been particularly significant. ICBA's 2005 survey of Section 404 costs for community banks revealed that the average community bank would spend during 2005 more than $200,000 and devote over 2,000 internal staff hours to comply with Section 404.[3] These costs far outweigh the benefits for these small companies.

[3] For a complete description of ICBA's Section 404 Survey of Community Banks, see ICBA's comment letter to the SEC dated March 31, 2005 concerning the formation and goals of the Advisory Committee.

Conclusion

Since proposed AS5 has not been field tested, ICBA recommends at least another one year delay in the Section 404 due dates for non-accelerated filers so that calendar year filers will have until the due date for their 2008 annual report to file their management internal control reports and the due date for their 2009 annual report to file the auditor's attestation report. To indicate that it is serious about reducing costs, ICBA also believes that the SEC should propose a quantitative benchmark or goal for the new standard that is tied to a reduction in overall SOX 404 audit costs. While a risk-based and scalable AS2 may reduce some of the high costs of SOX Section 404, ICBA still believes that smaller public companies should be partially or fully exempted from Section 404 in order to be competitive with larger companies and foreign competition.

ICBA appreciates the opportunity to offer comments in connection with the SEC's guidance under Section 404 of the Sarbanes-Oxley Act and the PCAOB's proposed auditing statement, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.* If you have any questions about our letter, please do not hesitate to contact me at 202-659-8111 or Chris.Cole@icba.org.

Sincerely,

Christopher Cole

Christopher Cole

Regulatory Counsel

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February 26, 2007

Dear Sir(s)/Mme(s):

Re.: PCAOB Rulemaking Docket No. 021
PCAOB Release No. 2006-007, December 19, 2006

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 Institut der Wirtschaftsprüfer in Deutschland [Institute of Public Auditors in Germany] (IDW) is pleased to have the opportunity to comment on the abovementioned Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, And Related Other Proposals (hereinafter referred to as the “proposed PCAOB auditing standard” or “proposed standard”).

The IDW represents the profession of public auditors in Germany and is seeking to comment on the proposed PCAOB auditing standard because a significant number of IDW members audit, or are involved in the audit of, SEC-Registrants or German subsidiaries of such registrants, and are therefore affected by the proposed standard, if adopted. Furthermore, these members will also be indirectly affected by the Securities and Exchange Commission’s proposed interpretative guidance for management regarding its evaluation of internal control over financial reporting and the related proposed rule amendments in the document

GESCHÄFTSFÜHRENDER VORSTAND:
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entitled "Management's Report on Internal Control Over Financial Reporting" (hereinafter referred to as the "proposed management guidance"), that represents the SEC's proposed management guidance counterpart to the proposed PCAOB auditing standard. Many of our comments are made in light of the relationship between these two documents and we therefore refer the PCAOB to our comment letter to the SEC on the proposed management guidance, which is attached for your reference.

Our letter contains matters of general concern. Further matters of specific concern and more detailed analyses are addressed in the Appendix to this letter.

General Matters

Comment period

We are pleased to note that the SEC and PCAOB have aligned their periods of exposure for the proposed management guidance and the proposed PCAOB auditing standard. However, we are disappointed to see the short exposure period in which comments can be provided to the SEC and PCAOB, particularly since both bodies published their proposals immediately prior to the Christmas holiday season and many organizations would like to have the opportunity to consult more thoroughly with their stakeholders. Due to the rather short comment period, we have only been able to "scratch the surface" in terms of the issues contained in the proposed PCAOB auditing standard.

Overall comments

We appreciate the initiative taken by both the SEC and the PCAOB to revisit the issue of internal control over financial reporting from both management and auditor perspectives and the effort made to align the two documents. In previous comment letters to the PCAOB and the SEC, we had noted a number of issues in the then proposed PCAOB auditing standard AS-2, and have most recently commented on the SEC's concept release that we support the issuance of guidance for management. We continue to believe that there is a need for principles-based requirements, and guidance, on management's design, implementation and operation of internal control over financial reporting, as well as for the performance of management's assessment of that internal control.

In particular, as a matter of principle (though not necessarily the manner proposed), we support the

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- top-down approach to determine which controls are the most significant and which of lesser significance,
- emphasis that has been placed on assessment of the risk of material misstatement,
- increased emphasis on professional judgment (rather than check-list mentality),
- approach to first consider general controls, and then application controls,
- introduction of SME guidance

However, we have serious concerns about the way in which these matters have been implemented in the proposed standard – in particular, the disconnect between the proposed PCAOB auditing standard and the proposed management guidance and some of the internal logical inconsistencies within the proposed PCAOB auditing standard. In particular, we also have the following concerns:

- the flexibility allowed in the approach to assessing internal control, for management, as no one way or method is prescribed, but the comparative lack of flexibility for the auditor. This will not allow for significant cost savings
- the authority of an auditing standard is higher than that of guidance for management, which means that the auditors are subject to requirements when auditing internal control, whereas management need only consult guidance when performing its assessment without being subject to any requirements
- the guidance proposed by the SEC for management's approach to assessing internal control is far less detailed and stringent than that in the proposed PCAOB auditing standard
- the standard does not reflect fairly the increasing degree to which controls are automated, e.g., embedded controls. There should be more scope for auditors to reduce their work effort as appropriate.

The impetus to amend or replace AS-2 appears to have been twofold: 1. the desire to align any new auditing standard with the newly proposed management guidance, and 2. the desire to ensure that audits of internal control are carried out efficiently to reduce unnecessary costs and burdens. We believe that, in light of the proposed guidance, the proposed PCAOB auditing standard will not meet the first objective, and that there is a danger that the proposed guidance will not achieve the second objective.

Proposed management guidance vs. PCAOB internal control standard

The Commission has emphasized "that management, not the auditor, is responsible for determining the appropriate nature and form of internal controls for the company as well as their evaluation methods and procedures".[1] We agree with this emphasis. However, the proposed management guidance allows management greater flexibility in carrying out its assessment of internal control over financial reporting than the proposed PCAOB auditing standard allows the auditor in auditing that internal control: the requirements and guidance in the proposed PCAOB auditing standard are more precise and stringent, allow less flexibility, and are in greater detail, than in the proposed management guidance. For example, the management guidance on company-level controls (page 25 et seq.) is far less detailed than that for the auditor (proposed AS-5 paragraphs 17-23). Another example is the fact that walk-through tests are required in the audit of internal control, but not for management's assessment of internal control.

This disconnect between the proposed management guidance and the proposed PCAOB auditing standard will inevitably lead to auditors auditing internal control over financial reporting using the more stringent criteria in the proposed auditing standard, than those applied by management in designing, implementing, operating and assessing that internal control, because PCAOB enforcement activities will drive auditors to apply the more stringent and detailed requirements and guidance in the proposed PCAOB auditing standard. Consequently, auditors would be placed into the position of pressuring management to apply the more stringent and detailed requirements and guidance in the proposed PCAOB auditing standard. If management were to apply the more stringent requirements in the auditing standard, then the first objective for issuing the proposed management guidance (i.e., the desire that management's design, implementation, operation and assessment of internal control not be driven by requirements in an auditing standard – see our comment letter on the proposed management guidance) will not be achieved. If management were not to do so on the basis that they are not required to do so by the proposed management

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[1]SEC, Management's Report on Internal Control Over Financial Reporting, File No. S7-24-06, p. 8

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guidance, auditors would apply the more stringent and detailed requirements and guidance in the proposed PCAOB auditing standard to the internal control system when management does not, and hence the first objective for issuing the new proposed PCAOB auditing standard (see above – i.e., the desire to align the auditing standard with the new proposed management guidance). Furthermore, this situation would lead to the inference that the auditor is taking greater responsibility for internal control than management is. This also appears to violate the fact emphasized by the SEC that management – not the auditor – is responsible for internal control.

The fact that the proposed management guidance allows management such a high degree of flexibility in performing its management assessment when the proposed PCAOB auditing standard does not for the auditor when auditing internal control also begs the question as to whether "reasonable assurance" for management is the same as "reasonable assurance" for the auditor (see discussion of reasonable assurance below). If they are the same, then the nature and extent of management's assessment ought to be at least the same as the nature and extent of the audit of internal control by the auditor (with of course, the exception of the auditor's procedures on management's assessment). If they are not (i.e, if management obtains less assurance than the auditor), then this again appears to violate the fact that management bears greater responsibility for internal control over financial reporting than the auditor.

Reduction of costs and burdens

The proposed management guidance together with the proposed PCAOB auditing standard anticipate cost savings, both for the entity directly and indirectly in respect of consulting and audit fees.

We believe that a significant part of the costs of implementing management's assessment and of AS-2 result from the fact that many entities do not possess sufficient documentation of their internal control. Consequently, companies require significant consulting from outside parties on the basis of AS-2 to document controls so that they are in a position to perform management's assessment of internal control, and so that auditors can audit internal control. Furthermore, auditors provide considerable advice on what would constitute effective internal control over financial reporting for the purposes of the audit based upon the detailed requirements and guidance in AS-2. Only when management has designed, implemented and is operating well-documented internal controls and has performed a well-documented assessment of those controls can audit costs be reduced. Nevertheless, even though the proposed PCAOB auditing standard represents a considerable reduction in the degree of detail when compared to AS-2, it is unlikely to radically affect the audit procedures in total, as the overall requirements have effectively not been reduced: the cost of documenting, and obtaining consulting on, internal control changes, management's assessment, and the audit of internal control will remain greater than anticipated by the proposed management guidance and the proposed PCAOB auditing standard because, as a whole, no effective reduction in the stringency of the requirements for management's assessment or the audit of internal control has taken place (see the discussion on "reasonable assurance" below.)

In this context, we note that shortcomings revealed by PCAOB inspections did not indicate an "over-audit" of internal control, but discussed aspects where not enough audit work had been performed. Thus auditor's will still be driven by the need to perform sufficient work to satisfy PCAOB inspections.

The suggested removal of the need for auditors to provide an opinion on management's assessment is supposed to reduce unnecessary duplication of work. However, given that management's assessment process constitutes an internal control over financial reporting from the auditor's point of view, auditors would have based part of their audit work on examining that assessment in any case. Consequently, the elimination of an opinion on management's assessment will not lead to cost savings that are as great as anticipated.

The proposed auditing standard on considering and using the work of others in an audit

Certain aspects of the proposed new auditing standard on "considering and using the work of others" may have a negative impact on audit quality, given that, in contrast to an auditor's own staff, staff of an audit client will always be subject to a conflict of interest and may not have been trained appropriately to perform such work. We discuss this issue further in section 7 of the Appendix.

Reasonable assurance and material weaknesses in internal control

We refer to section 4 in the Appendix for a brief outline of the problems with the current definitions of "reasonable assurance" and "material weakness in internal control" in AS-2, for a detailed examination of the actual meaning of the change in definition included in the proposed PCAOB auditing standard (and the proposed management guidance also), and for an analysis of the implications. **This analysis shows that no effective change has taken place in the meaning of**

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either "reasonable assurance" or "material weakness in internal control": The proposed definition means that reasonable assurance that the ICFR is reliable is achieved when the likelihood that a material misstatement will not be prevented or detected by the ICFR is *remote*.

We would like to point out that the effective use of a *remote* likelihood of risk as a threshold for reasonable assurance (for the reliability of internal control, for management's assessment, and for the audit of internal control) will drive the nature and extent of the design and operation of internal control, management's assessment of internal control and the audit of internal control. The flexibility given management in the proposed management guidance and the reduction in detailed requirements in the proposed PCAOB auditing standard will not lead to any significant reduction in the work effort of management or the auditor (and any significant reduction in costs) as long as this threshold drives their work.

We recommend that the SEC and the PCAOB adopt one definition of reasonable assurance that also forms the basis for the definition of material weakness as noted in section 4 in the Appendix.

Concluding Comments

In our view, based on the comments above and in section 2 in the Appendix, the approach taken by the SEC and the PCAOB ought to have been reversed from what has taken, and is taking, place. In other words, what is needed, first and foremost, are principles-based standards, and guidance, for management on the **design, implementation, and operation** of effective internal control over financial reporting, including **suitable effectiveness criteria** for, and **documentation** of, such design, implementation and operation. None of the mentioned internal control frameworks (COSO, CoCo, or Turnbull) actually provide any specific requirements or guidance on these matters specifically for internal control over financial reporting – particularly not on effectiveness criteria or management documentation.[2]

[2] We would like to point out that in Germany, the IDW has an accounting pronouncement (IDW FAIT 1) based upon legal requirements that does provide effectiveness criteria and documentation requirements specifically in relation to internal control over financial reporting.

Second, building on the standards and guidance for internal control over financial reporting, a principles-based standard with additional guidance is needed for management's assessment of internal control over financial reporting. The proposed management guidance allows considerable flexibility, but at the same time certain "stakes in the ground" (requirements) need to be set at a principles-based level if requirements of this sort are included in an auditing standard for auditors.

Finally, a PCAOB standard on the audit of internal control would use the standards and guidance on the design, implementation, operation and assessment of effective internal control over financial reporting by management as a basis for its principles-based requirements and guidance. Since the PCAOB standard would build on the standards for management, quite rightly the PCAOB standard should need less detail and requirements than the standards for management, since most of the requirements and guidance for the audit of internal control would flow from the requirements or guidance that apply to management.

To us, the current and proposed approach of the SEC and PCAOB appears backwards (i.e., the wrong way round). We do not believe that, in the long run, the problems associated with management's assessment of internal control over financial reporting or the auditor's opinion on internal control can be solved without improving the overall structure of pronouncements as noted.

We do welcome, in principle, the move to reduce the costs and burdens associated with management's assessment of internal control over financial reporting and the audit of that internal control by the auditor. However, based upon our reading of the Sarbanes-Oxley Act as noted in section 1 in the Appendix, we do not believe that some of the measures in the proposed management guidance and the proposed PCAOB auditing standard are appropriate. Consequently, we believe that consideration should be given to obtaining legislative changes to the Sarbanes-Oxley Act (hereinafter referred to as the "SOX"). Furthermore, without making the threshold for reasonable assurance and material weaknesses in internal control over financial reporting less stringent, the flexibility given management in the proposed management guidance and the reduction in detailed requirements in the proposed PCAOB auditing standard will not lead to significant reductions in the work effort of management or the auditors, and hence not lead to the desired cost reduction.

We would be very pleased to be of further assistance if you have any questions or comments about the contents of our letter.

Yours truly,

Klaus-Peter Feld	Wolfgang P. Böhm
Executive Director	Director, International Affairs

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Appendix

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APPENDIX: Specific Matters

1. The elimination of the opinion on management's assessment

In Section II.B.1. of the release, the PCAOB proposes to remove the requirement to evaluate management's process and also the opinion by the auditor on management's assessment. In section II.B.1. of the release, the PCAOB also states that it believes that

> "…the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process."

Furthermore, the separate opinion on management's assessment is viewed as redundant.

In our view, it is questionable whether the SEC and the PCAOB can remove the auditor's opinion on management's assessment, and whether the above-quoted "belief" is well-founded. SOX Section 404 (b) states:

> "Internal Control Evaluation And Reporting.- With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues an audit report for the issuer shall attest to, and report on, *<u>the assessment made by the management</u>* [*italics and underlining added*] of the issuer."

Furthermore, SOX Section 103 (a) (2) states:

> "In carrying out paragraph (1), the Board [the PCAOB]–
>
> (A) shall include in the auditing standards that it adopts, requirements that each registered public accounting firm shall– …
>
> (iii) describe in each audit report the scope *<u>of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404 (b)</u>* [*italics and underlining added*], and present (in such report or in a separate report)–
>
> (I) the findings of the auditor from such testing
>
> (II) *<u>an evaluation of whether such internal control structure and procedures</u>* [*italics and underlining added*]–
>
> (aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the issuer;

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(bb) *provide reasonable assurance that the transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer;* [*italics and underlining added*]

Without claiming to be experts in U.S. Federal Securities law, we have doubts that the opinion on management's assessment can be eliminated: we would like to point out that reading the plain English in the SOX, it appears to us that the SOX Section 404 requires an opinion by the auditor on *management's assessment of internal control* and that SOX Section 103 requires the PCAOB to have its auditing standards also include an *opinion by the auditor on the effectiveness of internal control* as defined in Section 103 (2) (A) (iii) (II) (aa) and (bb). As pointed out in our comment letter dated November 21, 2003 to the draft of AS-2, an opinion on management's assessment of internal control is *not* necessarily the same as an opinion on the effectiveness of internal control.

Some have interpreted the opinion on management's assessment as constituting an opinion on management's assertion with respect to internal control as opposed to an opinion on management's assessment.[3] However, this then begs the question as to why the SOX appears to require an opinion on the assessment and an opinion on internal control, since if an opinion on management's assessment represents an opinion on management's assertion, then no separate opinion on internal control by the auditor would be necessary. For these reasons, we believe that the SOX 404 is directing auditors to provide an opinion on management's assessment, whereas SOX 103 is directing the PCAOB to require in its auditing standards an auditor's opinion on internal control. Since management's assessment would be performed on the basis of the same nature and extent of procedures as the audit of internal control would (with the exception of the audit work on management's assessment), SOX requires a separate opinion on management's assessment *process* because that provides important information about internal control over financial reporting to investors.

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[3] See footnote 20 on page 15 in PCAOB Release 2007-007, 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

The proposal to eliminate the evaluation of management's assessment is designed primarily to reduce audit costs. To some extent this will be true, however, given that management's assessment process constitutes a part of the internal control over financial reporting from the auditor's point of view, the auditor will not be able to discount the process entirely and so cost savings may not be as great as anticipated.

Consequently, we have doubts that it would be appropriate to eliminate one or the other opinion pursuant to the SOX. It appears to us that the direct opinion by the auditor on internal control has less support in the SOX than the one on management's assessment: consequently, it is the former that is more of a candidate for elimination than the latter.

However, we would like to be clear that, in principle, we welcome the efforts by the SEC and the PCAOB to reduce the cost and burdens associated with implementing the SOX. On this basis, we would regard it to be preferable if the SOX had required a management assertion on internal control on the basis of a management assessment of internal control, and then an audit opinion on that management assertion only (in addition to the opinion on the financial statements, for the financial statements also represent assertions by management), rather than an audit opinion on internal control directly. This solution would emphasize management's responsibility for internal control. Unfortunately, the SOX does not appear to support that route. In our view, the correct solution to this problem can only be achieved by having the U.S. Congress amend the SOX.

2. The structure of the pronouncements

The audit of internal control over financial reporting is predicated upon adequate documentation of internal control by management. However, such documentation of internal control over financial reporting presupposes that there are adequate controls to be documented.

Nevertheless, when examining the proposed management guidance, it only addresses the performance, evidence, and documentation of management's assessment of internal control over financial reporting. An overall impression arising from the proposed management guidance is that management's assessment would almost be an extra task undertaken by management who would otherwise have little to do with internal control (for example the discussion as to the need to establish which controls are to be tested, where more than one control operates with the same control objective). In reality, this cannot be the case, since management has already had to take responsibility for the design and implementation of the internal control processes and procedures and so it already needs to have satisfied itself that these controls will be sufficient and capable of operating efficiently and effectively. Requirements and guidance with respect to the actual design, implementation and operation of effective internal control are not addressed except by reference to the internal control frameworks COSO, CoCo and Turnbull. An examination of COSO, CoCo and Turnbull reveals that none of these actually appear to contain effectiveness criteria for internal control over financial reporting – nor do they appear contain documentation requirements in relation to internal control over financial reporting.

Furthermore, the language used in the proposed management guidance is often vague. For example, on page 27 "…it is unlikely management will identify only this type of control….as adequately addressing a financial reporting risk…" This could be more precise, stating that "in rare circumstances" or something similar. The use of terms such as "ordinarily" and "generally" weakens the guidance, as management may not feel compelled to follow certain aspects even when it would be appropriate for them to do so.

In our view, what is lacking are principles-based standards, and guidance, for management on the design, implementation, operation (including effectiveness criteria) and documentation of effective internal control over financial reporting.[4] Without such standards and guidance, there is effectively no firm basis for management's assessment of internal control or the documentation thereof and hence no basis for the audit of either management's assertion or assessment of internal control over financial reporting, nor for the audit of internal control. In terms of the Assurance Framework as issued by the International Auditing and Assurance Standards Board, what is lacking are "suitable criteria" for internal control over financial reporting and documentation standards to make such internal control assessable or auditable.

To overcome this lack of suitable criteria, both the proposed management guidance and, even more so, the proposed PCAOB auditing standard, contain criteria for the assessment and audit, respectively, of internal control from which the

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[4] We would like to point out that in Germany, the IDW has an accounting pronouncement (IDW Stellungnahme zur Rechnungslegung: Grundsätze ordnungsmäßiger Buchführung bei Einsatz von Informationstechnologie (IDW RS FAIT 1) ["IDW Accounting Principle: Principles of Proper Accounting When Using Information Technology"] (IDW AcP FAIT 1)) based upon legal requirements that does provide effectiveness criteria and documentation requirements specifically in relation to internal control over financial reporting.

needed design, implementation and operation of internal control over financial reporting can be derived. However, this is not the appropriate place for these: it leads to the criteria in the proposed management guidance and the requirements and guidance in the proposed PCAOB auditing standard actually determining how effective internal control over financial reporting ought to be designed, implemented and operated. In other words, the standards and guidance for assessment and audit drive the design, implementation and operation of internal control over financial reporting. Needless to say, this is the wrong way round.

Furthermore, the lack of a principles-based documentation standard and guidance for the design, implementation, operation and assessment by management of internal control over financial reporting effectively leads to the PCAOB Auditing Standard No. 3 "Audit Documentation" (AS-3) becoming the standard for the documentation of management's design, implementation, operation and assessment of internal control because

- the PCAOB documentation standard is much more stringent than the concomitant documentation requirements for management's assessment and certainly more stringent than the nonexistent documentation requirements for the design, implementation and operation of internal control over financial reporting (For example, page 38 of the proposed management guidance states "Management may determine that it is not necessary to separately maintain copies of the evidence it evaluates; however, the evidential matter within the company's books and records should be sufficient to provide reasonable support for its assessment." However, there is no reference as to the fact this "reasonable support" would need to be sufficient from the point of view of a third-party expert or similar, such as for the auditor. As the assessment that management performs is itself an internal control, documentation needs to be at a similar level as that required of an auditor, such that it is capable of being audited. This guidance contrasts sharply with documentation requirements with which an auditor must comply. AS-3 no. 4 states that "Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached…"; no. 6 states that "Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement: a. To understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and b. To determine who performed the work and

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the date such work was completed as well as the person who reviewed the work and the date of such review.")

- PCAOB enforcement activities will drive auditors to comply with the documentation requirements in that standard,
- This will in turn drive auditors to require management to document their assessment and controls in a manner so that they can be audited and documented in accordance with AS-3.

Consequently, an auditing documentation standard will drive management documentation of internal control over financial reporting and their assessment thereof. When auditors are subjected to enforcement activities such as inspections, effectively the adage "not documented – not done" applies. The question arises as to why this does not apply to management in relation to internal control and its assessment.

We would like to point out that one of the main reasons for issuing the proposed management guidance was to avoid the situation where auditing standards drive management activities. It is apparent that due to more stringent requirements and detailed guidance for the audit of internal control, as well as for documenting that audit, than exists in the proposed management guidance, one of the primary objectives for the issuance of management guidance will not be achieved.

Furthermore, it is the existence of adequate documentation of internal control that more than any other measure would contribute to the reduction in audit costs in relation to internal control (e.g., when performing walk-through tests: PCAOB Proposed AS-5 paragraphs 36 et seq. state that "The auditor should perform a walk-through tests for each significant process…. " and "These probing questions are essential to the auditor's ability to gain a sufficient understanding of the process…"). Such documentation would also benefit management for the purposes of its assessment.

3. Inherent limitations of internal control

Although the second Note to A5 in the proposed PCAOB auditing standard does address inherent limitation of internal control (and hence of audits thereof), it does not do so in a systematic manner. By definition, inherent limitations are matters that can only be mitigated to some degree – not eliminated. The proposed PCAOB auditing standard should clarify that there are certain kinds of misstatement risks (and hence ICFR risks) that are not only higher, but to which internal control is not as an effective response as for other risks. In other words, some elements of financial statements or issues (e.g., fraud, management override, related party disclosures, significant accounting estimates, critical accounting policies, complex matters or those requiring significant judgment) represent inherent limitations on internal control that affect the effectiveness of internal control and hence the assurance that can be obtained on that effectiveness. This has an impact on the meaning of “reasonable assurance” in relation to the effectiveness of internal control and the audit of internal control, as well as its meaning in relation to the audit of the financial statements.

4. Reasonable assurance and material weaknesses in internal control

Current problem

The current description of reasonable assurance in extant AS-2, and hence the definitions of significant and material weaknesses, are dominated by the reference to reasonable assurance being an unmitigated “high” level of assurance and the link to a remote likelihood of misstatement risk. In particular, the description of reasonable assurance in AS-2 paragraph 17 states:

> “Reasonable assurance includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance.”

This description has been subject to considerable criticism by the IDW, among others, in its previous comment letters to both the PCAOB and the SEC on proposed AS-2 (see IDW comment letters to the PCAOB and SEC on proposed AS-2 dated November 21, 2003 and May 17, 2004, respectively). We refer you to our arguments in these comment letters on the meaning of reasonable assurance.

In particular, our comment letters noted that the implied contention that prudent officials (refer to definition of reasonable assurance in SEC final rule release no. 33-8238 as “…the degree of assurance as would satisfy prudent officials in the conduct of their own affairs”; this concept is also referred to within the proposed management guidance on page 15) are *always* able to use controls to obtain a burden of persuasion equivalent to a “*remote* likelihood of being wrong” and the reference to an unmitigated “high” level of assurance cause concern.

Effect of proposed changes

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We are pleased that the SEC and the PCAOB have recognized the need to amend the definition of material weakness and significant deficiency and then by implication, the meaning of reasonable assurance. We are particularly pleased with the description of reasonable assurance on page 15 of the proposed management guidance, which refers to the definition given in the Exchange Act Section 13 (b) (7) by means of the "degree of assurance as would satisfy prudent officials in the conduct of their own affairs." However, this description does not appear to be consistent with the description of reasonable assurance in paragraph 77 in the proposed standard, because this latter description is linked here to the term "significant deficiency" (this latter description also does not appear to be consistent with the definition of "significant deficiency" in paragraph A12 of the proposed standard), whereas the description from paragraph 13 (b) (7) appears to be linked to the term "material weaknesses" in the proposed management guidance.

Page 14 of the proposed management guidance states:

> "Management is required to assess as of the end of the fiscal year whether the company's ICFR is effective in providing reasonable assurance regarding the reliability of financial reporting."

Furthermore, paragraph A8 in the proposed standard defines the term "material weakness" as follows:

> "A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement in the company's annual or interim financial statements will not be prevented or detected."

By defining "material weakness" in this way, the proposed PCAOB auditing standard links reasonable assurance that an ICFR is reliable, with the reasonable possibility that a material misstatement will not be prevented or detected by the ICFR. <u>By implication, then, reasonable assurance that the ICFR is reliable would be when there is no reasonable possibility that a material misstatement will not be prevented or detected by the ICFR</u>.

However, closer examination of these definitions and the use of the term "reasonable possibility" rather than "remote likelihood" shows that the change in terminology has led to no substantive change in meaning. In particular the note to paragraph A8 in the proposed PCAOB auditing standard states that:

> "There is a **reasonable possibility** of an event as used in the definitions of *material weakness* and *significant deficiency* (<u>see</u> paragraph A12), when the likeli-

> hood of the event is either "reasonably possible" or "probable", as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS No. 5")."

However, the definitions of FAS 5 paragraphs 3b and c state:

> "*Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely."

> "*Remot*e. The chance of the future event or events occurring is slight."

Hence, reasonable assurance that the ICFR is reliable would be when the likelihood that a material misstatement will not be prevented or detected by the ICFR is neither reasonably possible (more than remote but less than likely) nor probable. In other words, reasonable assurance that the ICFR is reliable would be when the likelihood that a material misstatement will not be prevented or detected by the ICFR is neither more than remote but less than likely, nor probable. <u>This means that reasonable assurance that the ICFR is reliable would be when the likelihood that a material misstatement will not be prevented or detected by the ICFR is remote</u>. This is no real change from the current definitions.

The SEC and the PCAOB should recognize that if a remote likelihood of risk drives the definition of reasonable assurance and hence of significant deficiencies or material weaknesses, it is this likelihood that will continue to drive the nature and extent of management's assessment of internal control over financial reporting and the nature and extent of the audit of internal control by the auditor at two levels: 1. the reasonable assurance required of the internal control system, and the reasonable assurance required for management's assessment, and 2. the reasonable assurance required for the audit of internal control to determine whether internal control has achieved reasonable assurance of reliability. This definition will also drive the PCAOB enforcement function's interpretation of what represents a reasonable work effort. For these reasons, despite the flexibility given management in the proposed management guidance to perform management's assessment, and the reduction in the detailed requirements and guidance in the proposed PCAOB auditing standard, the retention of an effective threshold of a remote likelihood would prevent a significant reduction in the overall work effort for either management or auditors.

Furthermore, if "remote likelihood" drives the definition of reasonable assurance and hence of significant deficiencies or material weaknesses, it is hard for us to understand, how in virtually the "same breath", the proposed management guidance and the proposed PCAOB auditing standard can speak of the inherent limitations of internal control and of audits for such matters as management

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fraud involving collusion, and yet still claim that it is possible for management to reduce the risk of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's ICFR, or of the auditor not detecting material weaknesses not detected and corrected by management's assessment, to a remote likelihood of risk. These arguments apply to other instances where reasonable assurance may represent at most what we termed in our previous comment letters to be the "preponderance of the evidence" (e.g., such control and audit issues as the identification of related parties, revenue recognition in complex borderline cases, etc.).

On the other hand, there are many circumstances where internal control can reasonably, and therefore should, reduce the risk of misstatement to a remote likelihood, such as in relation to simple computations of a routine nature in relation to material account balances, or in those exceptional circumstances when accounting evidence, and hence audit evidence, in relation to a particular assertion needs no interpretation and is therefore incontrovertible. As a result, we firmly believe that what "reasonable assurance" is depends upon the circumstances – i.e., the nature of the assertion and related evidence, the resulting related potential risk of misstatement, and hence the nature of the controls or audit procedures that can reasonably be maintained or performed, respectively, to respond to that risk. *In our view, it is not possible to effectively define reasonable assurance (and hence material weaknesses) in terms of certain narrative expressions of Bayesian probability, and we therefore recommend that both the SEC and the PCAOB refrain from doing so.* Such narrative expressions of Bayesian probability could, at most, be used to describe the acceptable range within which the obverse of "reasonable assurance" may occur (i.e., between remote and less than likely, where the actual assurance that is reasonable within that range depends upon the circumstances).

We suggest that the SEC and PCAOB adopt one definition of reasonable assurance that ought to be applied to the definitions of significant deficiency and material weakness (and hence the desired reliability of the ICFR) and express the work effort for both management's assessment and the audit. We believe the most appropriate definition of reasonable assurance to be

> "…the degree of assurance as would satisfy prudent officials in the conduct of their own affairs",

as noted above and as effectively referred to on page 15 of the proposed management guidance. Since by its very nature, the level of "reasonable" assurance cannot be a constant; what is reasonable will vary according to the particular circumstances. We have no difficulty with the use of the word "high" in relation to assurance as long it is appropriately qualified to convey the varying nature of what "high" means. For this reason, if retention of the word "high" continues to be desired in the proposed PCAOB auditing standard (see item a. in Amendment to AU sec. 230 in Appendix 4 of the proposed standard), we suggest using the phrase "reasonable assurance is a high level of assurance subject to the inherent limitations of internal control", or "reasonable assurance is a high level of assurance subject to the inherent limitations of an audit", as appropriate (see discussion of inherent limitations in the Appendix).

By the same token, expressions of risk would also need to recognize their relative – as opposed to constant – nature by equating "reasonable assurance" with "acceptably low level of risk". For these reasons we propose defining a material weakness in internal control over financial reporting as:

> "A control deficiency, or combination of control deficiencies, such that there is a greater than acceptably low level of risk that internal control over financial reporting will not prevent, or detect and correct, a material misstatement in the financial statements on a timely basis".

5. Focus on controls needed to adequately address risk of material misstatements

The proposed PCAOB auditing standard emphasizes that the audit should focus on the matters most important to internal control (see page 5 of the Release). In particular, the proposed standard directs the auditor's attention towards the most important controls (see also page 5 of the Release). The proposed standard implements this objective in the note to paragraph 3 by stating that auditor should select for testing only those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to a given relevant assertion that could result in a material misstatement to the company's financial statements. Furthermore, paragraph 42 of the proposed standard notes that although there may be more than one control that addresses the assessed risk of misstatement for a particular assertion, it is neither necessary to test all controls to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

Although we agree in principle with this approach to focus on the controls needed to adequately address the risk of material misstatement, we would like to point out that there is an inherent contradiction on the way the approach is described.

It would be economically inefficient (i.e., the costs would exceed the benefits) for management to establish and maintain redundant internal controls that provided more assurance than reasonable assurance. Only where the redundancy is necessary to achieve reasonable assurance would such redundancy be a part of the control objective. To obtain reasonable assurance that internal control will prevent, or detect and correct material misstatements in relation to a particular financial statement assertion, based on the proposed definition of material weakness, management would establish those controls needed so that there is no reasonable possibility of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's internal control over financial reporting (see the discussion on reasonable assurance in section 3 of the Appendix). Leaving aside the issue of controls that are established to respond to a particular business or financial reporting risk but that *en passant* also respond to other financial reporting risks, controls established to respond to a particular risk of misstatement of a financial statement assertion therefore cannot be redundant by definition and therefore must all be necessary to ensure an adequate response to that misstatement risk, or management would have had no economic justification for establishing them in the first place.

If all of the controls established by management to respond to a risk of misstatement in relation to a particular financial statement assertion are necessary – as opposed to redundant – to determine whether there is reasonable assurance that internal control will prevent, or detect and correct material misstatements in relation to a particular financial statement assertion, then the auditor has no choice but to select those controls for testing, and to test the design and operating effectiveness of all of these controls to determine whether there is a reasonable possibility of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's internal control over financial reporting in relation to that assertion.

The only exception to this would be circumstances where controls are established to respond to a particular business or financial reporting risk but that *en passant* also respond to other financial reporting risks for which there are other adequate controls. In these circumstances, management need not assess the redundant controls and may focus on the control or controls that provide the necessary assurance.

6. Individual controls vs. the audit opinion on the company's internal control over financial reporting overall

The note under paragraph 51 in the proposed PCAOB auditing standard states:

> "Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control."

We agree that the auditor's objective is to express an opinion on the company's internal control over financial reporting overall, rather than an opinion on the effectiveness of each individual control. However, this paragraph leaves the impression that an auditor need not obtain sufficient competent audit evidence in relation to internal control over a particular financial statement assertion, which is contradicts paragraph 3 of the proposed standard and the second sentence of B4 in Appendix A1 of the Release.

This begs the question as to the relationship between the evidence obtained for individual controls, internal control over a particular assertion, and internal control over financial reporting as a whole.

To the extent that particular assertions within the financial statements are independent of one another, we believe that an auditor must obtain sufficient competent audit evidence in relation to internal control (although not for the individual controls) responding to an inherent risk relating to a particular assertion. Hence, while the auditor can vary the evidence obtained regarding the effectiveness of individual controls, the auditor cannot vary the sufficiency and competence of the evidence obtained regarding the effectiveness of internal control over a particular assertion.

As a result, when providing an opinion on internal control over financial reporting as a whole, to the extent the assertions and related controls thereover are independent of one another, the level of assurance obtained on internal control over financial reporting as a whole cannot exceed the assurance obtained for the control, over a particular assertion, for which the least assurance was obtained. Hence, an auditor must obtain sufficient competent audit evidence in relation to internal control over each financial statement assertion (even though what may be sufficient and competent in each case may vary).

7. Other Matters

We are concerned that the proposed standard contains a number of problematic statements or contentions. For example:

- Paragraph 12, first bullet point: The PCAOB appears to believe that, in the absence of documentation evidencing the effective operation of control, the auditor can supplement inquiry and observation (valid evidence only for that point in time) with "other procedures". What such "other procedures" could be is not discussed; we are unable to visualize what the PCAOB may have had in mind when drafting this. It appears to us to be unrealistic. To be able to perform an audit, an auditor needs to be able to draw upon existing management documentation of significant control processes and procedures, given that an auditor's objective is to obtain sufficient competent evidence and record findings within the audit documentation as required by PCAOB AS-3 "Audit Documentation". At the very least, management would have needed to document all of the controls necessary for effective control over financial reporting as part of it's assessment. In this vein, paragraph 56 makes no mention of the fact that an auditor may face a scope limitation when the auditor cannot obtain documentation that could reasonably be expected to exist. We refer to our comment letter to the SEC on its proposed management guidance, and in particular, on the need for more stringent documentation requirements for management in relation to the design, operation and assessment of internal control over financial reporting.

- Paragraph 12, second bullet point: We consider it unlikely that company level controls alone can always be sufficiently effective in addressing the risk of material misstatement at an assertion level.

- Paragraph 12, third bullet point: Is it realistic to rely on management controls to prevent management override in smaller entities where very few individuals work closely together, given the potential for collusion?

- Paragraph 12, last bullet point: In our experience there is almost always a need for modification of software, irrespective of an entity's size and complexity; perhaps the PCAOB should refer to "customizing" instead.

- The second note to paragraph 62 states: "When sampling is appropriate and the population to be tested is large, increasing the population size does not proportionately increase the required sample size." We would like to point out that this statement only applies to statistically valid sampling techniques.

- B31 appears oversimplified and is likely to be misleading: for example, it does not consider the other factors can change, e.g., environment can change, which may need to cause consideration as to whether unchanged programs remain appropriate.

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8. Proposed Auditing Standard "Considering and Using the Work of Others in an Audit"

We are concerned that when an issuer provides personnel to directly assist the auditor in the audit (proposed AS-5 paragraphs 20 –21), that this personnel will lack sufficient objectivity, necessitating certain steps. We are not convinced that it will be possible to address the conflict of interest, that will always apply to a member of staff of the entity subject to audit, in an effective and cost reductive manner. Such a conflict of interest would need to be addressed by increased supervision and testing of that persons work to an extent that it may negate potential cost savings.

There are many other aspects that need full consideration before an auditor can request direct assistance from personnel of the issuer that have not been given any consideration. For example, we question whether it would be appropriate for members of an issuer's personnel to take part in the "brainstorming" session required by AU sec. 316.14, given what such a session should entail. As a further example, we wonder what measures can an auditor reasonably undertake to ensure that such "borrowed" audit team members adopt the stringent ethical requirements applicable (e.g., confidentiality) to the audit team.

We believe there may be a need for the PCAOB to identify criteria for the auditor when the auditor determines how the work of others will alter the nature, timing, or extent of the auditor's work, as required by paragraph 17. In particular, although the PCAOB believes routine tests, such as walk-through tests, may be performed by others, it would not be appropriate for issuer staff members to ask the "probing questions" required in paragraph 39.

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Ms. Nancy M. Morris
Secretary, Securities and Exchange Commission
100 F Street, NE, Washington, DC 20549-1090
USA

By E-mail: rule-comments@sec.org

February 26, 2007

Dear Ms. Morris:

Re.: File Number S7-24-06
Release Nos. 33-8762; 34-54976
Management's Report on Internal Control Over Financial Reporting

The Institut der Wirtschaftsprüfer in Deutschland [Institute of Public Auditors in Germany] (IDW) is pleased to have the opportunity to comment on the above-mentioned releases concerning the Securities and Exchange Commission's proposed interpretative guidance for management regarding its evaluation of internal control over financial reporting and the related proposed rule amendments in the document entitled "Management's Report on Internal Control Over Financial Reporting" (hereinafter referred to as the "proposed management guidance").

The IDW represents the profession of public auditors in Germany and is seeking to comment on the proposed management guidance because a significant number of IDW members audit, or are involved in the audit of, SEC-Registrants or German subsidiaries of such registrants that may be affected by the proposed management guidance, if adopted. Furthermore, these members will be directly affected by the PCAOB's proposed new standard "An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements" (PCAOB Rulemaking Docket No. 21 – hereinafter referred to as the "proposed PCAOB auditing standard"), that represents the PCAOB's auditing counterpart to the SEC's proposed management guidance. Many of our com-

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Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands;
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Dr. Wolfgang Schaum, WP StB

ments are made in light of the relationship between these two documents and we therefore refer the SEC to our comment letter to the PCAOB on the proposed PCAOB auditing standard, which we have attached for reference.

Our letter contains matters of general concern. Further matters of specific concern and more detailed analyses are addressed in the Appendix to this letter.

General Matters

Comment period

We are pleased to note that the SEC and PCAOB have aligned their periods of exposure for the proposed management guidance and the proposed PCAOB auditing standard. However, we are disappointed to see the short exposure period in which comments can be provided to the SEC and PCAOB, particularly since both bodies published their proposals immediately prior to the Christmas holiday season and many organizations would like to have the opportunity to consult more thoroughly with their stakeholders. Due to the rather short comment period, we have only been able to "scratch the surface" in terms of the issues contained in the proposed management guidance.

Overall comments

We appreciate the initiative taken by both the SEC and the PCAOB to revisit the issue of internal control over financial reporting from both management and auditor perspectives and the effort made to align the two documents. In previous comment letters to the PCAOB and the SEC, we had noted a number of issues in the then proposed PCAOB auditing standard AS-2, and have most recently commented on the SEC's concept release that we support the issuance of guidance for management. We continue to believe that there is a need for principles-based requirements, and guidance, on management's design, implementation and operation of internal control over financial reporting, as well as for the performance of management's assessment of that internal control.

In particular, as a matter of principle (though not necessarily the manner proposed), we welcome the fact that management is allowed a high degree of flexibility in its approach to assessing internal control. The proposed top-down approach will allow management to determine which controls are the most significant for financial reporting purposes. In principle, we also support the

- emphasis that has been placed on assessment of the risk of material misstatement,

- increased emphasis on professional judgment (rather than check-list mentality),
- necessity of evidential support, and
- the approach to first consider general controls, and then application controls.

However, we have serious concerns about the way in which these matters have been implemented in the guidance – in particular, the disconnect between the proposed management guidance and the proposed PCAOB standard and some of the internal logical inconsistencies within the proposed management guidance.

The impetus to issue management guidance appears to have been twofold: 1. the desire that management's design, implementation, operation and assessment of internal control not be driven by requirements in an auditing standard[1], and 2. the desire to ensure that managements' assessments are carried out efficiently to reduce unnecessary costs and burdens.[2] We believe that, in light of the proposed PCAOB auditing standard, the proposed guidance will not meet the first objective, and that there is a danger that the proposed guidance will not achieve the second objective.

Proposed management guidance vs. PCAOB internal control standard

The Commission has emphasized "that management, not the auditor, is responsible for determining the appropriate nature and form of internal controls for the company as well as their evaluation methods and procedures".[3] We agree with this emphasis. However, the proposed management guidance allows management greater flexibility in carrying out its assessment of internal control over financial reporting than the proposed PCAOB auditing standard allows the auditor in auditing that internal control: the requirements and guidance in the proposed PCAOB auditing standard are more precise and stringent, allow less flexibility,

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[1] SEC, Management's Report on Internal Control Over Financial Reporting, File No. S7-24-06, p. 10.

[2] SEC, Management's Report on Internal Control Over Financial Reporting, File No. S7-24-06, p. 7.

[3] SEC, Management's Report on Internal Control Over Financial Reporting, File No. S7-24-06, p. 8

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and are in greater detail, than in the proposed management guidance. For example, the management guidance on company-level controls (page 25 et seq.) is far less detailed than that for the auditor (proposed AS-5 paragraphs 17-23). Another example is the fact that walk-through tests are required in the audit of internal control, but not for management's assessment of internal control.

This disconnect between the proposed management guidance and the proposed PCAOB auditing standard will inevitably lead to auditors auditing internal control over financial reporting using the more stringent criteria in the proposed auditing standard, than those applied by management in designing, implementing, operating and assessing that internal control, because PCAOB enforcement activities will drive auditors to apply the more stringent and detailed requirements and guidance in the proposed PCAOB auditing standard. Consequently, auditors would be placed into the position of pressuring management to apply the more stringent and detailed requirements and guidance in the proposed PCAOB auditing standard too. If management were to apply the more stringent requirements in the auditing standard, then the first objective for issuing the management guidance (see above – i.e., the desire that management's design, implementation, operation and assessment of internal control not be driven by requirements in an auditing standard) will not be achieved. If management were not to do so on the basis that they are not required to do so by the proposed management guidance, then auditors would apply the more stringent and detailed requirements and guidance in the proposed PCAOB auditing standard to the internal control system when management does not, which would lead to the inference that the auditor is taking greater responsibility for internal control than management is. This also appears to violate the fact emphasized by the SEC that management – not the auditor – is responsible for internal control.

The fact that the proposed management guidance allows management such a high degree of flexibility in performing its management assessment when the proposed PCAOB auditing standard does not for the auditor when auditing internal control also begs the question as to whether "reasonable assurance" for management is the same as "reasonable assurance" for the auditor (see discussion of reasonable assurance below). If they are the same, then the nature and extent of management's assessment ought to be at least the same as the nature and extent of the audit of internal control by the auditor (with of course, the exception of the auditor's procedures on management's assessment). If they are not (i.e, if management obtains less assurance than the auditor), then this again appears to violate the fact that management bears greater responsibility for internal control over financial reporting than the auditor.

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Reduction of costs and burdens

The proposed management guidance together with the proposed PCAOB auditing standard anticipate cost savings, both for the entity directly and indirectly in respect of consulting and audit fees.

We believe that a significant part of the costs of implementing management's assessment and of AS-2 result from the fact that many entities do not possess sufficient documentation of their internal control. Consequently, companies require significant consulting from outside parties on the basis of AS-2 to document controls so that they are in a position to perform management's assessment of internal control, and so that auditors can audit internal control. Furthermore, auditors provide considerable advice on what would constitute effective internal control over financial reporting for the purposes of the audit based upon the detailed requirements and guidance in AS-2. Only when management has designed, implemented and is operating well-documented internal controls and has performed a well-documented assessment of those controls can audit costs be reduced. Nevertheless, the cost of documenting, and obtaining consulting on, internal control changes, management's assessment, and the audit of internal control will remain greater than anticipated by the proposed management guidance and the proposed PCAOB auditing standard because, as a whole, no effective reduction in the stringency of the requirements for management's assessment or the audit of internal control has taken place (see the discussion on "reasonable assurance" below.)

In particular, the suggested removal of the need for auditors to provide an opinion on management's assessment is supposed to reduce unnecessary duplication of work. However, given that management's assessment process constitutes an internal control over financial reporting from the auditor's point of view, auditors would have based part of their audit work on examining that assessment in any case. Consequently, the elimination of an opinion on management's process will not lead to cost savings that are as great as anticipated.

Reasonable assurance and material weaknesses in internal control

We refer to section 3 in the Appendix for a brief outline of the problems with the current definitions of "reasonable assurance" and "material weakness in internal control" in AS-2, for a detailed examination of the actual meaning of the change in definition included in the proposed PCAOB auditing standard (and the proposed management guidance also), and for an analysis of the implications. **This**

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analysis shows that no effective change has taken place in the meaning of either "reasonable assurance" or "material weakness in internal control": The proposed definition means that reasonable assurance that the ICFR is reliable is achieved when the likelihood that a material misstatement will not be prevented or detected by the ICFR is *remote*.

We would like to point out that the effective use of a *remote* likelihood of risk as a threshold for reasonable assurance (for the reliability of internal control, for management's assessment, and for the audit of internal control) will drive the nature and extent of the design and operation of internal control, management's assessment of internal control and the audit of internal control. The flexibility given management in the proposed management guidance and the reduction in detailed requirements in the proposed PCAOB auditing standard will not lead to any significant reduction in the work effort of management or the auditor (and any significant reduction in costs) as long as this threshold drives their work.

We recommend that the SEC and the PCAOB adopt one definition of reasonable assurance that also forms the basis for the definition of material weakness as noted in section 3 in the Appendix.

Concluding Comments

In our view, based on the comments above and in section 2 in the Appendix, the approach taken by the SEC and the PCAOB ought to have been reversed from what has taken, and is taking, place. In other words, what is needed, first and foremost, are principles-based standards, and guidance, for management on the **design, implementation, and operation** of effective internal control over financial reporting, including **suitable effectiveness criteria** for, and the **documentation** of, such design, implementation and operation. None of the mentioned internal control frameworks (COSO, CoCo, or Turnbull) actually provide any specific requirements or guidance on these matters specifically for internal control over financial reporting – particularly not on effectiveness criteria or management documentation.[4]

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[4] We would like to point out that in Germany, the IDW has an accounting pronouncement (IDW FAIT 1) based upon legal requirements that does provide effectiveness criteria and documentation requirements specifically in relation to internal control over financial reporting.

Second, building on the standards and guidance for internal control over financial reporting, a principles-based standard with additional guidance is needed for management's assessment of internal control over financial reporting. The proposed management guidance allows considerable flexibility, but at the same time certain "stakes in the ground" (requirements) need to be set at a principles-based level if requirements of this sort are included in an auditing standard for auditors.

Finally, a PCAOB standard on the audit of internal control would use the standards and guidance on the design, implementation, operation and assessment of effective internal control over financial reporting by management as a basis for its principles-based requirements and guidance. Since the PCAOB standard would build on the standards for management, quite rightly the PCAOB standard should need less detail and requirements than the standards for management, since most of the requirements and guidance for the audit of internal control would flow from the requirements or guidance that apply to management.

To us, the current and proposed approach of the SEC and PCAOB appears backwards (i.e., the wrong way round). We do not believe that, in the long run, the problems associated with management's assessment of internal control over financial reporting or the auditor's opinion on internal control can be solved without improving the overall structure of pronouncements as noted.

We do welcome, in principle, the move to reduce the costs and burdens associated with management's assessment of internal control over financial reporting and the audit of that internal control by the auditor. However, based upon our reading of the Sarbanes-Oxley Act as noted in section 1 in the Appendix, we do not believe that some of the measures in the proposed management guidance and the proposed PCAOB auditing standard are appropriate. Consequently, we believe that consideration should be given to obtaining legislative changes to the Sarbanes-Oxley Act (hereinafter referred to as the "SOX").

Furthermore, without making the threshold for reasonable assurance and material weaknesses in internal control over financial reporting less stringent, the flexibility given management in the proposed management guidance and the reduction in detailed requirements in the proposed PCAOB auditing standard will not lead to significant reductions in the work effort of management or the auditors, and hence not lead to the desired cost reduction.

We would be very pleased to be of further assistance if you have any questions or comments about the contents of our letter.

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Yours truly,

Klaus-Peter Feld	Wolfgang P. Böhm
Executive Director	Director, International Affairs

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Appendix

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APPENDIX: Specific Matters

1. The elimination of the opinion on management's assessment

Page 52 of the proposed management guidance states :

> "Our rules implementing Section 404(b) of Sarbanes-Oxley require every registered public accounting firm that issues or prepares an audit report on a company's financial statements for inclusion in an annual report that contains an assessment by management of the effectiveness of the registrant's ICFR to attest to, and report on, such assessment. Pursuant to Rule 2-02(f), the accountant's attestation report must clearly state the "opinion of the accountant as to whether management's assessment of the effectiveness of the registrant's ICFR is fairly stated in all material respects." Over the past three years we have received feedback that the current form of the auditor's opinion may not effectively communicate the auditor's responsibility in relation to management's evaluation process. Therefore, we are proposing to revise Rule 2-02(f) to require the auditor to express an opinion directly on the effectiveness of ICFR. In addition, we are proposing revisions to Rule 2-02(f) to clarify the circumstances in which we would expect that the accountant cannot express an opinion.
>
> We are also proposing conforming revisions to the definition of attestation report in Rule 1-02(a)(2) of Regulation S-X. We believe this opinion necessarily conveys whether management's assessment is fairly stated."

In our view, it is questionable whether the SEC and the PCAOB can remove the auditor's opinion on management's assessment, and whether the above-quoted "belief" is well-founded. SOX Section 404 (b) states:

> "Internal Control Evaluation And Reporting.- With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues an audit report for the issuer shall attest to, and report on, *the assessment made by the management* [*italics and underlining added*] of the issuer."

Furthermore, SOX Section 103 (a) (2) states:

> "In carrying out paragraph (1), the Board [the PCAOB]–
>
> (A) shall include in the auditing standards that it adopts, requirements that each registered public accounting firm shall– …

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(iii) describe in each audit report the scope *of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404 (b)* [*italics and underlining added*], and present (in such report or in a separate report)–

(I) the findings of the auditor from such testing

(II) *an evaluation of whether such internal control structure and procedures* [*italics and underlining added*]–

(aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the issuer;

(bb) *provide reasonable assurance that the transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer;* [*italics and underlining added*]

Without claiming to be experts in U.S. Federal Securities law, we have doubts that the opinion on management's assessment can be eliminated: we would like to point out that reading the plain English in the SOX, it appears that the SOX Section 404 requires an opinion by the auditor on *management's assessment of internal control* and that SOX Section 103 requires the PCAOB to have its auditing standards also include an *opinion by the auditor on the effectiveness of internal control* as defined in Section 103 (2) (A) (iii) (II) (aa) and (bb). As pointed out in our comment letter dated November 21, 2003 to the draft of AS-2, an opinion on management's assessment of internal control is *not* necessarily the same as an opinion on the effectiveness of internal control.

Some have interpreted the opinion on management's assessment as constituting an opinion on management's assertion with respect to internal control as opposed to an opinion on management's assessment.[5] However, this then begs the question as to why the SOX appears to require an opinion on the assess-

[5] See footnote 20 on page 15 in PCAOB Release 2007-007, 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

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ment and an opinion on internal control, since if an opinion on management's assessment represents an opinion on management's assertion, then no separate opinion on internal control by the auditor would be necessary. For these reasons, we believe that the SOX 404 is directing auditors to provide an opinion on management's assessment, whereas SOX 103 is directing the PCAOB to require in its auditing standards an auditor's opinion on internal control. Since management's assessment would be performed on the basis of the same nature and extent of procedures as the audit of internal control would (with the exception of the audit work on management's assessment), SOX requires a separate opinion on management's assessment *process* because that provides important information about internal control over financial reporting to investors.

Consequently, we have doubts that it would be appropriate to eliminate one or the other opinion pursuant to the SOX. It appears to us the direct opinion by the auditor on internal control has less support in the SOX than the one on management's assessment: consequently, it is the former that is more of a candidate for elimination than the latter.

However, we would like to be clear that, in principle, we welcome the efforts by the SEC and the PCAOB to reduce the cost and burdens associated with implementing the SOX. On this basis, we would regard it to be preferable if the SOX had required a management assertion on internal control on the basis of a management assessment of internal control, and then an audit opinion on that management assertion only (in addition to the opinion on the financial statements, for the financial statements also represent assertions by management), rather than an audit opinion on internal control directly. This solution would emphasize management's responsibility for internal control. Unfortunately, the SOX does not appear to support that route. In our view, the correct solution to this problem can only be achieved by having the U.S. Congress amend the SOX.

2. The structure of the pronouncements

The performance of management's assessment of internal control over financial reporting is predicated upon adequate documentation of internal control so that such an assessment can be carried out. Likewise, the audit of internal control over financial reporting is predicated upon adequate documentation of internal control by management. However, such documentation of internal control over financial reporting presupposes that there are adequate controls to be documented.

Nevertheless, when examining the proposed management guidance, it only addresses the performance, evidence, and documentation of management's assessment of internal control over financial reporting. An overall impression arising from the proposed management guidance is that management's assessment would almost be an extra task undertaken by management who would otherwise have little to do with internal control (for example the discussion as to the need to establish which controls are to be tested, where more than one control operates with the same control objective). In reality, this cannot be the case, since management has already had to take responsibility for the design and implementation of the internal control processes and procedures and so it already needs to have satisfied itself that these controls will be sufficient and capable of operating efficiently and effectively. Requirements and guidance with respect to the actual design, operation and maintenance of effective internal control are not addressed except by reference to the internal control frameworks COSO, CoCo and Turnbull. An examination of COSO, CoCo and Turnbull reveals that none of these actually appear to contain effectiveness criteria for internal control over financial reporting – nor do they appear contain documentation requirements in relation to internal control over financial reporting.

Furthermore, the language used in the proposed management guidance is often vague. For example, on page 27 "…it is unlikely management will identify only this type of control….as adequately addressing a financial reporting risk…" This could be more precise, stating that "in rare circumstances" or something similar. The use of terms such as "ordinarily" and "generally" weakens the guidance, as management may not feel compelled to follow certain aspects even when it would be appropriate for them to do so.

In our view, what is lacking are principles-based standards and guidance for management on the design, implementation, operation (including effectiveness criteria) and documentation of effective internal control over financial reporting.[6] Without such standards and guidance, there is effectively no firm basis for management's assessment of internal control or the documentation thereof and

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[6] We would like to point out that in Germany, the IDW has an accounting pronouncement (IDW Stellungnahme zur Rechnungslegung: Grundsätze ordnungsmäßiger Buchführung bei Einsatz von Informationstechnologie (IDW RS FAIT 1) ["IDW Accounting Principle: Principles of Proper Accounting When Using Information Technology"] (IDW AcP FAIT 1)) based upon legal requirements that does provide effectiveness criteria and documentation requirements specifically in relation to internal control over financial reporting.

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hence no basis for the audit of either management's assertion or assessment of internal control over financial reporting, nor for the audit of internal control. In terms of the Assurance Framework as issued by the International Auditing and Assurance Standards Board, what is lacking are "suitable criteria" for internal control over financial reporting and documentation standards to make such internal control assessable or auditable.

To overcome this lack of suitable criteria, both the proposed management guidance and, even more so, the proposed PCAOB auditing standard, contain criteria for the assessment and audit, respectively, of internal control from which the needed design, implementation and operation of internal control over financial reporting can be derived. However, this is not the appropriate place for these: it leads to the criteria in the proposed management guidance and the requirements and guidance in the proposed PCAOB auditing standard actually determining how effective internal control over financial reporting ought to be designed, implemented and operated. In other words, the standards and guidance for assessment and audit drive the design, implementation and operation of internal control over financial reporting. Needless to say, this is the wrong way round.

Furthermore, the lack of a principles-based documentation standard and guidance for the design, implementation, operation and assessment by management of internal control over financial reporting effectively leads to the PCAOB Auditing Standard No. 3 "Audit Documentation" (AS-3) becoming the standard for the documentation of management's design, implementation, maintenance and assessment of internal control because

- the PCAOB documentation standard is much more stringent than the concomitant documentation requirements for management's assessment and certainly more stringent than the nonexistent documentation requirements for the design, implementation and operation of internal control over financial reporting (For example, page 38 of the proposed management guidance states "Management may determine that it is not necessary to separately maintain copies of the evidence it evaluates; however, the evidential matter within the company's books and records should be sufficient to provide reasonable support for its assessment." However, there is no reference as to the fact this "reasonable support" would need to be sufficient from the point of view of a third-party expert or similar, such as for the auditor. As the assessment that management performs is itself an internal control, documentation needs to be at a similar level as that required of an auditor, such that it is capable of being audited. This guidance contrasts sharply with documentation requirements with which an auditor must comply. AS-3 no. 4 states that "Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached…"; no. 6 states that "Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement: a. To understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and b. To determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review.)

- PCAOB enforcement activities will drive auditors to comply with the documentation requirements in that standard,
- This will in turn drive auditors to require management to document their assessment and controls in a manner so that they can be audited and documented in accordance with AS-3.

Consequently, an auditing documentation standard will drive management documentation of internal control over financial reporting and their assessment thereof. When auditors are subjected to enforcement activities such as inspections, effectively the adage "not documented – not done" applies. The question arises as to why this does not apply to management in relation to internal control and its assessment.

We would like to point out that one of the main reasons for issuing the proposed management guidance was to avoid the situation where auditing standards drive management activities. It is apparent that due to more stringent requirements and detailed guidance for the audit of internal control, as well as for documenting that audit, than exists in the proposed management guidance, one of the primary objectives for the issuance of management guidance will not be achieved.

Furthermore, it is the existence of adequate documentation of internal control that more than any other measure would contribute to the reduction in audit costs in relation to internal control (e.g., when performing walk-through tests: PCAOB Proposed AS-5 paragraphs 36 et seq. state that "The auditor should perform a walk-through tests for each significant process…. " and "These probing questions are essential to the auditor's ability to gain a sufficient understanding of the process…"). Such documentation would also benefit management for the purposes of its assessment.

3. Reasonable assurance and material weaknesses in internal control

Current problem

The current description of reasonable assurance in extant AS-2 , and hence the definitions of significant and material weaknesses, are dominated by the reference to reasonable assurance being an unmitigated "high" level of assurance and the link to a remote likelihood of misstatement risk. In particular, the description of reasonable assurance in AS-2 paragraph 17 states:

> "Reasonable assurance includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance."

This description has been subject to considerable criticism by the IDW, among others, in its previous comment letters to both the PCAOB and the SEC on proposed AS-2 (see IDW comment letters to the PCAOB and SEC on proposed AS-2 dated November 21, 2003 and May 17, 2004, respectively). We refer you to our arguments in these comment letters on the meaning of reasonable assurance.

In particular, our comment letters noted that the implied contention that prudent officials (refer to definition of reasonable assurance in SEC final rule release no. 33-8238 as "…the degree of assurance as would satisfy prudent officials in the conduct of their own affairs"; this concept is also referred to within the proposed management guidance on page 15) are *always* able to use controls to obtain a burden of persuasion equivalent to a "*remote* likelihood of being wrong" and the reference to an unmitigated "high" level of assurance cause concern.

Effect of proposed changes

We are pleased that the SEC and the PCAOB have recognized the need to amend the definition of material weakness and significant deficiency and then by implication, the meaning of reasonable assurance. We are particularly pleased with the description of reasonable assurance on page 15 of the proposed management guidance, which refers to the definition given in the Exchange Act Section 13 (b) (7) by means of the "degree of assurance as would satisfy prudent officials in the conduct of their own affairs." Unfortunately, on the one hand, page 14 of the proposed management guidance states "management is required to assess as of the end of the fiscal year whether the company's

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ICFR is effective in providing reasonable assurance regarding the reliability of financial reporting;" on the other hand, page 13 of the guidance states

> "A material weakness is a deficiency, or combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement in the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's ICFR"

Either the proposed management guidance has two incompatible definitions of reasonable assurance, or by defining "material weakness" in this way, the proposed management guidance links reasonable assurance that an ICFR is reliable, with the reasonable possibility that a material misstatement will not be prevented or detected by the ICFR. <u>By implication, then, reasonable assurance that the ICFR is reliable would be when there is no reasonable possibility that a material misstatement will not be prevented or detected by the ICFR</u>. Pages 24, and 41 to 42 – including footnote 74 – of the proposed management guidance provide further discussion of these issues.

However, closer examination of these definitions and the use of the term "reasonable possibility" rather than "remote likelihood" shows that the change in terminology has led to no substantive change in meaning. In particular footnote 32 in the proposed management guidance states that:

> "There is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable" as those terms are used in Financial Accounting Standards Board Statement No. 5, <u>Accounting for Contingencies</u>."

However, the definitions of FAS 5 paragraphs 3b and c state:

> "*Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely."

> "*Remot*e. The chance of the future event or events occurring is slight."

Hence, reasonable assurance that the ICFR is reliable would be when the likelihood that a material misstatement will not be prevented or detected by the ICFR is neither reasonably possible (more than remote but less than likely) nor probable. In other words, reasonable assurance that the ICFR is reliable would be when the likelihood that a material misstatement will not be prevented or detected by the ICFR is neither more than remote but less than likely, nor probable. <u>This means that reasonable assurance that the ICFR is reliable would be when the likelihood that a material misstatement will not be prevented or detected by the ICFR is remote</u>. This is no real change from the current definitions.

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The SEC and the PCAOB should recognize that if a remote likelihood of risk drives the definition of reasonable assurance and hence of significant deficiencies or material weaknesses, it is this likelihood that will continue to drive the nature and extent of management's assessment of internal control over financial reporting and the nature and extent of the audit of internal control by the auditor at two levels: the reasonable assurance required of the internal control system, and the reasonable assurance required for management's assessment and for the audit of internal control to determine whether internal control has achieved reasonable assurance of reliability. This definition will also drive the PCAOB enforcement function's interpretation of what represents a reasonable work effort. For these reasons, despite the flexibility given management in the proposed management guidance to perform management's assessment, and the reduction in the detailed requirements and guidance in the proposed PCAOB auditing standard, the retention of an effective threshold of a remote likelihood would prevent a significant reduction in the overall work effort for either management or auditors.

Furthermore, if "remote likelihood" drives the definition of reasonable assurance and hence of significant deficiencies or material weaknesses, it is hard for us to understand, how in virtually the "same breath", the proposed management guidance and the proposed PCAOB auditing standard can speak of the inherent limitations of internal control and of audits for such matters as management fraud involving collusion, and yet still claim that it is possible for management or auditors to reduce the risk of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's ICFR, or of the auditor not detecting material weaknesses not detected and corrected by management's assessment, to a remote likelihood of risk. These arguments apply to other instances where reasonable assurance may represent at most what we termed in our previous comment letters to be the "preponderance of the evidence" (e.g., such control and audit issues as the identification of related parties, revenue recognition in complex borderline cases, etc.).

On the other hand, there are many circumstances where internal control can reasonably, and therefore should, reduce the risk of misstatement to a remote likelihood, such as in relation to simple computations of a routine nature in relation to material account balances, or in those exceptional circumstances when accounting evidence, and hence audit evidence, in relation to a particular assertion needs no interpretation and is therefore incontrovertible. As a result, we firmly believe that what "reasonable assurance" is depends upon the circumstances – i.e. the nature of the assertion and related evidence, the resulting related potential risk of misstatement, and hence the nature of the controls or au-

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dit procedures that can reasonably be maintained or performed, respectively, to respond to that risk. *In our view, it is not possible to effectively define reasonable assurance (and hence material weaknesses) in terms of certain narrative expressions of Bayesian probability, and we therefore recommend that both the SEC and the PCAOB refrain from doing so.* Such narrative expressions of Bayesian probability could, at most, be used to describe the acceptable range within which the obverse of "reasonable assurance" may occur (i.e., between remote and less than likely, where the actual assurance that is reasonable within that range depends upon the circumstances).

We suggest that the SEC and PCAOB adopt one definition of reasonable assurance that ought to be applied to the definitions of significant deficiency and material weakness and express the work effort for both management's assessment and the audit. We believe the most appropriate definition of reasonable assurance to be

> "…the degree of assurance as would satisfy prudent officials in the conduct of their own affairs",

as noted above and as effectively referred to on page 15 of the proposed management guidance. Since by its very nature, the level of "reasonable" assurance cannot be a constant; what is reasonable will vary according to the particular circumstances. We have no difficulty with the use of the word "high" in relation to assurance as long it is appropriately qualified to convey the varying nature of what "high" means. For this reason, if retention of the word "high" continues to be desired in the proposed PCAOB auditing standard (which would mean retention in the proposed management guidance), we suggest using the phrase "reasonable assurance is a high level of assurance subject to the inherent limitations of internal control", or "reasonable assurance is a high level of assurance subject to the inherent limitations of an audit" (see discussion of inherent limitations in the Appendix).

By the same token, expressions of risk would also need to recognize their relative – as opposed to constant – nature by equating "reasonable assurance" with "acceptably low level of risk". For these reasons we propose defining a material weakness in internal control over financial reporting as:

> "A control deficiency, or combination of control deficiencies, such that there is a greater than acceptably low level of risk that internal control over financial reporting will not prevent, or detect and correct, a material misstatement in the financial statements on a timely basis".

4. Evidence to support the assessment

On page 28 the proposed management guidance states that "as part of its evaluation of ICFR, management must maintain reasonable support for its assessment". Pages 30 to 34 of the guidance provide further discussion of the evidence needed to support the assessment, including issues of quality, quantity; on page 38 the guidance also states: "Management's assessment must be supported by evidential matter that provides reasonable support for its assessment." This page then goes not to describe the nature of the evidential matter.

If one accepts the proposition that management, rather than the auditor, is responsible for internal control, and that therefore management's assessment must have the same nature and extent as the audit of internal control to obtain the same "reasonable assurance" about its operating effectiveness, then the evidence required to support management's assessment must be at least as sufficient and competent as that obtained by the auditor to support the auditor's opinion on internal control. Paragraph 3 of the proposed PCAOB auditing standards does make the connection between "reasonable assurance" and "sufficient competent evidence". The proposed management guidance does not: page 14 of the proposed management guidance only refers to the assessment of whether the ICFR is effective in providing reasonable assurance regarding the reliability of financial reporting, not whether management's assessment must obtain reasonable assurance whether this is in fact the case. We suggest that this connection also be made in the proposed management guidance so that more clarity exists about the needed management work effort

5. The lack of requirements and guidance on materiality for management

When the proposed management guidance addresses the "risks" or "financial reporting risks" that management considers in its assessment, it needs to be clear throughout that the "risk of material misstatement" is meant. The phrase "risk of material misstatement " is meaningless without a discussion, first as to what constitutes a *misstatement* and secondly, and more importantly, what is *material*. We would like to point out that the proposed management guidance provides neither standards nor guidance for either, whereas AU §312 contains a considerable number of requirements and considerable guidance for what is often called "planning materiality" (as opposed to the final materiality level that is applied in evaluating misstatements) that auditors apply in planning the audit, performing risk assessments, and designing audit procedures to respond to risk.

In fact, while there are some SEC pronouncements that apply to management that deal with the final materiality level used for evaluation of misstatements in the financial statements, there are none that deal with the considerations covered in AU § 312 (in relation to so-called "planning materiality") for management's assessment over financial reporting, and in particular for identifying financial reporting risks and identifying controls that adequately address financial reporting risks and performing assessment procedures to determine whether the risk assessment involving expectations of about operating effectiveness is appropriate. Nevertheless, paragraph 14 of the proposed PCAOB auditing standard requires that auditor apply these considerations when auditing internal control. Consequently, these considerations ought to apply equally to management when planning and performing its assessment of internal control.

Given our comments above that there ought to be principles-based standards and guidance for the design, implementation and operation of effective internal control over financial reporting, and the documentation thereof, we believe that in fact management requires principles-based requirements and guidance on the meaning of materiality such as in AU § 312 in order to be able to design, implement and operate effective internal control and document these. Without such requirements and guidance on "planning materiality", management would not be in position to design effective internal control.

Furthermore, when designing internal controls, management may accept that it is not necessary for a particular control to prevent, or detect and correct all misstatements, i.e., immaterial misstatements. Hence, for efficiency reasons, management may therefore establish that an internal control need not be effective for immaterial misstatements. However, due to the fact that individually immaterial misstatements may aggregate into a material misstatement, guidance is needed for management on setting such a threshold (often termed "tolerable error" in auditing literature or standards) significantly below materiality given management's misstatement rate expectations.

Likewise, when planning its assessment of internal control and performing its risk assessment for the assessment of internal control, and assessing the operating effectiveness of internal control, management would need to recognize its evaluation process needs to leave a margin for possible undetected weaknesses in internal control. For this reason, guidance is also needed on the application of a threshold lower than materiality when performing the assessment of internal control.

We note the proposed PCAOB auditing standard continues to apply the concept of a "significant deficiency", which is based upon the concept of a "significant misstatement". We have not explored the impact of the concept of a "significant misstatement" on the issues above, but would request that the SEC and the PCAOB address this impact in the proposed management guidance and proposed PCAOB auditing standard, respectively.

6. Inherent limitations of internal control

Page 4 of the proposed management guidance briefly addresses the inherent limitations of internal control with respect to fraud and notes that such fraud risks can be reduced, but not eliminated by means of internal control. Furthermore, page 34 of that guidance points out that certain financial reporting elements (significant accounting estimates, related party transactions, critical accounting policies) or those elements involving management override of internal control, significant judgment or complexity should generally be assessed as having higher ICFR risk.

However, the proposed management guidance does not address the inherent limitations of internal control generally, such as in the second Note to A5 in the proposed PCAOB auditing standard. By definition, inherent limitations are matters that can only be mitigated to some degree – not eliminated. The proposed management guidance should clarify that there are certain kinds of misstatement risks (and hence ICFR risks) that are not only higher, but to which internal control is not as an effective response as for other risks. In other words, these elements or issues as noted above (e.g., fraud, management override, related party disclosures, significant accounting estimates, critical accounting policies, complex matters or those requiring significant judgment) represent inherent limitations on internal control that affect the effectiveness of internal control and hence the assurance that can be obtained on that effectiveness. This has an impact on the meaning of "reasonable assurance" in relation to management's assessment and the audit of internal control, as well as its meaning in relation to the audit of the financial statements.

7. Focus on controls needed to adequately address risk of material misstatements

Page 16 of the proposed management guidance notes that "The proposed guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement in the financial statements" and ".. if management determines that the risks for a particular financial reporting element are adequately addressed by an entity-level control, no further evaluation of other controls is required." This issue is addressed again on pages 25 and 29 of the proposed management guidance. Additional discussion on page 25 then points out that where redundant controls exist, "management may decide to select the control for which evidence of operating effectiveness can be obtained more efficiently". Although we agree in principle with the approach to concentrate on significant controls and on those for which the evidence can be obtained most efficiently, we would like to point out that there is an inherent contradiction on the way the approach is described in the proposed management guidance.

It would be economically inefficient (i.e., the costs would exceed the benefits) for management to establish and maintain redundant internal controls that provided more assurance than reasonable assurance. Only where the redundancy is necessary to achieve reasonable assurance would such redundancy be a part of the control objective. To obtain reasonable assurance that internal control will prevent, or detect and correct material misstatements in relation to a particular financial statement assertion, based on the proposed definition of material weakness, management would establish those controls needed so that there is no reasonable possibility of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's internal control over financial reporting (see the discussion on reasonable assurance in section 3 of the Appendix). Leaving aside the issue of controls that are established to respond to a particular business or financial reporting risk but that *en passant* also respond to other financial reporting risks, controls established to respond to one particular financial reporting risk (i.e., a particular risk of misstatement of a financial statement assertion) therefore cannot be redundant by definition and therefore must all be necessary to ensure an adequate response to that misstatement risk, or management would have had no economic justification for establishing them in the first place.

If all of the controls established by management to respond to a risk of misstatement in relation to a particular financial statement assertion are necessary – as opposed to redundant – to obtain reasonable assurance that internal control will prevent, or detect and correct material misstatements in relation to a particular financial statement assertion, then management has no choice but to choose to assess the operating effectiveness of all of these controls to determine whether there is a reasonable possibility of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's ICFR in relation to that assertion (the same would apply to the auditor's tests of control).

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The only exception to this would be circumstances where controls are established to respond to a particular business or financial reporting risk but that *en passant* also respond to other financial reporting risks for which there are other adequate controls. In these circumstances, management need not assess the redundant controls and may focus on the control or controls that provide the necessary assurance.

8. Consideration of general vs. application controls

The consideration of general and application controls on page 27 needs to be clarified that only if general controls prevent or detect material misstatement at the assertion level on their own with reasonable assurance can the management determine it is appropriate to disregard further detailed (application) controls. Furthermore, it is increasingly common for general controls to be embedded in IT systems. The guidance uses an increasingly artificial separation which does not adequately reflect current developments in internal control systems.

9. Materiality, Risk and Misstatement Risk

The sentences, on page 33 of the proposed management guidance, describing the relationship between materiality, risk, misstatement risk need slight revision to make them conceptually sounder. In particular, the second and third sentences ought to read:

> "For a given chance of misstatement, as the materiality of the financial reporting element increases in relation to the amount of misstatement that would be considered material to the financial statements, management's assessment of risk of misstatement would increase. Likewise, for a given materiality of a financial reporting element, as the chance of misstatement increases, the management's assessment of the risk of misstatement also increases."

10. Reporting guidance

The reporting guidance on page 46 states:

> "Because of the significance of the disclosure requirements surrounding material weaknesses beyond specifically stating that material weaknesses exist, companies should also consider including the following in their disclosures:
>
> - the nature of any material weakness,

- it impact on financial reporting and control environment, and
- management's current plans, if any, for remediating the weakness."

However, management may not actually provide this disclosure, or provide it improperly. The proposal in the proposed management guidance and the proposed PCAOB auditing standard to no longer require the auditor to opine upon management's assessment, but yet have the auditor evaluate whether management's presentation is complete and fairly presented (see the proposed PCAOB auditing standard paragraph 81 et seq. in combination with C2) without *requiring* such management disclosure or that management's presentation to be complete and fairly presented, appears to be counterproductive because it leaves the impression that the detection and response to material weaknesses is an auditor, rather than a management responsibility. We therefore recommend that the management disclosure noted above be made mandatory.

11. Outsourcing

The treatment of outsourcing on page 48 of the guidance needs to be expanded considerably. For example, there is no discussion of the overlap between the internal control at the service organization and the user entity, nor is there a discussion of the importance of general controls the service organization and whether they may have been subject to audit etc. These are significant issues which the guidance may need to address.

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

26 February 2007

ICAEW response: 08/07

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J. Gordon Seymour
Office of the Secretary
Public Company Accounting Oversight Board
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Dear Ms Morris and Mr Seymour,

Securities and Exchange Commission Release on Management's Report on Internal Control over Financial Reporting

Public Company Accounting Oversight Board Proposed Auditing Standard on An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals

The Institute of Chartered Accountants in England and Wales (ICAEW) welcomes the opportunity to comment on the SEC and the PCAOB documents published in December 2006 relating to section 404 of the Sarbanes-Oxley Act.

The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular in respect of auditors, is overseen by the Financial Reporting Council (FRC). As a world leading professional accountancy body, the ICAEW provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained.

Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

Our experience

The ICAEW is an experienced and significant contributor and commentator on risk management and internal control, as well as on accounting and auditing. Relevant work includes:

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- our publication in 1999 of the Turnbull guidance, *Internal Control: Guidance for Directors on the Combined Code*;
- our support to the FRC in the preparation of its 2004 guide *The Turnbull guidance as an evaluation framework for the purposes of Section 404(a) of the Sarbanes-Oxley Act*;
- our project management support to the FRC Turnbull Review Group that produced the revised Turnbull guidance in October 2005;
- our contribution to the March 2005 discussion paper *Risk management and internal control in the EU* and the related follow-up paper of April 2006, published by FEE, the representative body of the European accountancy profession;
- our work on US and UK corporate governance regimes in our *Beyond the Myth of Anglo-American Corporate Governance* thought leadership programme which has included engagement with the SEC and the PCAOB; and
- the ongoing work of expert committees of members in public practice and in business in the areas of PCAOB auditing standards and corporate governance.

We have previously submitted comment letters to the SEC and to the PCAOB in relation to section 404 commencing with a letter to the SEC on 29 November 2002 and a letter to the PCAOB on 21 November 2003 on its proposals for Auditing Standard No. 2 (AS 2). We have consistently expressed concern about the direction taken by the SEC and the PCAOB; the resulting inflated scope of the work of auditors, additional costs and wasteful inefficiencies; and the pervasive impact of AS 2 on the audit methodologies used by the global audit networks. We have also consistently pointed out that not all 'attestations' are 'audits'.

ICAEW members work in SEC registrants and audit firms registered with the PCAOB and in all sectors of the UK and global economies. The ICAEW responds to consultation documents issued by the SEC and the PCAOB because we believe that it is in the public interest for the US authorities to hear a voice from the accountancy profession outside the United States with direct recent experience of public policy issues related to internal control in listed companies.

We are therefore pleased to submit our comments in this letter on both the SEC and PCAOB documents. The interaction between the two documents is of critical importance and we have paid particular attention to this matter. We have chosen to submit a single letter because we have identified issues that need to be jointly addressed by both bodies and we believe that each body should be aware of what we are saying about the other's document. Supporting this letter are three appendices that cover:

1. comments applicable to both documents;
2. comments on the SEC document and answers to specific questions raised by the SEC; and
3. comments on the PCAOB's proposed auditing standard and answers to specific questions raised by the PCAOB.

Our principles

In preparing this letter, we have applied three overriding principles:

- internal control over financial reporting in any organisation needs to be led from the top of that organisation. In the current US context this means that the focus should be on management;
- whatever work auditors undertake, it must not duplicate the work that management undertakes but must be based on evidence of what management has done; and
- future regulatory efforts should be proportionate and should draw on emerging international best practice in the field of regulation.

In our view, the SEC and the PCAOB documents do not measure up well against these principles and do not present compelling alternatives.

There is still much to do

We are supportive of the SEC and the PCAOB in so far as they want to:

- improve the effectiveness and efficiency with which management and auditors assess a company's internal control over financial reporting (ICOFR) and so lead to cost reductions;
- adopt a top-down, risk-based approach with emphasis on the control environment;
- propose principles-based, high level guidance to enable management and auditors to make judgements based on their knowledge and experience of the business;
- recognise that there is a need for flexibility and discourage a one-size-fits-all checklist mentality; and
- consider issues related to the scalability of the requirements as applied to different companies.

However, whilst we consider the initiatives of the SEC and the PCOAB to be steps in the right direction, we have a number of major concerns about the documents. .

It is assumed that audit costs can be reduced by implementing proposed Auditing Standard No. 5 (AS 5). We are not convinced that this will always be the case and we are concerned that there may be overly optimistic expectations in the market about the magnitude of cost savings that will arise as a direct consequence of the changes proposed by the SEC and PCAOB. For example, we are aware that by using different words in its definitions, such as that for material weakness, the PCAOB is attempting to raise the threshold of materiality. However, we note that the words used in the new AS 5 and in the old AS 2 both have their origins in FAS 5. We are therefore sceptical about whether this attempt will be successful and whether in substance much will be achieved.

Simply stating that proposals are principles-based and risk-based does not mean that this is so or that management and auditor behaviour will be principles-based and risk-based in practice. There are dangers that:

- the expectations created by press releases and the words in the introductory sections of both documents will only be partially met;
- AS 5 will not significantly change auditor behaviour; and
- management will still have look to auditing standards for guidance.

In short, we caution the SEC and PCAOB against 'declaring victory' prematurely and publishing final documents that are substantially the same as the proposals. There is much still to be done not only on AS 5 and the guidance for management, but also on how these documents are interpreted and implemented

The SEC and PCAOB documents need further alignment

The SEC and PCAOB documents are not sufficiently aligned. For example, there are different definitions of material weakness in the two documents. On such a fundamental matter, this is unacceptable. The SEC and PCAOB should adopt one definition of material weakness and the SEC should take direct responsibility for this. We also note that the proposed management and auditor assessment methodologies set out by the SEC and the PCAOB respectively are somewhat different. The SEC's is more high-level and risk-focussed and the PCAOB's is more detailed and control-focussed. We outline these matters and further examples of areas that are not aligned in Appendix 1.

Lack of alignment is likely to cause confusion, misinterpretation, unnecessary cost and unmet expectations of change. More diligence is needed with the SEC and PCAOB working together to inspire greater confidence in the consistency of the documents. In view of the fundamental importance of the issues we highlight, we believe that there should be further public consultation on revisions to the SEC guidance and AS 5.

The proposals alone cannot change behaviour fundamentally

Ultimately, the attitudes and behaviours of individuals working for registrants, auditors and regulatory agencies will determine whether or not the implementation of section 404 is substantially improved. This will depend on people being persuaded and prepared to implement fundamental changes to previous ways of working and methodologies developed under earlier requirements. There is a need for a substantial re-education, re-investment and re-incentivisation. The revised SEC and PCAOB documents have important roles to play in this.

However, the SEC and the PCAOB need to recognise that the guidance and the standard are only parts of a bigger picture. Other factors influencing the behaviour of management and auditors include fears of SEC enforcement actions, adverse PCAOB inspection findings and litigation. Such fears have made management and auditors very cautious in their implementation of section 404. In themselves, the proposed guidance and standard offer only limited incentives to act differently.

The perceived focus of PCAOB inspection reports is on auditor shortcomings, inadequacies in audit work and the under-auditing of financial statements. By contrast, the focus of AS 5 is on preventing the ‘over-audit’ of internal control over financial reporting. This is evidenced by a significant number of notes referring to the fact that auditors ‘need not’ or are ‘not required to’ perform a particular procedure. However, AS 5 cannot prevent auditors from over-auditing in that it does not say that auditors must not perform a particular procedure. It is quite possible that auditors will continue to over-audit despite the changes if their behaviour is being driven by an inspection and enforcement regime that is seen as encouraging defensive auditing.

It is important that the PCAOB sends out a consistent message to auditors. Individual auditor behaviour is likely to be more sensitive to the approach taken by the PCAOB in its inspection and enforcement activities than it is to changes in auditing standards and it is therefore important that one reinforces the other. We do not believe that it will be enough for the PCAOB to say that its inspectors will have regard to the efficiency as well as the effectiveness of the auditor’s work. It also needs to be accepted that to be efficient auditors have to make judgements with which inspectors might not agree and which might be seen differently with the benefit of hindsight.

If the inspection and enforcement approach focuses on detailed disclosure errors in published financial statements and compliance with the letter of standards rather than on the manner in which the audit was conducted and the quality of significant audit judgements, then changes to auditing standards will have a very limited effect on auditor behaviour. Another factor which is likely to affect management and auditor behaviour is the elimination of the auditor’s opinion on management’s assessment.

The consequences of separate auditor and management assessments are hard to predict

The SEC and PCAOB documents provide for separate management and auditor assessments of internal control over financial reporting. This represents an intriguing experiment analogous to requiring management and auditors each to prepare separate financial statements for an issuer. Given the political sensitivity of section 404 and the need to stabilise its implementation, we doubt the wisdom of such experimentation.

It might be argued that there are already separate assessments under AS 2 and that therefore there is little incremental risk. However, there is a major difference. Currently, management has to rely on AS 2 in making their assessment whereas in future management will be able to follow the SEC guidance or another methodology of their choosing. To extend the financial statement analogy, management and auditors would not only prepare separate financial statements but they would also not be required to follow the same GAAP.

The SEC and PCAOB are in danger of creating a situation where an issuer could have two different conclusions validly drawn from two different assessment methodologies, one from management and another from the auditor. This possibility is likely to confuse investors and markets. We believe that there should be one approach, and that this would be more efficient and cost effective. Hence, our interest in the further alignment of the SEC and PCAOB documents.

If the SEC and PCAOB documents are not aligned, there will be tensions that have to be resolved because we do not believe that a difference between the approaches taken by management and auditors would be sustainable in the medium term. Either the present situation would reassert itself, with auditors under pressure from PCAOB inspectors holding the whip hand over management, or management's approach would prevail with auditors feeling pressured to acquiesce in the face of public expectations that auditors and auditing standards should no longer drive the section 404 reporting process.

The proposals do not appear to reflect Congressional intent

In attempting to improve the effectiveness and efficiency of implementing section 404, both the SEC and the PCAOB are proposing to change the AS 2 requirements by the elimination of the requirement for the auditor to express an opinion on management's assessment of internal control over financial reporting. AS 5 would only address the auditors' own assessment of the issuer's internal control over financial reporting.

Yet section 404(b) of the Sarbanes-Oxley Act states, in respect of the internal control assessment required of management under section 404(a), that the auditor "….shall attest to, and report on, the assessment made by the management of the issuer." In AS 2 and AS 5, the PCAOB has interpreted section 404(b) as mandating an audit opinion which expresses the auditor's own assessment of the issuer's internal control over financial reporting.

We have two issues with this interpretation:

- Firstly, not all 'attestations' are 'audits'. We first raised this point in our letter to the PCAOB dated 21 November 2003 and have repeated this concern on subsequent occasions, most recently in our letter dated 18 September 2006 to the SEC on its Concept Release. We do not believe that the SEC or PCAOB have satisfactorily set out in print the reasons for their view that an audit is required.
- Secondly, we believe that the SEC and PCAOB should have eliminated the opinion on the issuer's internal control over financial reporting, not the opinion on management's assessment of internal control over financial reporting. They have also failed to provide a proper basis for their action. The subject of the auditors' work specified by the Act is 'the assessment made by the management' not 'the company's internal control over financial reporting' as specified by AS 5. We do not see how these two terms can be equivalent. We note that the wording in the proposed report by the auditors on page A1-38 of AS 5 correctly refers to 'management's assessment' even though this is a source of potential confusion to the reader of the report who might not be aware that AS 5 does not require this assessment to be audited.

These two fundamental issues should be re-examined and debated fully and publicly to confirm whether the SEC and the PCAOB have correctly interpreted Congressional intent.

The SEC and the PCAOB should recognise and assert the primacy of management

Section 404(a) places a clear responsibility on management to assess and report on internal control over financial reporting. Management should understand its responsibilities and ensure, taking professional advice where appropriate, that control systems are working properly to address the significant risks to their company's financial reporting.

The proposed elimination of the auditors' assessment of what management has done reduces the focus on the work of management. We believe that the SEC and PCAOB proposals are therefore at variance with our principles as set out at the start of this letter.

In our letter of 18 September 2006 to the SEC on its Concept Release, we commented that the primacy that should be accorded to management's assessment of the effectiveness of internal control over financial reporting raises fundamental questions about the need for auditors to undertake their own separate audit of the effectiveness of internal control over financial reporting.

We understand that some people may be concerned that if the auditor's own assessment were to be eliminated and the auditor was only required to attest to management's assessment then there would be no need for auditors to test the underlying controls. We do not believe this to be the case. For example, as part of an audit of financial statements, International Standards on Auditing require auditors to undertake testing of internal controls to enable them to form an opinion on the financial statements. Likewise, if auditors were to express an opinion on management's assessment, they would be expected to perform testing of the underlying controls and could be required to do so.

The implementation of revised proposals calls for innovative monitoring

We have previously stated that the proposed AS 5 is only part of a bigger picture. How AS 5 is applied and how PCAOB inspectors undertake their work will be important factors in the future implementation of section 404. At the current time, it is a matter of speculation whether revised proposals will result in an actual reduction in costs and burdens. We would have liked to have seen some proposals for pilot testing to give real world results and evidence. Whilst we recommend that the SEC and PCAOB give consideration to this possibility for all registrants, it may be that such testing may not be feasible.

If this is the case, we strongly suggest that the SEC and the PCAOB put forward innovative ways of monitoring on a real-time basis the future implementation of section 404. Evidence gained should include information on changes in behaviour, costs and burdens that would be useful in assessing the need for a further round of policy reform if there are continuing problems with the implementation of section 404.

Individuals in all registrant companies and audit firms should be able to report to the SEC and PCAOB their views, concerns and real-world experiences of the implementation of section 404 on an on-going basis without the fear of regulatory action. The SEC and PCAOB need to announce their plans for on-going monitoring and soliciting of feedback and state that they will be open to further suggestions for change in the light of experience.

In conclusion, companies need effective systems of internal control over financial reporting, not only for external reporting purposes but also for the purposes of running the business. We suggest that having auditors attest to, but not necessarily audit, management's assessment of the effectiveness of internal control over financial reporting would be more valuable than what is proposed in AS 5.

If you would like to discuss our comments in further detail, please contact me or Jonathan Hunt, Head of Corporate Governance (jonathan.hunt@icaew.com), or Katharine Bagshaw, Manager, Auditing Standards; (katharine.bagshaw@icaew.com).

Yours sincerely

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cc: Chairman, SEC
Commissioners, SEC
Chairman, PCAOB
Board Members, PCAOB
Chairman, Senate Committee on Banking, Housing and Urban Affairs
Chairman, House Financial Services Committee

Appendix 1

General comments on both the SEC and PCAOB documents

1.1 Introduction

The SEC and PCAOB documents need to be aligned to ensure a consistency of approach to the implementation of section 404. The individual documents must also be internally consistent.

A lack of alignment and internal inconsistencies will cause:
- confusion and misinterpretation;
- misaligned methodologies of management and auditors, and
- a consequential and unnecessary waste of time and money.

Depending on the extent of the problem, the issue could lead to the need for increased auditor testing, which could offset potential efficiencies that may result from the PCAOB's proposed auditing standard.

We believe that there are areas where the two documents are not currently aligned and we highlight a number of them below. More diligence is needed with the SEC and PCAOB working together to rectify these matters.

We strongly recommend that the SEC, with its oversight role of the PCAOB, should ensure that the documents should be submitted for a further round of public consultation and should be internally consistent and better aligned.

1.2 Definition of material weakness

There is inconsistency in the definition of material weakness. This is unacceptable. The SEC and PCAOB should adopt one definition of material weakness and the SEC should take direct responsibility for this.

The SEC's definition of 'material weakness' (page 13) is: "A material weakness is a deficiency, or combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's ICFR."

The PCAOB defines 'material weakness' (paragraph A8) as follows: "A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected."

The SEC's definition is better in that it relates material weaknesses solely to deficiencies in internal control over financial reporting. A 'control deficiency' in the PCAOB's definition is capable of being wider than a deficiency in internal control over financial reporting. The SEC's definition is also better in that it refers to 'a timely basis' which is preferable to having no time constraints. There is no such reference in the PCAOB's definition.

However, we find the SEC's definition to be less satisfactory in that the final sentence ends with the words "by the company's ICFR" (internal control over financial reporting). A material misstatement would not necessarily be indicative of a material weakness where it would be detected on a timely basis by means other than a company's internal control over financial reporting.

1.3 The use of judgement in the current US framework

We applaud the intention to move towards the increased use of judgement by management and auditors in the area of internal control over financial reporting. Sound judgement is a hallmark of good management and experienced professionals and we believe that this is the way forward.

We are aware that senior SEC staff and the Chairman of the FASB have accepted that there is too much complexity in US accounting. One matter that US regulators will have to consider is the practical application of judgement on matters of internal control over financial reporting in the context of a financial reporting framework that is too detailed and complex and not sufficiently intuitive.

There may thus be inherent limitations in the application of judgement to internal control over financial reporting and the SEC may need to consider the implication of being unable fix one part of the financial reporting framework in isolation.

1.4 Restatements as a strong indicator of a material weakness in ICFR

The ‘restatement of previously issued financial statements to reflect the correction of a material misstatement’ is identified as being a strong indicator of a material weakness. However, this may not fully recognise the possibility of mistakes arising despite the application of sound process and judgement.

Whilst we appreciate that page 45 of the SEC’s document states that “the correction of a material misstatement includes misstatements due to error or fraud; it does not include retrospective application of a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle”, we ask the SEC and PCAOB to reconsider this whole area.

Perfection cannot easily, if ever, be achieved especially in such matters as accounting standards and internal control over financial reporting especially given the complexity of some parts of US GAAP. There is a perception that every honest mistake in the application of an accounting standard that results in restatement will give rise to a material weakness and a failure of internal control over financial reporting.

For example, consider the complex standard FAS 133, Accounting for Derivative Instruments and Hedging Activities. It is possible that even very well respected and well controlled companies may fall foul of the requirement for a restatement with 20:20 hindsight, even though at the time of preparation of the financial statements the issuer had taken every reasonable step to identify issues and take professional advice on its approach to the application of FAS 133 to specific transactions.

Where an issuer has tried its best via a clear and robust process to make an appropriate judgement on the application of complex standards and subsequently the SEC staff disagree and force an issuer to make a restatement, then such an honestly made mistake should not lead to the future public reporting of a material weakness in the issuer’s internal control over financial reporting.

We suggest that further consideration is given to the area of restatements as a strong indicator of a material weakness in the circumstances we describe. We recognise that the words ‘strong indicator’ do not mandate a particular treatment. However, in practice, we believe that a risk averse approach by individuals will over-ride the non-compulsory classification and that restatements will automatically give rise to material weaknesses.

1.5 A top-down, risk-based approach?

We commend the SEC for its statement on page 16 that "The guidance describes a top-down, risk-based approach to this principle, including the role of entity-level controls in assessing financial reporting risks and the adequacy of controls. The proposed guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement in its financial statements. There is no requirement in our guidance to identify every control in a process or document the business processes impacting ICFR."

However, as the top-down approach is explained in the guidance, there is progressively more detail and terminology. For example, we move from "financial reporting element" to "characteristics of the financial reporting elements to which the controls relate and the characteristics of the controls themselves" (page 31) to "characteristics of the financial reporting element…..include both the materiality of the financial reporting element and the susceptibility of the underlying account balances, transactions or other supporting information to material misstatement." (page 33).

The increasing level of detail must not be allowed to blur the overall need for management judgement and a top-down approach so correctly noted by the SEC on page 5 of its document when it states that "Management must bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and that provides reasonable assurance for its assessment"

Although it starts with the same lofty ambition, the PCAOB's AS 5 appears to have a different interpretation of the risk-based approach. For example, page 19 of its document says that the auditor should "determine the evidence to be obtained based on the risk associated with the control" and in the next paragraph that "…determining that a control presents low risk overall…". Proposed AS 5 gets into ever-increasing detail with lists of matters that the auditor needs to address.

The wording in the documents is capable of being easily misinterpreted, thus creating confusion as to whether the approach by management and auditors should be an approach that starts with:

- risks; "management to focus on those controls that are needed to adequately address the risk of a material misstatement in its financial statements." (page 15, proposed SEC guidance); or
- controls; "directing the auditor's testing to the most important controls; emphasizing the importance of risk assessment" (page 4, proposed AS 5).

The impression given is that there may be two types of 'risk-based, top-down' approach. Whichever approach is deemed to be correct, and we prefer that of the SEC, it should be consistent throughout both documents. The danger of inconsistency in the application of and approach to 'risk' throughout the SEC and PCAOB proposals could trigger different interpretations.

We ask the question whether in a risk-based approach where the attention is directed to controls that address the risk of a material misstatement in the financial statements, reference should be made to 'low risk areas'. Whilst we appreciate the curtailment of time and evidence that may be needed for the low risk areas, we question whether this gives the right message to the individuals who will have to implement the guidance.

In the following paragraphs, we highlight a number of areas where further work is needed by the SEC, supported by the PCAOB. We provide a few brief examples to help illustrate our points.

1.6 Differing terminology

Two examples of differing terminology include:

(a) the proposed SEC guidance refers to controls that address "financial reporting risks" that could result in "material misstatement" whereas AS 5 refers to controls that address "relevant assertions" related to "significant accounts".

(b) the proposed SEC guidance refers to "financial statement elements". It is not clear whether this is the same as the "significant accounts" referred to in AS 5.

1.7 Differences in approach exist between the SEC and PCAOB texts

(a) The SEC guidance rightly proposes that management need not document every control in an accounting process, needing only to identify the relevant risks. This appears to adopt a top-down, risk-based approach. But AS 5 expects auditors to document walkthroughs of all significant accounting processes. This appears to be a bottom-up approach that does not take account of risk.

(b) The SEC proposes a framework for assessing deficiencies. Why is this not given equal prominence in AS 5?

1.8 Different standards of accountability for management and auditors

AS 5 requires the auditor to test the design effectiveness of controls by determining whether the company's controls can effectively prevent or detect errors or fraud that could result in material misstatement. In a corresponding paragraph, the SEC guidance uses the phrase "adequately address the risk of" rather than "can effectively prevent or detect". This seems to be a different and less absolute requirement.

1.9 Specific requirements for auditors that do not exist for management

AS 5 has specific requirements where, irrespective of the analysis of risk, the auditor is required to perform certain procedures. In areas of high risk, such as the assessment of the control environment, this appears reasonable. However, the requirement to perform walkthroughs of significant processes and to assess the competence of those evaluating controls are just two examples of a greater degree of specificity in AS 5 than might be necessary given the level of risk.

1.10 Inconsistencies within a text

The introduction to AS 5 explains the significant differences between AS 2 and AS 5. Much, but not all, of this text is consistent with the subsequent proposed standard. However, the statement that the proposed standard "requires risk assessment at each of the *decision points* in a top-down approach" (emphasis added in italics) is inadequately explained. AS 5 appears to prompt a continuous stream of decisions, rather than specific "decision points".

Appendix 2

Comments on the SEC's Release on Management's Report on Internal Control over Financial Reporting

2.1 Mixed messages

We note a contrasting approach between:
- comments at the start of the document that set the scene and objectives; and
- subsequent guidance material.

For example, contrast the following two statements:

1. "if management determines that the risks for a particular financial reporting element are adequately addressed by an entity-level control, *no further evaluation of other controls is required.*" (page 16 – introductory comments – emphasis added in italics)

2. "while management ordinarily would consider entity-level controls of this nature when assessing financial reporting risks and evaluating the adequacy of controls, it is unlikely management will identify only this type of entity-level control as adequately addressing a financial reporting risk identified for a financial reporting element." (page 27- part of the guidance).

Mixed messages will lead to different interpretations and confusion and the adoption, as a rational response, of a more cautious response than may be necessary.

2.2 SEC's guidance to management is rooted in an auditors' approach

The SEC's proposed guidance is unlikely to resonate well with management as it is not very user-friendly. The approach taken by the guidance and the language it uses are rooted in an auditor's approach to internal control over financial reporting instead of language that may be better understood by management. For example, the proposed guidance makes reference to the 'design' and 'operation' of controls which is perceived as 'auditor' parlance.

2.3 Fraudulent financial reporting

The wording in the proposed SEC guidance goes well beyond fraudulent financial reporting to cover misappropriation of assets and corruption. Page 23 states "Management's evaluation of financial reporting risks should also consider the vulnerability of the entity to fraudulent activity (e.g., fraudulent financial reporting, misappropriation of assets and corruption) and whether any of those exposures could result in a material misstatement of the financial statements."

The SEC should carefully consider:
- whether this exceeds the scope of the Sarbanes-Oxley Act; and
- the consequences of this wording and whether an expectations gap will develop giving investors a false sense of security and providing a potential future hostage to fortune.

2.4 Balance of the document

We have some concerns that the high-level approach is not consistently implemented throughout the document with the result that, in places, it lapses into a greater degree of detail than may be necessary for high-level guidance.

We assume that IT controls are included in the main body of the proposed SEC guidance (pages 27 and 28) because they have been cited as a problem area over the last two years. Whilst we understand the need to address these issues, we question whether their inclusion in the main body of the proposed guidance is really the best way to deal with the matter. Will such an approach set a precedent for the future with requests for problem areas that are identified in the next few years to be included in yet more guidance?

Respondents to the SEC's proposed guidance may well request additional guidance in different areas, probably in the form of practical examples. Acceptance of such requests will have the effect of moving away from the concept of management judgement. We hope that the SEC will resist requests for further guidance and will also reconsider the extent of the guidance in the current documents. It is not enough simply to support the provision of guidance by means of a footnote reference to a request for guidance from those commenting on the Concept Release. The SEC should also consider other matters, such as whether guidance adds points of substance and is strictly necessary, whether it will limit the scope for exercising appropriate judgement and whether it will tend to make the document too lengthy and inaccessible for its intended audience to read.

2.5 Questions asked by the SEC on the proposed interpretive guidance

We have chosen not to answer all the questions on pages 49 to 51, pages 53 and 54 and page 60. Unanswered questions are left blank.

	Question	**Comment**
1	Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process?	Generally yes. The guidance is a step forward, but, as we state in our letter of 26 February 2007, we have a number of concerns and believe that there is still much to do. Overall, we commend the SEC on its intention to adopt a generally high-level and principles-based approach for the preparation of its proposed interpretive guidance for management. In Appendix 1.5 we refer to the top-down, risk-based approach and, in particular, the risk that detail might blur the overall need for management judgement.
	Does the proposed guidance allow for management to conduct an efficient and effective evaluation?	It is not possible to say at this time. The acid test is whether expectations of change will be met. We refer to our letter of 26 February 2007 in which we point out that the proposals alone cannot fundamentally change behaviour.
2	Are there particular areas within the proposed interpretive guidance where further clarification is needed? If yes, what clarification is necessary?	Points requiring greater clarity are set out in our letter of 26 February 2007 as well as in our comments on alignment with the PCAOB standard in Appendix 1 and in all comments in Appendix 2. However, as stated in Appendix 2.4 we are very wary of calls for further clarification where this does not add points of substance and merely limits the scope for exercising appropriate judgement and makes the document too lengthy and inaccessible.
3	Are there aspects of management's annual evaluation process that have not been addressed by the	No. Respondents to the SEC's proposed guidance may well request additional guidance in different areas, probably in the form of practical

	proposed interpretive guidance that commenters believe should be addressed by the Commission? If so, what are those areas and what type of guidance would be beneficial?	examples. Acceptance of such requests will have the effect of moving away from the concept of management judgement. We hope that the SEC will resist requests for further guidance.
4	Do the topics addressed in the existing staff guidance (May 2005 Staff Guidance and Frequently Asked Questions (revised October 6, 2004)) continue to be relevant or should such guidance be retracted? If yes, which topics should be kept or retracted?	The May 2005 documents should be retracted.
5	Will the proposed guidance require unnecessary changes to evaluation processes that companies have already established? If yes, please describe.	We hope that unnecessary changes will not happen, but this depends on how the new requirements are implemented. The Commission should accept that some companies may have changes to make to previously established processes. However, costs that have already been incurred are sunk costs and should not be taken into account when deciding on future regulatory policy. We are concerned that the SEC and PCAOB documents are not aligned. A lack of alignment and internal inconsistencies will cause confusion and misinterpretation, misaligned management and auditor methodologies and a significant consequential waste of resources. Much work is needed to rectify these matters.
6	Considering the PCAOB's proposed new 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*, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to resolve the incompatibility?	See Question 5 above, matters raised in our letter of 26 February 2007 and Appendix 1.

7	Are there any definitions included in the proposed interpretive guidance that are confusing or inappropriate and how would you change the definitions so identified?	See Appendix 1.2 and 1.4. In particular, there are differences in the wording of the definitions proposed by the SEC and the PCAOB. On a matter as fundamentally important as this there should be no inconsistency. The definitions throughout the guidance appear to use language that is more commonly used by auditors than by management.
8	Will the guidance for disclosures about material weaknesses result in sufficient information to investors and if not, how would you change the guidance?	In principle, yes but in practice we are concerned that legal advice will limit the usefulness of disclosures to investors. On the issue of material weaknesses, we refer to Appendix 1.2 and 1.4.
9	Should the guidance be issued as an interpretation or should it, or any part, be codified as a Commission rule?	The document should be issued as interpretive guidance and not as a rule.
10	Are there any considerations unique to the evaluation of ICFR by a foreign private issuer that should be addressed in the guidance? If yes, what are they?	Yes. We agree that the management of FPIs that file financial statements prepared in accordance with home country generally accepted accounting principles or IFRS with a reconciliation to U.S. GAAP should plan and conduct their evaluation process based on their primary financial statements (i.e., home country GAAP or IFRS) rather than the reconciliation to U.S. GAAP(footnote 47). We also support the SEC's reference in footnote 16 to frameworks used in other countries, for example the Turnbull guidance adopted in the UK.
11	Should compliance with the interpretive guidance, if issued in final form, be voluntary, as proposed, or mandatory?	Voluntary, as proposed.
12	Is it necessary or useful to amend the rules if the proposed interpretive guidance is issued in final form, or are rule revisions unnecessary?	-
13	Should the rules be amended in a different manner in view of the proposed interpretive guidance?	-

14	Is it appropriate to provide the proposed assurance in Rules 13a-15 and 15d-15 that an evaluation conducted in accordance with the interpretive guidance will satisfy the evaluation requirement in the rules?	Yes.
15	Does the proposed revision offer too much or too little assurance to management that it is conducting a satisfactory evaluation if it complies with the interpretive guidance?	Despite the safe harbour that may be provided, if auditors are still required to form their own opinion on the issuer's internal control over financial reporting and to work to a more detailed, non-aligned standard which a high level of detail, management will still look to the auditing standard for guidance.
16	Are the proposed revisions to Exchange Act Rules 13a-15(c) and 15d-15(c) sufficiently clear that management can conduct its evaluation using methods that differ from our interpretive guidance?	Yes.
17	Do the proposed revisions to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X effectively communicate the auditor's responsibility? Would another formulation better convey the auditor's role with respect to management's assessment and/or the auditor's reporting obligation?	See the comments in our letter of 26 February 2007 on the proposed elimination of the requirement on the auditor to evaluate management's assessment. We strongly believe that the SEC and PCAOB have proposed the elimination of the wrong auditors' opinion. We believe that the SEC and PCAOB should re-examine their decision. Yes. The auditors' opinion on management's assessment currently proposed for elimination should be retained and the other opinion required by AS 2 should be eliminated.
18	Should we consider changes to other definitions or rules in light of these proposed revisions?	If this question is aimed at definitions of material weakness, see Appendix 1.2.
19	The proposed revision to Rule 2-02(f) highlights that disclaimers by the auditor would only be appropriate in the rare circumstance of a scope limitation. Does this adequately convey the narrow circumstances under which an auditor may disclaim an opinion under our proposed rule? Would another formulation provide better guidance to auditors?	-

20	We request comment on the nature of the costs and benefits of the proposed amendments, including the likely responses of public companies and auditors concerning the introduction of new management guidance.	It is clear where the costs are, it is less easy at this stage to assess the benefits. We have concerns around expectations of cost reductions as noted in this letter. We recommend that the SEC keeps these matters under constant review, gathering information on the costs of implementation. We refer to this matter in our letter of 26 February 2007 under the heading of '*The implementation of revised proposals calls for innovative monitoring'.*
21	We seek evidentiary support for the conclusions on the nature and magnitude of those costs and benefits, including data to quantify the costs and the value of the benefits described above.	-
22	We seek estimates of these costs and benefits, as well as any costs and benefits not already identified, that may result from the adoption of these proposed amendments and issuance of interpretive guidance.	-
23	With increased reliance on management judgment, will there be unintended consequences?	See comments in our letter of 26 February 2007 on '*The consequences of separate auditor and management assessments are hard to predict*' and '*The proposals do not appear to reflect Congressional intent*'.
24	We also request qualitative feedback and related evidentiary support relating to any benefits and costs we may have overlooked.	-

Appendix 3

Comments on the PCAOB's proposed auditing standard – an audit of internal control over financial reporting that is integrated with an audit of financial statements

3.1 Overall comments

AS 5 represents an improvement on AS 2. However, there are a number of important issues that will need to be addressed by the PCAOB and the SEC. These major issues include:

- alignment between the SEC and PCAOB documents;
- risk vs. control-based approaches;
- the level of detail in guidance that reduces the need for professional judgement; and
- a proposed auditing standard that is less focussed on the higher level issues than the SEC's guidance to management.

We stress the importance of auditor and PCAOB inspector behaviour in the success or otherwise of AS 5 in the implementation of section 404 of the Sarbanes-Oxley Act. Changing behaviour in an environment where litigation and fear of PCAOB inspections promotes conservatism will not be a short-term or an easy task. If there is to be success in meeting the expectations for change that now exist in the marketplace, the PCAOB and the SEC will need to carry out a careful examination of the issues raised by the consultation on AS 5.

3.2 Management assessment

Page 16 of AS 5 contains some apparently contradictory statements. Firstly, the PCAOB states that it "believes that the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process".

Later on the same page it states that "an auditor still would need to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which he or she will use the work of others. The extent of work necessary for these purposes, however, should be limited."

While these statements might be capable of being reconciled to each other using sophisticated technical arguments, they are most readily construed as contradicting each other. We also question the validity of the first statement and ask whether an auditor can perform an effective audit of internal control without performing an evaluation of the quality of management's evaluation process. We believe that the starting point for an auditor's evaluation of an organisation's controls is to understand the process used by management in carrying out their assessment.

3.3 Definitions

We note the PCAOB's proposed changes in definitions and also that the old and the new definitions are derived from FAS 5.

We hope that the new definitions achieve their intended purpose, but we re-emphasise the points made above and in our letter of 26 February 2007 about risk averse behaviour and the need to align the definitions of material weakness. The proposals alone cannot fundamentally change behaviour.

3.4 Change in responsibility for the UK Turnbull guidance

Footnote 5 of AS 5 should be updated. Responsibility for the Turnbull guidance passed from the Institute of Chartered Accountants in England and Wales to the Financial Reporting Council in 2005.

3.5 Questions asked by the PCAOB in its document

We have chosen not to answer all the questions in PCAOB Release 2006-007. Unanswered questions are left blank.

	Question	**Comment**
1	Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?	AS 5 represents an improvement on AS 2, although we have a number of concerns about alignment with the SEC's guidance and risk vs. controls-based approaches. No-one should expect however that AS 5 will, of itself, result in more efficient auditing, particularly if extraneous structural factors driving defensive auditing behaviour are not changed. Furthermore, the PCAOB should avoid creating an expectation that the level of judgement required to conduct an efficient audit will be reduced or that audits of internal control will necessarily become more uniform as a result of these changes. We also caution against an excessive focus in these proposals on the need to eliminate a perceived level of over-auditing.
2	Does the proposed standard place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud?	Fraud controls are important but should be seen in the context of a risk-based approach to internal control over financial reporting and not over-emphasised. We believe that there is insufficient emphasis on the inherent limitations of internal control and the concept of reasonable assurance in the document. These matters are covered in paragraphs 16-18 of the existing standard and we believe they should be carried over to the current standard.
3	Will the top-down approach better focus the auditor's attention on the most important controls?	See Question 1 above.

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?	The problem that existed with company level controls in AS 2 has not been eliminated in the proposed standard. References to reliance on company level controls in order to reduce or eliminate the testing of other controls are difficult to translate into practice. We therefore caution against the suggestion that testing of controls can routinely be eliminated as a result of the testing of company level controls and we believe that the proposed standard should recognise the rarity of this situation in paragraph 43.
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?	See Question 1 and Appendix 1. It is important to remember that an assessment of risk is just that, an assessment. One auditor's assessment may be different from another's and both may be acceptable based on the facts. The relationship between risk and necessary evidence is also a highly judgemental area.
6	Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?	We refer you to our comments in Appendix 1 on a risk-based approach. We caution against the belief that walkthroughs are a panacea for over-auditing. The question refers to lower risk controls. We would prefer to see these referred to as controls that address lower risks which by their nature need not be tested to the same level as controls that address higher risks. The suggestions here, and again in Q17 and paragraph 48 of proposed AS 5 that walkthroughs can be used to eliminate any further tests of design and operating effectiveness, and that a single walkthrough might be sufficient with regard to the former may encourage a 'bare minimum' approach to auditing. The standard should not make any specific references to sample sizes. The reference to the fact that a sample of 'one' may be sufficient is a dangerous bright line. Sample sizes should be left to the professional judgement of the auditor.

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?	See Appendix 3.3. The proposed definition is different to the definition in AS 2 and, theoretically, this should make the standard easier to apply, but no less judgement will be required in its application. -
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	- Auditor behaviour is only partly driven by auditing standards and addressing the extraneous structural factors driving defensive auditing behaviour referred to above is far more likely to achieve this outcome than any amount of explanation in the standard itself.
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?	See Appendix 3.3. The proposed changes to the definitions will not of themselves necessarily result in more efficient or effective audits unless extraneous structural factors driving defensive auditing behaviour are also addressed. These changes will create an expectation among CEOs, CFOs and audit committee chairs that the scale of audits will be reduced.
10	Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present?	Yes. Question 8 assumes that weaknesses do not necessarily result in misstatements. Similarly, the fact that some significant fraud or error has occurred does not, of itself, necessarily indicate that a material deficiency exists. The inherent limitations of internal control systems mean that well designed and operated systems will, from time to time, fail to prevent or detect material weaknesses. As discussed in Appendix 1.4, this is particularly likely to be the case in the context of the complex US financial reporting framework.

	Will this change improve practice by allowing the use of greater judgment? Will this change lead to inconsistency in the evaluation of deficiencies?	Yes. The reduction of inconsistencies in the evaluation of deficiencies is an aim that the PCAOB strives to achieve. However, it cannot and should not expect to eliminate inconsistencies that represent genuine judgement differences.
11	Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?	Further clarifications will always be desirable in the eyes of those who seek ever-greater certainty but our experience of principles-based standard-setting shows clearly that an excessive level of detail in auditing standards is ultimately counter-productive. Changes to the extraneous structural factors driving defensive auditing behaviour would be a better guarantor of the avoidance of unnecessary testing than further clarifications.
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?	-
13	Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?	We believe that eliminating the opinion on management's assessment is the wrong route. Our comments are set out in our letter of 26 February 2007 under the heading '*The consequences of separate auditor and management assessments are hard to predi*ct' and *'The proposals do not appear to reflect Congressional intent'.* If the proposal to eliminate the opinion on management's assessment is retained, then it will probably eliminate some audit work, but we do not believe that this work is without value.
14	Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?	No. See comments in Appendix 3.2. We also refer to our letter of 26 February 2007 in which we note that views should be sought on the fundamental question of whether the auditor's attestation needs to take the form of an audit in order to meet the apparent intentions of Congress. It is our continued belief that not all attestations are audits.

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?	With hindsight, investors may wish that the auditors had been required to put their names to the evaluation of management's assessment rather than to their own evaluation. Auditors and their clients are often accused of being too close to each other. In reality, failures can occur when the opposite happens. The tension resulting from the enforced proximity of auditors and companies with regard to internal control may not be comfortable for either party but it is a healthy tension.
16	Does the proposed standard appropriately incorporate the value of cumulative knowledge?	We welcome the recognition of the value of cumulative knowledge in paragraphs 65-69. However, these paragraphs do not adequately circumscribe the use of this knowledge which could be over-used or abused. International Standards on Auditing (ISAs) recognise a three year cycle for the audit of certain internal controls and we believe that consideration of some similar circumspection would be helpful.
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 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?	Yes. Auditors should be allowed to use their judgement, recognising that locations that are not subject to audit over a period of time may pose some risks. Bright lines in principles-based standards can however be dangerous.
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?	Yes. Any other approach would be inefficient. -

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?	-
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.
22	Is the principal evidence provision that was in AS No. 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?	No. The principal evidence provisions have probably led to inefficiencies in the implementation of section 404. Requirements for objectivity and competence taken together with paragraphs 8 and 9 on the sole responsibility of the auditor are adequate. We believe that these paragraphs would benefit from being strengthened with wording similar to that in Paragraph 8 of ISA 610, "Considering the work of internal audit".
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?	Yes. No. There is insufficient emphasis on situations in which it will be inappropriate for the work of others to be used and no recognition of the fact that reliance on the work of others will rarely if ever eliminate the need for the involvement of the auditors. Paragraph 8 of ISA 610 deals with this. No.
24	Has the Board identified the right factors for assessing competence and objectivity? Are there other factors the auditor should consider?	Yes. No.

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 would not expect the effect to be significant and would therefore suggest that this factor is excluded in the interests of simplicity.
26	Will requiring a walkthrough only for all significant processes reduce the number and detail of the walkthroughs performed without impairing audit quality?	Not necessarily. Requiring a walkthrough only for significant processes may reduce the number of the walkthroughs performed in some cases but the only example given (relating to revenues) is a poor one. The walkthrough requirements are of themselves inefficient.
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?	Yes. -
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?	In our view the needs of smaller companies are best addressed by setting "think small first" principles-based standards, rather than by requiring auditors of smaller companies to apply additional requirements and complex guidance.
29	Are there other attributes of smaller, less-complex companies that the auditor should consider when planning or performing the audit?	We note that the language used in the proposed standard is very similar to that used in auditing guidance for the audit of very small owner managed businesses. The difficulty with smaller entities as envisaged by the market capitalisation is that they are often, by definition, growing, or in a period of transition, during which they bear some characteristics of both larger and smaller entities.
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?	See Question 29.
31	Does the discussion of complexity within the section on scalability inappropriately limit the application of the scalability provisions in the proposed standard?	See Question 28.

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?	See Question 28.
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?	It should be emphasised that an auditor should not accept an engagement for the provision of internal control related services when the auditor concludes that the threats to independence cannot be reduced to an acceptable level through appropriate safeguards. It is also not clear that there is any process for reviewing auditor independence after the initial approval has been made, be this at the annual audit committee meeting or on an ad hoc basis. Once an initial assessment and approval of auditor independence is made by the audit committee, then there should be the opportunity to review and update this assessment as circumstances change. The assessment of an auditor's independence should not be a one-off evaluation at a point in time but there should be a process for continually evaluating an auditor's independence. It should also be the responsibility of the auditor to inform the audit committee of any changes in circumstances that may affect the auditor’s independence, since the auditor rather than the audit committee is likely to have knowledge about those changed circumstances.
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?	We believe that this question is premature since there is still s substantial amount of work for the PCAOB and the SEC to do to ensure that AS 5 delivers benefits, for example, in terms of flexibility.

The Institute of Internal Auditors

David A. Richards
Certified Internal Auditor
President

February 26, 2007

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
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Response e-mailed to: comments@pcaobus.org

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

Dear Sir/Madam:

The Institute of Internal Auditors (The IIA) welcomes the opportunity to comment on the referenced proposals. Our comments are based on in-depth analysis and discussions, harnessing the experience of a core team of prominent chief audit executives from major U.S. corporations who serve on The Institute of Internal Auditors' Professional Issues Committee.

The following are our principal observations. Detailed responses to each of the questions contained in the proposals can be found in Attachment A.

1. The proposed standard is a clear improvement to the existing guidance in Auditing Standard Number 2 (AS2). However, we do recommend revising the order of the steps in the top-down approach as noted below.

    - Determine materiality level for planning purposes (what would constitute a material misstatement of the consolidated financial statements).
    - Identify significant accounts and locations.
    - Identify relevant assertions.
    - Assess the control environment and related risk of management override.
    - Identify and assess other company-level controls, including the period-end financial reporting process.
    - Identify major classes of transactions and significant processes.
    - Identify key controls.

    The top-down approach is continued for IT General Controls:

    - Determine which key controls of those identified in the last step above involve critical IT functionality (e.g., automated controls, key reports, or other functionality such as calculations, updates, and interfaces) relied upon to prevent or detect a material misstatement.

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- Identify in-scope financially significant applications: applications containing critical IT functionality, or where an unauthorized change to data is at least reasonably likely not to be detected and result in a material misstatement of the financials.
- Identify risks with IT general controls processes and related control objectives that provide assurance over the consistent operation of the automated controls or which protect the data from unauthorized change.
- Identify key IT General Controls.

2. We believe the use of *judgment* is insufficiently emphasized in the proposed Standard. The Standard should require the auditor to always exercise professional judgment and ensure a true and fair assessment of the quality of the system of internal control.

3. We recommend that "significant deficiency" should be redefined as a condition (generally one or more control deficiencies) that the auditor believes represents a risk to the business of such significance that it should be reported to the audit committee. This enables items to be classified and discussed with the audit committee that do not meet the test of representing a reasonable risk of significant error in future financial statements.

   This change in the definition would allow the auditors to bring issues of importance to the attention of the audit committee without implying there is an unacceptable risk of error in the financial statements. To this end, we believe this recommended change to the definition of a significant deficiency will allow both appropriate communications to the audit committee and a realistic assessment of the quality of the system of internal control as of the assessment date.

4. As stated in our responses to the SEC in May and September 2006, The IIA continues to believe the intent and the benefit of the Sarbanes-Oxley Act[1] are met with only two attestations – namely, management's attestation, and the external auditor's attestation over management's attestation.

   We further believe that the third attestation – the auditors own report on internal control over financial reporting – represents a fundamentally unrealistic and unfair expectation on the part of the auditors, which in turns leads to operating inefficiencies and costs. The essence and sole responsibility of auditing is to give an opinion on management's statement not to create a management statement. Making statements about operations status, financials, internal controls accomplishments, tone at the top, and strategy, is the sole responsibility of management and are duties that solely management has capacity to fulfill. For the auditors, the best auditing methodologies and techniques cannot compete nor make up for

   - Management position in an organization
   - Management responsibility over operations and processes
   - Management accountability

Sarbanes-Oxley Act - §404. Management's Assessment of Internal Controls. (b) "Internal control evaluation and reporting – with respect to internal control assessment required by subsection (a) each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagement issues or adopted by the Board (PCAOB). Any such attestation shall not be the subject of a separate engagement.

5. Additional guidance on the assessment of IT general controls would be valuable. This area represents a significant portion of the scope of work and efficiencies can be obtained. The scoping of IT General Controls (ITGC) continues to be a significant issue for both auditors and management. In a recent IIA survey almost 49% of the respondents felt their organizations' costs related to scoping ITGC were too high (see our attached survey results – Attachment C). We strongly suggest additional guidance, potentially incorporating material The IIA has included in its GAIT Methodology, be included in the Standard.

6. There is a great deal of value in the changes, and we encourage measures (including authoritative guidance on key items before the entire Standard is released) that will enable prompt implementation by the audit firms.

7. The clarification is excellent that the only controls to be tested are those required to prevent or detect a material misstatement of the consolidated financial statements.

The IIA would like to offer its assistance to the PCAOB in the development of their guidance. We have an extensive volunteer network of individuals with specific knowledge in this area that could be valuable contributors to the PCAOB.

The IIA welcomes the opportunity to discuss any and all of these recommendations with you.

Best regards,

David A. Richards, CIA, CPA

Attachment – (A) Detailed Comments to PCAOB Rulemaking Docket Matter No. 021
Attachment – (B) IIA's Response to SEC Release Nos. 33-8762; 34-54976; File No. S7-24-06
Attachment – (C) IIA's GAIN Survey Results – Scoping Information Technology General Controls (ITGC)

About The Institute of Internal Auditors

The IIA is the global voice, acknowledged leader, principal educator and recognized authority of the internal audit profession and maintains the *International Standards for the Professional Practice of Internal Auditing (Standards)*. These principles-based standards are recognized globally and are available in 25 languages. The IIA represents more than 130,000 members across the globe, and has 247 affiliates in 92 countries that serve members at the local level.

Attachment A

Institute of Internal Auditors (IIA)
Response to PCAOB Rulemaking Docket Matter No. 021

Questions from the proposals are in ***bold italics***, with IIA responses following.

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

The proposed standard is a clear improvement to the existing guidance in Auditing Standard Number 2 (AS2). It builds on the additional guidance from the Public Company Accounting Oversight Board (PCAOB) staff in their answer to Q38.

We have a number of observations and suggestions for further improvement:

- The order of the steps can be improved by including the activity of defining materiality as the first step in the approach. Since the scope of work for §404 should be limited to "testing only those controls necessary to obtain reasonable assurance about whether material weaknesses exist," defining the level of error that would be involved is a critical first step. The discussion in paragraph 14 is limited and not included as part of the top-down approach section.

- We also believe that the above excerpted quote from the end of paragraph 16 should be given more prominence. It cannot be over-emphasized.

- The second step, before the assessment of company-level controls (we commend the use of this term, which is more appropriate than "entity-level") should be the identification of significant accounts and locations. Although some areas of company-level controls (including those in the control environment) are quite separate and unaffected by the selection, a number of areas (including the period-end financial reporting process, shared service center operations, and IT information processing) are directly impacted by the selection of accounts. The review of activities and controls in the period-end financial reporting process should be limited to those relevant to significant accounts.

  Further, the identification of significant locations affects a number of areas, including those in the control environment as well as in shared service centers, risks assessment, monitoring, etc. For example, a number of organizations' control environment risks are heavily influenced by cultural and ethical differences. In addition, the adequacy of monitoring activities should be assessed based on the locations and portions of the business that are more significant to financial reporting.

- Additional guidance should be provided relative to the selection of significant accounts. The proposed standard does not explain why significant accounts should be identified, which may lead to the inappropriate selection of too many accounts. We suggest paragraph 25 should include a reference to the definition of a significant account in paragraph A11. In addition, a definition of a significant location should be included in paragraph 29, consistent with the definition of a significant account.

- The control environment should be assessed prior to other company-level controls. The results should be used in assessing the risk of control failure, especially management override. We recommend establishing control environment as a separate step, prior to company-level controls.
- The period-end financial reporting process includes, in addition to those listed, other important controls that may be key higher level controls: period-to-period, budget to actual, forecast to actual, and other variance and trend analyses and financial metrics. These key controls may be selected for testing rather than activity level controls, especially for accounts that are not expected to fluctuate significantly or are close to the materiality level. In addition, the strength of these controls can influence the assessment of risk related to controls at the activity level.
- Although the auditor must perform his or her own assessment, we believe the auditor should be encouraged to discuss his or her top-down approach and make every reasonable effort to understand the opinions of management on such matters as materiality and significant accounts and locations. Such discussions between the auditor and management should occur early on in the process and on an regular basis during the engagement. Gaining management's insights on materiality and significant accounts in the beginning is crucial to an ongoing dialogue that facilitates an efficient engagement.
- The term "key control" is now generally accepted and we suggest the PCAOB adopt it in the standard.
- The scoping of IT general controls (ITGC) continues to be a significant issue for both auditors and management. We strongly suggest additional guidance, potentially incorporating material The IIA has included in its GAIT Methodology, be included in the standard.
- We have noted significant variance in the level of work audit firms are performing relating to walkthroughs of automated application controls. While some have joint financial and IT audit specialists performing walkthroughs together by way of interviews and observation of processing, others are tracing transactions through complex IT applications. On occasion, they are performing more detailed work on a walkthrough than is required to test the operation of the automated control. Additional guidance in this area to enable efficiency and consistency would be valuable.

We recommend the top-down approach be amended as follows:

Current Steps	Recommended Steps
	Determine materiality level for planning purposes (what would constitute a material misstatement of the consolidated financial statements)
Identify and assess company-level controls	
Identify significant accounts and locations	Identify significant accounts and locations
Identify relevant assertions	Identify relevant assertions

	Assess the control environment and related risk of management override and other control failures at either company or activity level
	Identify and assess other company-level controls, including the period-end financial reporting process and the risk of management override of controls
Identify major classes of transactions and significant processes	Identify major classes of transactions and significant processes
Identify key controls	Identify key controls

The top-down approach is continued for IT general controls:

- Determine which key controls of those identified in the last step above involve critical IT functionality (e.g., automated controls, key reports, or other functionality such as calculations, updates, and interfaces) relied upon to prevent or detect a material misstatement.

- Identify in-scope financially significant applications: applications containing critical IT functionality, or where an unauthorized change to data is at least reasonably likely not to be detected and result in a material misstatement of the financials.

- Identify risks with IT general controls processes and related control objectives that provide assurance over the consistent operation of the automated controls or which protect the data from unauthorized change.

- Identify key IT general controls.

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 places sufficient emphasis on the importance of controls that prevent or detect fraud that results in a material misstatement of the financials.

We have a concern related to the use in paragraphs 45 of the phrases “company’s *programs* and controls” and in paragraph 78 “antifraud *program*” (emphasis added). The assessment should be limited to the adequacy of controls that prevent or detect fraud that could result in a material misstatement. Inclusion of the word “program” has the effect of influencing audit firms to assess whether the company has a specific, formal anti-fraud program. Even if the company has effective controls to prevent or detect fraud, the audit firms may suggest (based on paragraph 78) that the failure to have a formal anti-fraud program is not only a deficiency but potentially at least a significant deficiency. Since there is currently no requirement that a “program” be in place, we believe it could create an “opportunistic” environment to suggest one is necessary, as opposed to controls aimed at preventing or detecting fraud. Adequate controls and processes will make more impact in fraud prevention and detection than suggesting that a purchased program could prevent fraud.

There is a substantial linkage between the results of the assessment of the Control Environment and the risk of fraud. Studies of fraud risk have shown risks to be higher when there are environmental factors such as poor 'tone at the top' or employee morale. We recommend that the standard discuss these factors as well as others that affect the likelihood of fraud, such as the liquid nature of assets, and explain how the assessment and testing of fraud-related controls are affected.

The proposed standard should also require the consideration of these fraud risk indicators when assessing control deficiencies in areas where the risk is primarily fraud, e.g., IT security, approvals of credit memos, physical inventory adjustments, etc.

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

We agree that the top-down, risk-based approach is critical if the scope of work is to be effective and efficient. We believe the suggestions and comments in our response to question 1 above are *essential* improvements. The definitions of significant account and significant location are very important. The area most in need of additional guidance and tightening of scope is ITGC.

With respect to the discussion of materiality in paragraph 14, one of the major audit firms has informed us that their methodology requires them to allocate tolerable error to each location. They identify significant accounts at each location based on this allocated tolerable error, resulting in the need to test additional controls for the financial statement portion of their audit: controls that are not part of their scope of work for the assessment of internal control over financial reporting.

We recommend that the standard address this issue. The same set of controls should satisfy both elements of the integrated audit, and should be set based on consolidated and not allocated materiality.

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?

The discussions in the proposed standard on company-level controls are important and provide improved guidance compared to the current standard. Please see also our response to question 1.

Improvements can be made in the following ways:

- In both paragraphs 17 and 41, the auditor is guided to "test those controls that are *important* (emphasis added) to the auditor's conclusion." This language is weaker than the language in paragraph 16: "The top-down approach thereby leads to the auditor testing only those controls necessary to obtain reasonable assurance about whether material weaknesses exist." We strongly urge PCAOB staff to define the controls to test consistently as only those necessary to obtain reasonable assurance about whether material weaknesses exist. Using the term "important" allows controls at the company-level to be tested that do not meet this criterion.

- The language in paragraphs 41–44 could be improved to make it clearer that the auditor's selection of controls to test could be at company-level or activity-level. The controls selected to test to address a specific risk could be singular or a combination of controls. The auditor should be guided to select that combination of controls that is both efficient and provides a reasonable level of assurance.

- Changing the order of the steps in the top-down process to position the identification of significant accounts and locations ahead of the discussion of company-level controls will improve the understanding of relevant company-level controls.

- Separating the discussion of control environment controls from company-level controls will also contribute to a better understanding as well as improved risk assessment practices.

- Paragraph 20 should be amended to include the following area to assess as part of the control environment:
    - Whether there are sufficient quality, experienced, and qualified personnel in all areas significant to internal control over financial reporting.

- The language "on a timely basis" is important when discussing detective controls. Our recommendation is to provide guidance that "on a timely basis" should be interpreted as sufficiently timely to avoid material errors in either the interim or annual financial statements.

- We believe the standard should include language on the auditor's obligation to perform an efficient as well as an effective audit.

- The relevance of controls within the Committee of Sponsoring Organizations of the Treadway Commission (COSO) control environment, information and communications, risk assessment, and monitoring layers to the risk of material misstatement of the financials remains unclear. The proposed standard includes these areas in company-level controls but does not provide guidance on which controls in those areas, if any, should be selected for test or how an assessment of these controls impacts the overall risk assessment of the company.

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

Paragraphs 8 and 51–60 represent a reasonable introduction to the role of risk assessment and related evidence requirements. However, we believe further guidance is appropriate and necessary.

- While the level of work performed should be directly related to the risk, there is a point at which the level of work should be "none." For example, if there is less than a reasonable likelihood that an account (or an account at a location) could contain a material misstatement, then no further work on controls related only to that account should be performed. While this is briefly stated in paragraph 8 of the standard, it bears repeating in the paragraphs relating to testing to ensure clarity and consistency.

- The identification of significant locations can affect the assessment of the controls environment and the risk of management override. Please see our response to question 1.
- The assessment of the controls environment and the risk of management override should be discussed further, as it may impact risk assessment of controls in the period-end financial process and at the activity level.
- As mentioned earlier, the scoping of work on ITGC that is risk-based is an important area and needs additional guidance.
- Although there is discussion on major classes of transactions, clear guidance is needed that controls over classes of transactions where there is less than a reasonable possibility that they might be the source of material misstatement do not have to be tested.
- We believe additional guidance is needed for the auditor's decision of whether exceptions found during testing indicate that a control deficiency exists. We have noted that when external auditors find one or two exceptions in a daily or more than daily control, they frequently do not extend the sample size or consider the results from management testing before asserting the existence of a control deficiency.

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

The performance of a walkthrough might be sufficient to provide reasonable assurance about both the design and operating effectiveness of certain controls. For example, a walkthrough might be sufficient when the frequency of control and/or the number of transactions is low. The auditor should be able to use judgment in making this decision.

As noted earlier, guidance on the performance of walkthroughs related to automated application controls would be valuable. In some cases, depending on how the walkthrough is performed, it may be sufficient to confirm that the automated control is adequately designed and operating effectively.

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, unfortunately, continues to be less than clear and more than reasonably likely to result in inconsistent application. It also does not appear to meet the objectives of the SEC, namely that the audit committee is informed of all internal control deficiencies of significance. In the past, a number of control issues have been given the label "significant deficiency" when they do not necessarily indicate, as described in the definition in paragraph A12, "that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected." Examples would include the restatement of prior period financial statements as a result of errors identified in the current period, an ineffective internal audit department, or ineffective controls to prevent fraud (when there are strong controls to detect fraud and prevent misstatement of the financial statements).

We recommend that “significant deficiency” should be redefined as a condition (generally one or more control deficiencies) that the auditor believes represents a risk to the business (which may not be limited to the integrity of the financial statements) of such significance that it should be reported to the audit committee.

This change in the definition would allow the auditors to bring issues of importance to the attention of the audit committee without implying there is an unacceptable risk of error in the financial statements.

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?

The inappropriate identification of a material error in the absence of an actual material misstatement is not common in our experience. However, guidance has not been clear either for the auditor making the assessment, or for management to challenge the auditor’s assessment.

The proposed standard represents a risk that auditors will assess inappropriately the quality of the system of internal control when there has been a restatement due to a material misstatement in a prior period. Instead of considering specific facts and circumstances, auditors may believe that the existence of an error that leads to a restatement necessarily means there is at least a significant deficiency and potentially a material weakness.

The restatement of previously issued financial statements to reflect the correction of a misstatement, contrary to paragraph 79, should not be considered a strong indicator of a material weakness without other factors present indicating the cause of the error has a reasonable possibility of reoccurring.

By definition, the error occurred in a prior period and is not necessarily any indication that the current system of internal control is not adequate. For example, there may have been significant changes in the system of internal control since that period. Frequently, the improved system of internal control enabled management to identify the prior period error.

We suggest the PCAOB consider whether the root cause of a material misstatement in a prior period was the result of an event that was reviewed and agreed with the external auditor. The review and agreement by the external auditor should be prima facie evidence that reasonable steps were taken and there was no material weakness.

Rather than the restatement indicating a significant deficiency in the system of internal control as of the assessment date, many restatements indicate that the system of internal control is highly effective as of the assessment date.

As stated in the current version of Standard Number 2, even an effective system of internal control is not perfect and errors may occur.

> "Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures."

A material error in a prior or current period can be the "once in a lifetime" exception that is (due to the presence of humans in the process) inevitable. One situation of which we know was the result of three unrelated controls happening to fail at the same time. The auditors agreed with management that this confluence, a perfect storm of control failures, was highly unlikely ever to occur again. However, guidance suggests that this would require an assessment of significant deficiency or material weakness. Yet, a reasonable official would not assess the design and operation of the system of internal control as of the assessment date as ineffective. In this situation, it is not logical and is even misleading to describe the same system of internal control effective three years, ineffective when there is a single exception, then effective again.

We recommend that an assessment that indicates the quality of the system of internal control as of the assessment date, and the assurance provided relative to the integrity of financial statements be filed with the SEC in the next year. That assessment would be more valuable and less misleading to the investor and other stakeholders.

The standard should require the following tests when a significant or material misstatement is detected in either the current or a prior period:

- Was the root cause of the misstatement a failure of internal control in the current period?
- Was the failure an isolated incident or did it indicate one or more control deficiencies?
- Is the control deficiency (or multiple control deficiencies) present as of the assessment date? If multiple control deficiencies contributed to the misstatement, are they reasonably likely to fail together?
- Would a prudent official conclude that there is a reasonable likelihood of a similar significant or material misstatement?

Our suggested redefinition of a significant deficiency would enable the auditors to bring all important internal controls, in their judgment, to the attention of the audit committee.

We believe the use of *judgment* is insufficiently emphasized in the proposed standard. The definitions are useful, especially when the changes noted above are made and the assessment truly is focused on the quality of the system of internal control as of the assessment date. The auditor should understand the principles and objectives of internal control, the purpose of their assessment, and use their judgment to assess deficiencies.

If judgment is given sufficient emphasis, paragraphs 78 and 79 are not needed and can be deleted in their entirety. Paragraph 77 is excellent and should be the last word on this topic.

If the PCAOB prefers to retain the discussion of areas that are more likely to be significant deficiencies, the descriptions of each area should allow for:

- Consideration of compensating and mitigating controls that reduce the risk of error in the financial statements.

- De minimis failures. Not all controls are equal and failure is not binary. For example, a control may require that a journal entry be approved by both the controller and the chief financial officer. If only one signed for one month without formally delegating to the other, the control technically fails as it is not operating as documented. However, the risk is probably low as at least one senior financial manager approved the entries.

- Application of the prudent official rule in paragraph 77, emphasizing the judgment of the auditor.

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?

In our response to question 8 above, we commented on the fact that the guidance in the existing and the proposed standard incorrectly guides the auditor to assessing as significant and even material weakness issues that do not present a reasonable possibility of material misstatement.

We agree with the need to ensure the audit committee is informed whenever there is an important issue relating to the system of internal control. However, including such issues as significant deficiencies in the current system of internal control results in misleading assessments. Items are being assessed as significant deficiencies and material weaknesses that are inconsistent with their definitions. Reporting the presence of significant and/or material weaknesses when the system of internal controls provides a reasonable level of assurance could mislead readers of the assessment.

Our recommended change to the definition of a significant deficiency will, we believe, allow both appropriate communications to the audit committee and a realistic assessment of the quality of the system of internal control as of the assessment date.

The standard should require the auditor always to exercise professional judgment and ensure a true and fair assessment of the quality of the system of internal control. The auditor should answer the question: "Does the system of internal control as of the assessment date provide reasonable assurance that material errors in the financial statements filed with the SEC would either be prevented or timely detected?" We believe the assessment should be based on the probability of material errors in the financial statements to be filed with the SEC in the next year, assuming no material changes in the design or operation of the system of internal control over financial reporting.

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?

As noted above, we disagree with the strong indicators and recommend deletion of the section in its entirety. Please refer to our answers to questions 7–9.

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

We believe progress can still be made. The most important step would be to take every opportunity to repeat the guidance that the scope of work should be limited to accounts, locations, processes, transactions, and controls where there is at least a reasonable possibility of a material error in the financial statements. Controls should not be tested when it is already known, should they be found to fail, that they would not be material weaknesses.

This is especially true in the case of IT general controls. Failures in IT general controls only have an indirect effect on the risk of material error in the financials, so great care is needed to ensure unnecessary testing is avoided. The proposed standard does not advise the auditor as to how this can be done. Attached to this letter is a copy of our Guide to the Assessment of IT General Controls Scope Based on Risk (GAIT) Methodology, which we commend to the PCAOB as a potential source of ideas for additional guidance.

The sequence of steps in the top-down approach can be enhanced, as noted in our answer to question 1, to improve the efficient testing of company-level controls.

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?***

We have recommended that the assessment should be based on the probability of material errors in the financial statements to be filed with the SEC in the next year, assuming no material changes in the design or operation of the system of internal control over financial reporting. Those financial statements will include interim as well as annual financial statements. Therefore, the risk of misstatement of interim financial statements should remain part of the assessment of the quality of the system of internal control as of the assessment date, and part of the evaluation of deficiencies.

However, when planning and defining the scope of testing, materiality should be based on annual and not interim materiality levels. This should be more clearly stated in the standard in paragraph 14.

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

Removal of this requirement will have minimal impact (reduction) of external audit work. However, understanding management’s assessment process, especially the identification of significant accounts, locations, and key controls, is an opportunity for the auditor.

We believe the external auditor should be encouraged to perform an efficient audit. The auditor should work with management (and the internal auditing function if they perform independent testing of controls for Section 404) to coordinate his or her work and reduce overall costs.

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

The auditor can certainly perform an effective audit of internal control over financial reporting without also evaluating management's assessment process. However, the auditor should be encouraged to work with management and the internal auditing function to perform an efficient audit.

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?

If the auditor performs an assessment of the effectiveness of the system of internal control but not of management assessment process, the opinion should be limited to the effectiveness of the system of internal control.

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

The language in paragraphs 65–67 provides solid guidance in this area.

We disagree with the conditions for benchmarking in the proposed standard. Paragraph B31 requires all of the following:

- Adequate controls over:
    i. Program changes
    ii. Access to programs, and
    iii. Computer operations
- Verification that the automated application control has not changed

The requirements should be modified to reflect the true nature and extent of risk to the continued operation of the automated application controls. The auditor should use his or her judgment to assess whether the conditions are met and benchmarking provides a reasonable level of assurance. Our concerns with B31 include the following:

- If it can be verified that the automated application control has not changed, there is no reliance on controls over program changes or on access to the programs. In fact, if it can be verified that automated application controls have not been changed, controls over program changes should not have been tested. Only those general controls where a failure would represent at least a reasonable likelihood of an undetected failure of automated applications controls (such that they are at least reasonably likely to fail to prevent or detect a material misstatement) or to the undetected change of data (that would lead to a material misstatement) should be included in the auditor's scope of work.

- Not all automated application controls are affected by or reliant on the proper operation of controls over computer operations.

- The auditor should use his or her judgment to assess the risk of IT general controls to the operation of automated application controls. For example, controls over program changes may be effective for some applications and not others. Decisions on the use of benchmarking should be based on an assessment of the quality of IT general controls and the risk to continued proper operation of automated applications controls.

- The risk of deliberate changes to automated application controls may be low, as there frequently is no benefit to the individual. (When assessing the risk of deliberate change to programs or data, similar factors should be considered to those relevant to the assessment of the likelihood of fraud: the ability to use the scheme to divert assets, the convertibility of assets, employee morale, etc.) In addition, unauthorized changes are likely either to result in application failures or other prompt detection by the users. Depending on specific facts and circumstances that should be assessed by the auditor, the risk to the proper operation of automated application controls presented by defects in access to programs may therefore also be low.

- When there are effective IT general controls, especially those over program changes, the auditor should be able to test a representative sample of automated application controls each year.

We would welcome the opportunity to discuss the specifics of benchmarking and applicable revisions to the standards with PCAOB staff.

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?

Please see our answer to question 6.

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?

We believe the goal will only be achieved by making the language clearer.

- The section that starts with paragraph B12 should directly state that the selection of locations or combination of locations (if and only if multiple simultaneous errors are at least reasonably possible) should be based on the consolidated financial statement materiality level, not on an allocated portion. One CPA firm shared their approach with us in January 2007:

> “We analyze financial significance of each individual location (that is done through analysis of contribution of each individual location to consolidated results of operations), and based on this analysis determine the locations in-scope. Further, we identify (for each financially significant location) significant accounts that are material for each individual location. All of these procedures are fully compliant with A16 of AS2.

We do not believe that using consolidated materiality for determining significance of accounts for each individual location is appropriate (due to the aggregation issue, i.e., errors slightly less than consolidated materiality in two or three separate locations would aggregate to consolidated error of amount over consolidated materiality)."

- The conditions required for consideration of aggregation should be discussed. We suggest that the auditor should use his or her judgment to determine whether simultaneous multiple failures are at least reasonably possible. Conditions that might affect that assessment might include:

    i. Whether the controls over transactions flowing into the same accounts at different locations are performed by the same people (e.g., at a shared service center).

    ii. Common use of the same IT applications and/or key reports. (Note: it may only be necessary to test the automated controls if that is the only common risk among the different locations).

    iii. The strength of company-level or other higher level controls (e.g., regional controls or controls at a business unit level).

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?

The adoption of a single framework is a solid step in the right direction. Additional benefits can be achieved by guiding the auditor to consider the potential use of the work of others during the planning process. Discussions with appropriate parties should be held early to ensure that the work will be performed to quality standards and agree on the scope of work to be performed.

Including in the standard comments about the auditor's responsibility to perform an efficient audit would be valuable. Relative to the use of the work of others, the guidance might stress the need for early planning and definition of the scope of work, and the possibility of increased reliance on the work of others.

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?

Paragraph 4 of the proposed standard defines relevant activities as:

> "tests performed by others that provide evidence about the design and operating effectiveness of a company's internal control over financial reporting or that provide evidence about potential misstatements of the company's financial statements. Tests performed by others that provide such evidence typically are similar in nature, timing, and extent to the procedures that the auditor would have performed himself or herself as part of obtaining sufficient, competent evidence to support the auditor's opinion.

We do not believe this is consistent with the intent of the PCAOB:

- The procedures described in paragraph 7 are not always "tests." In particular, procedures performed when obtaining an understanding of the company's internal control over financial reporting, and procedures performed when assessing risk, are not necessarily tests. For example, the auditor should be able to rely on walkthroughs or analytical reviews for risk assessment performed by internal auditors. We recommend the standard use the word *procedures* instead of *tests*, and extend the description to include any work that the auditor can use to reduce or eliminate tasks they otherwise would have to perform themselves.

- Management has a number of ways in which they can obtain assurance of the adequate operation of controls. They include the use of continuous monitoring or auditing techniques. These techniques may not be "similar in nature, timing, and extent to the procedures that the auditor would have performed," but the auditor should have the ability to rely on them after assessing their adequacy.

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

The requirement in paragraph 6 is important. However, we believe that this is already standard practice and therefore will not affect audit quality.

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 agree with the change in the standard and the elimination of the principal evidence provision. The latter was not consistently interpreted and the new language enables the use of judgment.

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?

This is an area of specific interest to The IIA. We believe other factors to be considered when assessing competency and objectivity should include:

- Whether the individual's activities are governed by a Code of Ethics, such as that of The IIA.

- Whether the individual or the department adheres to recognized standards that address quality and objectivity, such as *The International Standards for the Professional Practice of Internal Audit*.

- Whether the certifications held by the individual are relevant to the work performed.

We suggest that the objectivity of individuals who test matters in areas in which they work, even if they are not in supervisory positions, may be impaired (see paragraph 15a).

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

Please see our answer to question 23.

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?

This is an interesting addition to the factors to be considered. While we would prefer the auditor to assess compensation practices rather than policies (as there may not be formal policies on this topic), we agree that the factor should be included in some form. We recommend the language be revised to state:

> "Compensation practices (such as bonuses related to successful testing results or to the absence of deficiencies) that might impair the objectivity either of the tester, the reviewer of the testing, or the individual responsible for the function."

The practical effect should be positive, deterring the use of inappropriate bonuses.

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

In our experience, the auditors have only been performing walkthroughs for significant processes, so there should not be a major change. However, as stated earlier, we believe additional guidance is necessary to ensure consistency in walkthroughs of automated application controls.

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 auditors should be able to use direct assistance for any activity normally performed by the auditor, applying professional judgment to the selection of tasks assigned and the level of supervision and review applied.

We believe the external auditor should be able to exercise professional judgment and rely on walkthroughs performed by others, if performed by competent and objective personnel. A number of internal audit functions already perform walkthroughs prior to testing. If there is an opportunity for the external auditor to rely on internal auditor walkthroughs, then we expect more internal audit functions would 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?

COSO's *Internal Control over Financial Reporting - Guidance for Smaller Public Companies* identifies a number of key considerations in its Executive Summary. These are captured in the proposed standard and we believe their description is appropriate and clear.

The issue of scalability, including the assessment of complexity, is part of and should be included in the risk assessment process. Many larger companies are relatively non-complex, and some smaller organizations have quite complex systems and processes. As COSO says, the principles in its Guidance for Smaller Public Companies should be considered by and are valuable for companies of all sizes. Our recommendation is to fold this discussion into the Risk Assessment process for companies of all sizes. The standard might indicate that some of the issues are more common in smaller companies.

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

Please see our response to question 28.

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?

Please see our response to question 28.

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

Please see our response to question 28.

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?

Please see our response to question 28. We do not believe the capitalization and revenue thresholds have practical application. The principles to be followed in risk assessment should apply to companies of all sizes.

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?

We believe one significant item of information should be provided: estimated fees, which are a direct proxy for the level of work to be performed. The regulations currently require only that the service be pre-approved. Some firms are relying on this to obtain agreement for the service from the audit committee and then negotiate fees with management. We recommend strongly that to preserve independence, the fees must be approved and not just the service.

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?

Early implementation of the clarifications and changes included in the proposed standards is both valuable and necessary. Companies and their auditors need to have certainty in their assessment and audit processes. We recommend that the PCAOB continue to move rapidly to obtain and review comments, make the necessary changes, and move towards as early an effective date as possible, and certainly this year.

Audit firms should be encouraged to be 'early adopters' of the proposed standard, as soon as the PCAOB is able to indicate which areas are likely to change and which are unlikely to change.

The PCAOB should consider making their answers to frequently asked questions authoritative, or provide them in a different form. One of the issues is that the guidance provided in past documents as well as the May 2005 policy statement, were not authoritative.

If the PCAOB were able to achieve the above, consideration should be given to using that facility to implement those portions of the revised standard that are generally accepted and can be adopted before the entire standard is effective.

***

Attachment B

The Institute of Internal Auditors

David A. Richards
Certified Internal Auditor
President

February 26, 2007

Ms. Nancy M. Morris
Secretary, U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Response e-mailed to: rule-comments@sec.gov

Re: SEC Release Nos. 33-8762; 34-54976; File No. S7-24-06
MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Dear Ms. Morris:

The Institute of Internal Auditors (The IIA) welcomes the opportunity to comment on the referenced release. Our comments are based on in-depth analysis and discussions, harnessing the experience of a core team of prominent chief audit executives from major U.S. corporations who serve on The Institute of Internal Auditors' Professional Issues Committee.

The following are our principal observations. Detailed responses to each of the questions contained in the release can be found in Attachment A.

The draft document prepared by the SEC staff is helpful in establishing clear general principles regarding management's assessment of internal control over financial reporting (ICFR). While we commend the SEC staff for this initiative, we do not believe the document fully addresses the pressing need of management — whether of large or small companies — for more detailed guidance in specific areas (such as the scoping of information technology general controls, see our attached survey results – Attachment C). We identified many of these areas in our comments dated September 18, 2006 on the Concept release.

The IIA recommends that the SEC staff proceed with the following steps:

- Refine the draft document as one documenting general principles, incorporating the items commented on in this response.

- Work with the Public Company Accounting Oversight Board (PCAOB) to upgrade Audit Standard No. 2; we have attached our comments on their revised standard draft – see Attachment B. The most efficient approach for management is to align its approach to that used by the external auditor, as discussed in our answer to question 1 in Attachment A.

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- Additional detailed authoritative guidance can then be issued by the SEC where management's approach should vary or where clarification is necessary. For example, the external auditors need to follow existing standards when establishing materiality levels. Plain English guidance should be provided for management, who also need to establish materiality levels but are not required to follow auditing standards. This additional guidance could take the form of an authoritative Q&A.

Further, as stated in our responses to the SEC in May and September 2006, The IIA continues to believe the intent and the benefit of the Sarbanes-Oxley Act[1] are met with only two attestations – namely, management's attestation, and the external auditor's attestation over management's attestation. We believe that the third attestation – the auditors own report on internal control over financial reporting – represents a fundamentally unrealistic and unfair expectation on the part of the auditors, which in turns leads to operating inefficiencies and costs. The essence and sole responsibility of auditing is to give an opinion on management's statement not to create a management statement. Making statements about operations status, financials, internal controls accomplishments, tone at the top, and strategy, is the sole responsibility of management and are duties that solely management has capacity to fulfill. For the auditors, the best auditing methodologies and techniques cannot compete nor make up for

- Management position in an organization
- Management responsibility over operations and processes
- Management accountability

We also continue to believe that the principle of identifying areas as automatic sources of significant deficiencies and strong indicators of material weaknesses is inappropriate. Each situation should be assessed on its specific facts and circumstances, determining whether there is at least a reasonable likelihood of a significant or material misstatement of the financial statements.

An area of concern to our practitioners is that while the assessment date is the registrant's year-end, many, if not most, of the year-end procedures and controls are performed after year-end. The external auditors test those year-end controls and consider as deficiencies any failures in their execution, even though they are performed after the assessment date. We believe the assessment date should be changed to a date proximate to the filing date for the financials on Form 10-K (or equivalent). Guidance should limit tests of transactions to those included in year-end balances and tests of controls to those performed prior to the assessment date. We have included this recommendation in our response to the PCAOB.

One area not covered by our comments below, and where we believe additional guidance would be of value in both a general principles document and in detailed guidance, relates to the linkage between the annual assessment of internal control over financial reporting required by Section 404 of the U.S. Sarbanes-Oxley Act of 2002 and the certifications required under its Sections 302 and 906.

Sarbanes-Oxley Act - §404. Management's Assessment of Internal Controls. (b) "Internal control evaluation and reporting – with respect to internal control assessment required by subsection (a) each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagement issues or adopted by the Board (PCAOB). Any such attestation shall not be the subject of a separate engagement.

Again, The IIA would like to offer its support to the SEC in the development of their guidance. We have an extensive volunteer network of individuals with specific knowledge in this area that could be valuable contributors to the SEC.

The IIA welcomes the opportunity to discuss any and all of these recommendations with you. We would suggest spending two hours in an open dialogue with a few members of our volunteer network to discuss our comments, the basis for them, and suggestions that will support companies in their compliance efforts.

Best regards,

David A. Richards, CIA, CPA

Attachment – (A) Detailed Comments to SEC Release Nos. 33-8762; 34-54976; File No. S7-24-06 (included herein)
Attachment – (B) IIA's Response to PCAOB Rulemaking Docket Matter No. 021
Attachment – (C) IIA's GAIN Survey Results – Scoping Information Technology General Controls (ITGC)

About The Institute of Internal Auditors

The IIA is the global voice, acknowledged leader, principal educator and recognized authority of the internal audit profession and maintains the *International Standards for the Professional Practice of Internal Auditing (Standards)*. These principles-based standards are recognized globally and are available in 25 languages. The IIA represents more than 130,000 members across the globe, and has 247 affiliates in 92 countries that serve members at the local level.

Attachment A

Institute of Internal Auditors (IIA)
Response to SEC Release Nos. 33-8762; 34-54976; File No. S7-24-06

Questions from the Release are **bolded**, with IIA responses following.

1. **Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process? Does the proposed guidance allow for management to conduct an efficient and effective evaluation? If not, why not?**

   We do not believe that the high-level interpretive guidance alone is sufficient to enable an efficient and effective evaluation. It does not address and provide guidance on the difficult issues for management. We refer the SEC staff to our prior comments (attached) on the Conceptual Release. We identified a number of areas (particularly in our answers to questions 11, 16, and 24) where more specific, practical guidance would be valuable.

   To work toward providing more detailed guidance in difficult areas, we suggest that the SEC focus attention on the proposed standard issued by the PCAOB with consideration of how the standard will impact actions by management. While management does not have to follow the same process as the external auditors, there are significant advantages to following a process that is substantially the same. For example:

   - Management desires an approach that is efficient when considering the cost of its own assessment and the external auditor's audit. One way to optimize costs is maximize reliance by the auditor on the work of management, which may be performed by the internal audit function. That is best obtained when the external auditor and management identify the same significant accounts and locations, and test the same key controls. The likelihood of reliance is enhanced when management's testing methods are similar to those preferred by the auditor.

   - The work of the external auditor is more efficient when the auditor is able to review and benefit from management's risk assessment, identification of significant accounts and locations, and selection of key controls. If management and the auditor identify the same key controls, documentation of the design of those controls will be available for the auditor, and operating management will be better prepared to assist the auditor.

   - When a process is used that is substantially the same, it is likely that both management and the auditor will identify the same deficiencies, compensating or mitigating controls, and arrive at the same assessment of their significance.

   Our recommendation is for the SEC to work with the PCAOB to enhance its guidance to the external auditors. We have attached our response to the PCAOB with comments on the proposed revised standard. There are a number of areas where we disagree with the proposed standard, some of which also apply to sections of the SEC's draft interpretive guidance (e.g., the assessment of significant deficiencies and material weaknesses).

Once the PCAOB's standard has been updated and released, the SEC should issue guidance — potentially through *authoritative* questions and answers (Q&A) — on areas of difficulty for management. The SEC and the PCAOB should ensure consistent guidance is provided to auditors and management. The Q&A also can be used to explain how management may take different approaches to those required for the auditor. The Q&A should be focused on specific areas, for example the assessment of the control environment, where management may not be truly objective in assessing the tone at the top.

With respect to the control environment, we continue to believe there is too much focus in both the PCAOB and the SEC guidance on control activities. In our response to the Conceptual Release, we said:

> "We suggest that SEC Staff perform an assessment of risk related to materially misstated financials, with particular reference to those incidents (many of which companies have become household names) that led to significant investor losses. The root causes should be identified. We believe that such an assessment will identify more issues existed within the COSO Controls Environment layer, with little risk within Control Activities.
>
> "This assessment and the identification of root causes should determine what the Commission should require both of management and their auditors. The current approach under §404 and Auditing Standard 2 is not, in our opinion, addressing the root causes and therefore not providing the assurance to investor that the SEC and Congress desires.
>
> "One alternative for consideration is the development, together with parties such as The IIA, the National Association of Corporate Directors, the AICPA, the FEI, and the Ethics and Compliance Officer Association, of a corporate governance standard. Companies could be asked to assess their practices against such a standard and explain any exceptions."

We again make these recommendations.

2. Are there particular areas within the proposed interpretive guidance where further clarification is needed? If yes, what clarification is necessary?

Please see our answer to question 1 above.

The discussion of the role of entity-level controls needs to be repositioned and clarified. The first part in the evaluation process included in the draft (identifying financial reporting risks and controls) has five steps:

- Identify financial reporting risks.
- Identify controls that adequately address financial reporting risks.
- Consider entity-level controls.
- Role of general information technology controls.
- Evidential matter to support the assessment.

The order of these steps can be improved as consideration of entity-level controls should come before identifying controls placed in operations to address financial reporting risks. The identification and review of specific controls (i.e., control activities) discussed in the second step should only be performed after careful consideration of the entity-level controls — especially the control environment. With the recommended change in the order of these steps, the guidance would encourage the appropriate practice of assessing control activities only after considering the risk-based impact of the control environment.

3. Are there aspects of management's annual evaluation process that have not been addressed by the proposed interpretive guidance that commenters believe should be addressed by the Commission? If so, what are those areas and what type of guidance would be beneficial?

Please see our answer to question 1 and our response to the SEC dated September 18, 2006. Additional detailed guidance should be based on an updated PCAOB Auditing Standard No. 2, clarifying issues not sufficiently addressed in that standard or where additional guidance is required specifically for management.

4. Do the topics addressed in the existing staff guidance (May 2005 Staff Guidance and Frequently Asked Questions (revised October 6, 2004)) continue to be relevant or should such guidance be retracted? If yes, which topics should be kept or retracted?

The May 2005 Staff Guidance was extremely valuable and remains relevant. There are no areas that should be retracted at this time.

If the SEC agrees with our recommended approach, the May 2005 FAQ can be used as a starting point for preparing the more detailed guidance we are recommending.

We recommend that the SEC work closely with the PCAOB to ensure that its guidance is authoritative for both management and the external auditor.

5. Will the proposed guidance require unnecessary changes to evaluation processes that companies have already established? If yes, please describe.

The proposed guidance is general and should not affect established evaluation processes.

6. Considering the PCAOB's proposed new 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,* are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to resolve the incompatibility?

Please see our response to question 1. The proposed interpretive guidance is high-level and does not conflict with the PCAOB's draft standard. However, we disagree with a number of elements of the draft standard, some of which also apply to elements of the SEC's draft guidance.

7. Are there any definitions included in the proposed interpretive guidance that are confusing or inappropriate and how would you change the definitions so identified?

We have proposed to the PCAOB a change in the definition of *significant deficiency* (please refer to our answers to their questions 7 and 8). Our recommendation is that *significant deficiency* be defined as:

> "A condition (generally one or more control deficiencies) that the auditor believes represents a risk to the business (which may not be limited to the integrity of the financial statements) of such significance that it should be reported to the audit committee."

We understand the intent of the SEC is to ensure all important matters related to the system of internal control are discussed with the audit committee. As a result of this intent, guidance in both the auditing standard and the interpretive guidance direct the assessment of control failure as significant deficiencies — even if they do not represent a reasonable risk of material misstatement in future periods — based on the quality of the system of internal control as of the assessment date. Examples discussed in our response to the PCAOB include the assessment as significant deficiencies restatements of previously issued financial statements to correct a material misstatement or the identification of a material misstatement by the auditor in the current period when it is not reasonably likely that an error would reoccur in future periods. In addition, the examples provided in footnote 74 of the proposed guidance define deficiencies as significant deficiencies without regard to their potential impact on the company, their likelihood of occurrence, etc. An assessment of risk elements should always be included in the determination of a significant deficiency.

8. Will the guidance for disclosures about material weaknesses result in sufficient information to investors and if not, how would you change the guidance?

We believe the guidance in paragraph B3 is sufficient. However, as stated above, we disagree with some of the guidance in paragraph B1 relative to the assessment of deficiencies.

9. Should the guidance be issued as an interpretation or should it, or any part, be codified as a Commission rule?

We believe that both the high-level guidance and the needed more detailed guidance should be codified as authoritative guidance, which can be in the form of an interpretation.

10. Are there any considerations unique to the evaluation of ICFR by a foreign private issuer that should be addressed in the guidance? If yes, what are they?

While we believe they should be addressed as recommended in our response to question 1 above, there are a number of issues relevant only for foreign issuers:

- The use of internal control frameworks other than COSO, and how their use may be reconciled to the external auditor's use of a different framework.

- Efficiencies that may be obtained by assessing controls not only over financial statements filed with the SEC, but also those filed with other countries' regulators.

- Reconciliations between financial statements prepared in accordance with the issuer's local GAAP with U.S. GAAP requirements.

- Varying governance standards and practices (e.g., the impact on the control environment of the absence of an audit committee).

QUESTIONS ON THE PROPOSED REVISIONS TO EXCHANGE ACT RULES 13A-15(C) AND 15D-15(C) AND RULES 1-02 AND 2-02 OF REGULATION S-X

1. **Should compliance with the interpretive guidance, if issued in final form, be voluntary, as proposed, or mandatory?**

   If the guidance is issued, compliance should be voluntary.

2. **Is it necessary or useful to amend the rules if the proposed interpretive guidance is issued in final form, or are rule revisions unnecessary?**

   We do not believe that the guidance addressing high-level principles is sufficiently detailed to support the assessment that management's evaluation was appropriate.

   Assuming more detailed guidance is also prepared, rules revisions are not likely needed.

3. **Should the rules be amended in a different manner in view of the proposed interpretive guidance?**

   We recommend that the need to amend the rules be deferred until the updated PCAOB Auditing Standard No. 2 has been released and the need for additional management guidance is fully addressed.

4. **Is it appropriate to provide the proposed assurance in Rules 13a-15 and 15d-15 that an evaluation conducted in accordance with the interpretive guidance will satisfy the evaluation requirement in the rules?**

   Please see our answer to question 2 in this section.

5. **Does the proposed revision offer too much or too little assurance to management that it is conducting a satisfactory evaluation if it complies with the interpretive guidance?**

   Please see our answer to question 2 in this section.

6. **Are the proposed revisions to Exchange Act Rules 13a-15(c) and 15d-15(c) sufficiently clear that management can conduct its evaluation using methods that differ from our interpretive guidance?**

   Please see our answers to questions 2 and 3 in this section.

7. **Do the proposed revisions to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X effectively communicate the auditor's responsibility? Would another formulation better convey the auditor's role with respect to management's assessment and/or the auditor's reporting obligation?**

   We understand that the requirement for the external auditor to review management's assessment will be removed, with the auditor only required to perform an independent assessment of the system of internal control.

We disagree with this decision. We believe the auditor should only attest to management's process as we recommended in our letter of September 18, 2006.

The revised language requires the auditor to "attest to, and report on, such [i.e., management's] assessment." It also requires the auditor to audit management's assessment. This language is not consistent with the intent of removing the requirement to review management's assessment. In fact, it supports our position that the auditor should only review and attest to management's assessment and not perform an independent audit of the system of internal control.

8. Should we consider changes to other definitions or rules in light of these proposed revisions?

As noted earlier, we believe the definition of a significant deficiency should be revised. It will enable all important internal control issues to be brought to the attention of the audit committee without misleading them or others that there is a risk of significant misstatement in future periods.

We also believe that the assessment of internal control should reflect the quality of the system of internal control as of the assessment date, and the assurance provided that there will not be material misstatement of financial statements to be filed with the SEC in the next year.

Further, we believe guidance should clarify that testing of events subsequent to the assessment date (e.g., the operation of controls involved in the preparation of the Form 10-K) should only be performed when clearly relevant to the assessment as of the assessment date. Tests of routine controls (e.g., approvals of vendor invoices) within a few days after the year-end are likely reflective of the quality of the system of internal control as of the effective date. However, testing the operation of controls in February for a December year-end company may not be reflective of the assessment date quality.

9. The proposed revision to Rule 2-02(f) highlights that disclaimers by the auditor would only be appropriate in the rare circumstance of a scope limitation. Does this adequately convey the narrow circumstances under which an auditor may disclaim an opinion under our proposed rule? Would another formulation provide better guidance to auditors?

We have no comment on this point.

COMMENTS ON THE COST AND BENEFITS OF THE PROPOSED AMENDMENTS

We request comment on the nature of the costs and benefits of the proposed amendments, including the likely responses of public companies and auditors concerning the introduction of new management guidance. We seek evidentiary support for the conclusions on the nature and magnitude of those costs and benefits, including data to quantify the costs and the value of the benefits described above. We seek estimates of these costs and benefits, as well as any costs and benefits not already identified, that may result from the adoption of these proposed amendments and issuance of interpretive guidance. With increased reliance on management judgment, will there be unintended consequences? We also request qualitative feedback and related evidentiary support relating to any benefits and costs we may have overlooked.

We do not believe the proposed guidance and rule amendments, with the exception of the removal of the requirement for the external auditor to provide an opinion on management's assessment, will result in significant change in companies' assessment processes. The proposed guidance of high-level principles is unlikely to have a fundamental impact on the processes most companies follow.

However, we do believe that detailed guidance on some specific issues — like those we identified in our response dated September 18, 2006 to the Concept release — could result in significant changes in a company's assessment process.

The proposed changes to Audit Standard No. 2, especially if our recommendations are adopted, should result in significant improvement in the efficiency of the external auditors' work, and accordingly, reductions in auditor fees.

QUESTIONS ON THE INITIAL REGULATORY FLEXIBILITY ANALYSIS

1. **The number of small entity issuers that may be affected by the proposed extension;**
2. **The existence or nature of the potential impact of the proposed amendments on small entity issuers discussed in the analysis; and**
3. **How to quantify the impact of the proposed amendments.**

We do not believe the proposed interpretive guidance will result in a significant change in approach for small entity issuers.

***

Attachment C

Scoping Information Technology General Controls (ITGC)

Type: Executive Summary Report

Date: 1/25/2007

Total invitations sent: 11,118

Total number of responses collected: 532 (4.79%)

1: What percentage of your organization's SOX 404 costs relate to ITGC?

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Less than 10%		18.7%	98
11-20%		25.2%	132
21-30%		**29.6%**	**155**
31-40%		12.6%	66
41-50%		8.6%	45
More than 50%		5.3%	28
Not Answered			8
		Valid Responses	**524**
		Total Responses	**532**

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2: How do you feel about your organization's costs related to scoping ITGC for SOX 404?

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
The costs are in line with what should be spent		41.5%	219
The costs are too high		**48.7%**	**257**
Neither (explained below)		9.8%	52
Not Answered			4
		Valid Responses	528
		Total Responses	532

2a: Additional comments regarding the organization's costs related to scoping ITGC for SOX 404:

Response
We are not a public company and therefore do not fall under Sox
Government Agency not subject to SOX at this point
No sox requirement
No sox requirements for company
Not enough spent on this. however, we are voluntary
SOX 404 does not apply to the school district
Glad to integrate into SOX process - more efficient for company
Costs are marginally too high
We are in Year One but we estimate costs to be 20-30%.
Overall costs are too high, but relative to non-IT costs, ITGC costs are in line
Not sure where the cost figure should be.
The costs were very high, but we did benefit. My issue is with the number of systems that were determined to be "in-scope" based on input from our external auditors.
Educational non-profit institution, but still interested in ITGC information

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Attachment C

I don't feel there is good communication between external auditors for ITGC and operational controls, so the expense may be low.
We co-source the ITGC testing, so the cost will be higher than in house.
Not enough value is placed on the role of ITGC
We are a government agency and SOX does not apply
The learning curve is past its apogee and has now helped us to reduce the costs.
Not enough focus on ITGC to date
SOX compliance is not required
We don't have enough resources to adequately scope all ITGC needed.
We have not scheduled it yet as a Private Company.
We do not have SOX costs - we are a private company
Not doing enough around ITGC
Costs were due to remediation efforts
No funding for this
Our effort in this area needs to be more robust
ITGC costs are higher because they require a specific resource skill set
Not required to comply with SOX
Private company not subject to SOX
The costs are as low as we think they can be, given the requirement to evaluate general computer controls. However, given that backup/recovery has little to do with financial reporting, our overall costs could be reduced if this area was excluded.
SOX 404 do not apply to us.
We do not have to comply with SOX.
We simply don't agree with the scope that our external auditors require. If we relate overly broad scope to the excessive audit procedures required to fulfill it, then I suppose you could say that scoping costs are too high.
Probably disproportionately low
I think we need to spend more and rely on the scoping more
We are a not-for-profit and doing "lite-SOX"

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External auditors get too focused on the controls as they apply to the financial systems. They ignore or minimize the controls relating to the running the business. Other systems are far more critical than the financial apps.
SOX is not currently applicable to my organization - it's NFP
We do not do enough in the area of ITGC
Do not have to comply with SOX
Not a company which falls under SOX 404 rules.
Hard to determine since the PCAOB SOX recommendations keep changing. They are moving in the right direction though.
Not affected
As a non-profit entity, the organization has not yet developed a full blown plan for the identification and testing of ITGCs.
We do not have to comply with SOX at this time.
As an OCC regulated bank, this is woven into our compliance program
The concern is overall cost on SOX404 and the efficient use of resources.
ITGC are extremely important for us whether or not they deal with SOX

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Attachment C

3: Please rate how valuable you think guidance on scoping of ITGC would be:

		(1) Not Valuable At All	(2)	(3)	(4)	(5)	(6) Extremely Valuable	Total	Mean
How valuable do you feel guidance on the efficient scoping of ITGC would be?	Count	6	9	44	62	153	**258**	**532**	5.107
	% by Row	1.1%	1.7%	8.3%	11.7%	28.8%	**48.5%**	**100.0%**	
Total	Count	**6**	**9**	**44**	**62**	**153**	**258**	**532**	N/A
	% by Row	**1.1%**	**1.7%**	**8.3%**	**11.7%**	**28.8%**	**48.5%**	**100.0%**	

4: Please rate how you feel about the following efficiency factors related to scoping ITGC:

		(1) Not Efficient At All	(2)	(3)	(4)	(5)	(6) Extremely Efficient	Total	Mean
How do you feel about your organization's efficiency in scoping ITGC?	Count	28	64	**172**	151	74	12	**501**	3.429
	% by Row	5.6%	12.8%	**34.3%**	30.1%	14.8%	2.4%	**100.0%**	
How do you feel about your external auditor's efficiency in scoping ITGC?	Count	61	114	**195**	114	39	6	**529**	2.951
	% by Row	11.5%	21.6%	**36.9%**	21.6%	7.4%	1.1%	**100.0%**	
Total	Count	**89**	**178**	**367**	**265**	**113**	**18**	**1030**	N/A
	% by Row	**8.6%**	**17.3%**	**35.6%**	**25.7%**	**11.0%**	**1.7%**	**100.0%**	

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5: Please select the title that best fits your current position:

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Chief Audit Executive (CAE)		**32.1%**	**168**
Audit Director		20.0%	105
Audit Manager		19.8%	104
IT Audit Director		6.9%	36
IT Audit Manager		10.7%	56
Other (specified below)		10.5%	55
Not Answered			1
		Valid Responses	**524**
		Total Responses	**525**

5a: Please select the other title that best fits your current position:

Response
Finance
IT Security Staff
VP Technology Controls and Compliance
IT Audit Supervisor
Audit Senior
Senior Internal Auditor
Director of Compliance
SOX 404 Manager
Compliance Manager
Director Internal Control

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Attachment C

SOX 404
Compliance Director
Internal Control Manager
Senior Exec
Internal Auditor
Internal control manager
Internal Controls Senior Manager
Internal Audit
Accounting & SOX Manager
SOX Project Mgr/Assistant Controller
VP Audit
Compliance Manager
Staff
Controller
Consultant
Sr. Auditor
Audit Supervisor
Senior Leader, IT Audit
Director, Financial Controls
IT Supervisor
Asst. VP, IT Audit
Risk Manager
SOX IT Specialist
Sarbanes Oxley Compliance Manager
IT Compliance Manager
Director, Internal Controls

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CEO
Sr. Manager Internal Accounting Controls
IT Auditor
IT Risk Analyst
SOX Manager
World-Wide SOX Director
Accounting manager
Financial Compliance
Consultant
SOX Team ITGC Liaison
Controller
SOX Auditor
Sr. IT Audit Mgr (Leading IT Audit function)
SOX Auditor
Staff
Internal Assurance, IMT Specialist
General Partner

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February 13, 2007

Re: SEC File No. S7-24-06 <u>and</u> PCAOB Rulemaking Docket No. 021

The **Institute of Management Accountants** applauds the efforts made to date by the SEC and PCAOB to make SOX implementation more cost-effective and practical while still protecting investors. We are pleased to continue sharing our extensive global research and recommendations with the SEC, PCAOB, professional accounting associations, the trade media, the U.S. Chamber of Commerce, Members of Congress and other security regulators around the world interested in this issue.

IMA's conclusion, after careful consideration of the SEC and PCAOB December 2006 proposals, is that significant additional actions are required to optimize the cost/benefit equation. This letter contains a **main body (7 pages)** and **3 attachments** (Attachment 1 – IMA Risk-Based Framework; Attachment 2 – Technical Analysis of SEC Guidance; Attachment 3 – Technical Analysis of PCAOB draft audit standard).

We have summarized below the five interrelated issues that we believe remain to be addressed, together with our technical analysis and recommendations for change. These five issues have been identified through extensive research and careful consideration of the reasons cited by Canada, the EU and Japan for not fully adopting the current U.S. SOX regulations.

- **Issue 1**: Two rule books (SEC, PCAOB) for the same assessment task – a recipe for unintended confusion and complexity. In short, without major changes to the draft rules ASX/5 will likely replace AS2 as management's de facto standard.
- **Issue 2**: The proposals are not risk-based by global risk management standards, reducing the benefits that could accrue from an assessment approach that focuses on identifying specific significant risks and understanding residual risk status.
- **Issue 3**: The current "quality bar" of zero material defects in draft financial statements is expensive without significantly increasing investor protection. This situation is compounded by the current requirement that identification of even one material control weakness requires management publicly report ineffective ICFR.
- **Issue 4**: The draft proposals call for elimination of the audit opinion on management's ICFR assessment process and retention of the auditor's subjective opinion on ICFR effectiveness. While some agree with this interpretation of the Act, it is contrary to IMA's and IIA's publicly reported views, some early comment letter responses, and the current stance of the U.S. federal government, Japan, Canada, and the EU capital market regulatory bodies.
- **Issue 5**: The draft proposals are still not practical for smaller public companies – all four issues listed above disproportionately impact smaller public companies.

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Issue #1/Impact	***What Needs to Change***
Two rule books for the same task – a recipe for unintended confusion and complexity. The SEC proposed rule is high level and broad to the point of being vague on minimum expectations in a number of key areas, including but not limited to the need to specifically identify, document and assess major risks and residual risk status. The PCAOB standard is more granular, prescriptive and control focused. The PCAOB rules constitute the "exam grading rule book" auditors must use or risk severe PCAOB sanctions and increased litigation exposure. Because under the current proposals auditors will still determine ICFR pass/fail rating, PCAOB rules will likely continue to be the de facto rule book for management that want a passing grade. This is a sub-optimal situation and contrary to what we believe is the true intent of the Act. A few examples of the more significant differences and/or inconsistencies that exist between the SEC and PCAOB proposals include: 1. **Control Environment Evaluation** – ASX/5 indicates that the auditor should assess the company's control environment and lists 5 specific areas for attention. The SEC guide makes passing reference to the concept but does not provide specific evaluation criteria or any information on what would constitute a failing grade on control environment. 2. **Identifying Significant Accounts** – ASX/5 lists 9 specific factors that should be used to identify significant accounts. SEC guidance has no parallel guidance for management. 3. **Strong Indicators of Material Weakness** – ASX/5 lists almost 3 pages of specific factors that are relevant to determining if a material weakness is present. The SEC guidance starting on page 41 provides similar but different criteria to be used by management.	**The SEC guidance should be the only ICFR "how to" assessment guidance.** Management teams that follow SEC interpretative guidance should be fully entitled to say they have done what is expected of them without fear of being overruled and/or contradicted by the more prescriptive, granular and control-centric PCAOB rules. Although the SEC proposed rule states that this result is indeed a goal, we believe that management will have to use and conform to the PCAOB rules in order to satisfy their external auditors. When revisions to the draft PCAOB standard are done following the comment period, we recommend all sections that describe how to complete an assessment of ICFR should be deleted from the Standard and **auditors directed to use the same SEC interpretative guidance used by management.** The focus in ASX/5 should be solely on audit considerations. However, the SEC primary ICFR assessment guidance should be revised to reflect IMA recommendations made in Issues 2-5 below.

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Issue #2/Impact	***What Needs to Change***
The SEC proposed rule and PCAOB revised standard are still not top-down/risk-based by global risk management standards. If these documents were truly top-down/risk-based users would be encouraged and allowed by the SEC to use globally accepted risk assessment frameworks such as AS/NZ 4360, COSO ERM, or the IMA top-down/risk-based ICFR assessment framework proposed in September. Application of any of these approaches would require that assessments start by formally documenting and assessing significant risks at both the entity and account/note level - risks that are already known to have resulted in materially unreliable financial statements. We would argue that this level of guidance is the appropriate balance between ambiguity at one extreme and prescription at the other. Although there is some reference to this step in the SEC guidance this step is not emphasized sufficiently or clearly enough. No examples or guidance on how to complete this step are currently in either set of draft rules. It is also important to note that nowhere in the SEC or PCAOB draft guidance do the authors use the words "residual risk" or "residual risk status". Identification and assessment of residual risk is a key element of any true risk-based assessment methodology and a cornerstone of all internationally recognized risk management standards. For example, the PCAOB proposed standard on page 5 directs auditors to start by examining and testing company level controls without first carefully identifying and assessing entity-level risks. In contrast, the SEC guidance alludes to starting with risks but does not take advantage of globally accepted methods to provide some level of practical "how to" guidance.	**Both the SEC and PCAOB proposals should be rewritten to reflect and require a true top-down/risk-based ICFR assessment approach. We are seeking "balance, not bias" between risk and controls-based methods.** A true top-down/risk-based approach starts with management identifying major risks at the entity level that are already known to be primary causes of material financial statement errors. Controls in place to mitigate these statistically predictable risks are then documented and specifically linked to the risks identified. Management must decide whether to mitigate the significant risks identified using controls, share or transfer risks using vehicles like outsourcing and/or insurance, accept the risk, or avoid the risk entirely. Residual risk status, including current detected error rates, is identified, documented and assessed by both management and auditors. Auditors are entitled and expected to adjust their audit approach to fully compensate for any retained ICFR residual risks the company has decided to accept. In severe cases where the ICFR systems in place exhibit levels of residual risk totally unacceptable to the company's auditor, they have the right and ability to refuse to provide an opinion on the company's financial statements and/or resign from the engagement. Well-run and tightly controlled companies will be rewarded with a lower cost of capital and significantly lower audit fees relative to companies that prepare poor quality ICFR assessments and/or accept higher levels of ICFR residual risk. **IMA's top-down/risk-based ICFR framework is included as Attachment 1 to this letter with greater detail available at**: www.sec.gov/comments/s7-11-06/s71106.shtml

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Issue #3 / Impact	*What Needs to Change*
The draft financial statement and ICFR "quality bars" are set too high, resulting in high cost without a commensurate increase in investor protection. Current SEC and PCAOB regulations require management produce draft financial statements with zero material defects for their external auditors or risk being publicly labeled in SEC filings as having "ineffective" ICFR. This is a complex issue that is directly linked to Issue 4 below. We believe that retaining the audit opinion on control "effectiveness" combined with the high quality bar on draft financial statements and ICFR is a dangerous mix. It is important to note that zero material defects is a level of draft financial statement quality and ICFR that is not currently expected, or required, by capital market regulators anywhere else in the world, including Canada, the UK, Europe or Japan. While zero material defects in ICFR and financial statement drafts prepared by management is a laudable "goal", we believe that it is a level of perfection that will result in the U.S. being at a competitive global disadvantage relative to countries viewed as having similarly reliable corporate governance systems without this requirement. In January, 2007 the McKinsey Report "Sustaining New York's and the US' Global Financial Services Leadership" study referenced the UK regulatory approach of discussing (draft) issues constructively and not penalizing companies for proactively coming forward with a potential issue; by contrast, in the U.S. "executives by and large are hesitant to raise even minor problems with regulators for fear that simply broaching the subject will lead to immediate enforcement action or, worse yet, a highly charged public prosecution".	**Allow companies to have ICFR systems that are less expensive than zero material defect systems. Require, via specific PCAOB auditing standards, that auditors adjust their work to fully compensate for control deficiencies identified by management and, in cases where management's ICFR assessment work was not rated as fully reliable, their own supplemental ICFR analysis. Auditors should publicly report on the reliability of management's ICFR assessment process (see Issue 4).** We believe that the primary goal of management's assessment of ICFR should be to clearly identify and candidly report areas of significant residual risk (using robust quality management systems) to the company's audit committee and external auditors. Using this type of approach external auditors audit and report on the reliability of the risk and control assessment <u>process</u> maintained by management. Auditors are required to modify the scope and extent of their substantive audit work to compensate for any areas of residual risk currently being accepted by the company's management and audit committee. Any errors identified in the draft financial statements by the company's auditors must be corrected by management prior to filing the accounts with the SEC. The frequency and magnitude of auditor detected errors in drafts prepared by management should be an important input to auditor opinions on the reliability of management's ICFR assessment process. A Glass & Lewis research study published in June 2005 provided clear evidence that literally hundreds of U.S. public companies claimed to have fully effective disclosure and ICFR systems right up to the point in time auditors had to provide an opinion on the reliability of their assessment work. At that point in time management, under the zero material defect rule, had to acknowledge material ICFR deficiencies existed. Good regulation should result in providing <u>positive</u> incentives to management to be candid and proactive in identifying issues in the financial statement drafting process.

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Issue #4/Impact	***What Needs to Change***
Misapplication of what we believe was Congress' intent in Section 404 (b), resulting in external auditors duplicating management's accountability for controls testing and assessment. Section 404 (b) of the Act states: "With respect to the internal control assessment required by sub-section (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer …". We do not believe that it was the intent of Congress to require that a company's auditor provide their own subjective view on whether control is or is not "effective". IMA research and other studies demonstrate that current ICFR standards and frameworks are not mature enough to produce repeatable conclusions on controls effectiveness. In other words, we do not believe that any framework is "fit for purpose" in terms of the SEC's four suitability criteria which include repeatability, sufficiently complete, free from bias and relevance. Revenue generation opportunities combined with a litigious environment provide tangible incentives for auditors to "raise the control bar". While this is a contentious issue, we fully support what we believe is the true intent of 404 (b) – an independent report on whether management is taking the responsibility assigned in section 404 (a) seriously and conscientiously. There is growing support for IMA's stance on this issue: 1. Global regulatory regimes that have carefully studied the U.S. SOX regime and chosen not to include the audit opinion on effectiveness (e.g., Japan, Canada and the U.K.), 2. The public position taken on the issue by the Institute of Internal Auditors, and 3. The comment letter from The Alamo Group, a $400M accelerated filer.	**Eliminate the costly and subjective audit opinion on controls effectiveness but retain/strengthen the audit opinion on management's assessment process in the context of a true risk-based approach**. Our basis for this recommendation is that current frameworks are not fit for purpose in making the pass/fail effectiveness conclusion, the process is costly and inefficient, it de-emphasizes management's accountability, and further increases the enormous litigation exposure of auditors (passed on to management in the form of higher fees). Additionally, an audit of management's (true) risk-based assessment process is more likely to uncover fraud (<u>leading</u> indicator of material weakness vs. <u>lagging</u> indicator of controls effectiveness). We recommend instead that the company's auditors audit and report on whether the company's management "has conformed, in all material ways, with SEC requirements to complete a top-down/risk-based ICFR assessment and reported the results to the company's audit committee and to us, the company's external auditors". This process would include careful analysis of residual risk status (the risk remaining after considering risk treatments) by both management and external auditors. It is important to note that the need for a redefined Section 404 (b) is building globally. Preliminary evidence suggests that, unfortunately, in countries where there is a requirement that management publicly report on ICFR – but, without a requirement for the auditor to report on the quality of that work – some companies do very little formal assessment work to support their public representations. The situation is even worse in countries that have no mandatory requirements for management to assess and report on ICFR. Canadian securities regulators have explicitly acknowledged this very real risk and are currently monitoring the situation to determine if corrective steps are necessary. We believe that audit opinions issued should reference the revised SEC guidance for management as the benchmark.

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Issue #5/Impact	*What Needs to Change*
The draft regulations are still not practical or scaleable for smaller public companies. ("SPCs") As one example, control structures capable of achieving zero material defects in draft statements are very expensive - money that is often better directed in SPCs to growing the company and producing increased shareholder value. All four issues described above disproportionately impact smaller public companies. It is important to note that the AICPA in the U.S. and audit standard setters in countries like Canada, the UK and Europe continue to believe and assert, correctly or otherwise, that auditors can produce a level of audit opinion quality and reliability on financial statements on par with SOX audit opinions without the use of a SOX-like assessment of ICFR. Investors are not currently being explicitly told that there is any differential in audit opinion quality on audited financial statements (e.g., non-accelerated vs. accelerated, public companies vs. private, etc). There is currently no empirical research we are aware of that validates the premise of differential audit quality. The recent study commissioned by the City of New York prepared by McKinsey & Company has recommended that U.S. listed SPCs be allowed to "opt out" of current PCAOB audit requirements but be required to make conspicuous disclosure of the risks that come with less emphasis on ICFR and potentially lower audit opinion reliability. We respectfully do not agree with the study suggestion that SPCs be allowed to opt out of SOX because of the implications of a "grade B" audit opinion, but we do understand the motivation. It is important to note that the U.S. government has, itself, not adopted a requirement that auditors provide opinions on the effectiveness of ICFR in federal departments and agencies at this point.	**We believe that if all four primary issues above are addressed "disproportionate *benefits*" will accrue to smaller public companies**: one set of assessment rules with management in the lead; a practical and scalable risk assessment process; and, setting the quality bar for material defects in financial statement drafts at a reasonable level combined with auditors opining on the assessment process (and not the pass/fail subjective audit opinion on effectiveness). In addition to generally increasing the practicality of the SOX rules through the reforms we are proposing, the skills and tools necessary to complete true risk-based/top-down assessments can be used in companies of all sizes and types not just for ICFR. They can be applied to other key areas like product quality, customer service, safety, cost control, revenue generation and other areas key to longer term business success. This helps improve the overall ROI of a true risk-based approach for all types of organizations. With due respect to the preeminent committees that have examined this issue, we do not believe that any public company should be exempted from section 404(b) of the Act but do believe the interpretation of the section should be redefined. Investors should be provided with information on the quality of the assessments prepared by management – a very good indicator of ICFR assessment skill and "tone at the top". This should include assessments made on the quality of operations driven by a robust QMS (Quality Management System). The mantra "building quality in" better enables sustainable financial reliability. Additional research on audit opinion reliability with, and without, ICFR assessment and audit assurance on management's ICFR assessment process should be initiated by the SEC, PCAOB, and/or the AICPA as soon as possible. If audit opinions produced under the SOX reporting regime prove to be no more reliable than Canadian or UK audit opinions that do not require similarly costly audit assurance on ICFR, Congress should reevaluate the cost/benefit of section 404(b).

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IMA solutions-oriented resources available to practitioners include:

1. **IMA Research Study**: "Internal Control: COSO 1992 Control Framework and Management Reporting on Internal Control: Survey and Analysis of Implementation Practices", Professor Parveen Gupta, LLB, Ph.D.

2. **IMA Discussion Paper**: "A Global Perspective On Assessing Internal Control Over Financial Reporting" submitted to the SEC 9/15/06.

3. **IMA Statement on Management Accounting**: "Enterprise Risk Management: Frameworks, Elements and Integration" released January 17, 2007. Professor William Shenkir, Ph.D.,CPA, Professor Paul L. Walker, Ph.D.,CPA. A second SMA focused on ERM Tools and Techniques ("how to") will be available in the early Spring of 2007.

The IMA is a global organization representing a diverse constituency and as such the observations and recommendations in this letter are meant to have broad application in the private and public sectors in countries around the world. This comment letter went through a formal exposure process with the IMA membership.

We would be pleased to assemble our senior team (including practitioners) and provide further details on the issues we have identified and corrective actions we have recommended. As always, the IMA stands ready to share transformational solutions to SOX 404 implementation that protect and grow shareholder investments, allow company management to get on with the business of doing business, and restore U.S. global competitiveness for sustained long term growth.

Sincerely,

Paul A. Sharman

Paul A. Sharman, ACMA
President and CEO

Jeffrey C. Thomson

Jeffrey C. Thomson
Vice President of Research & Applications Development

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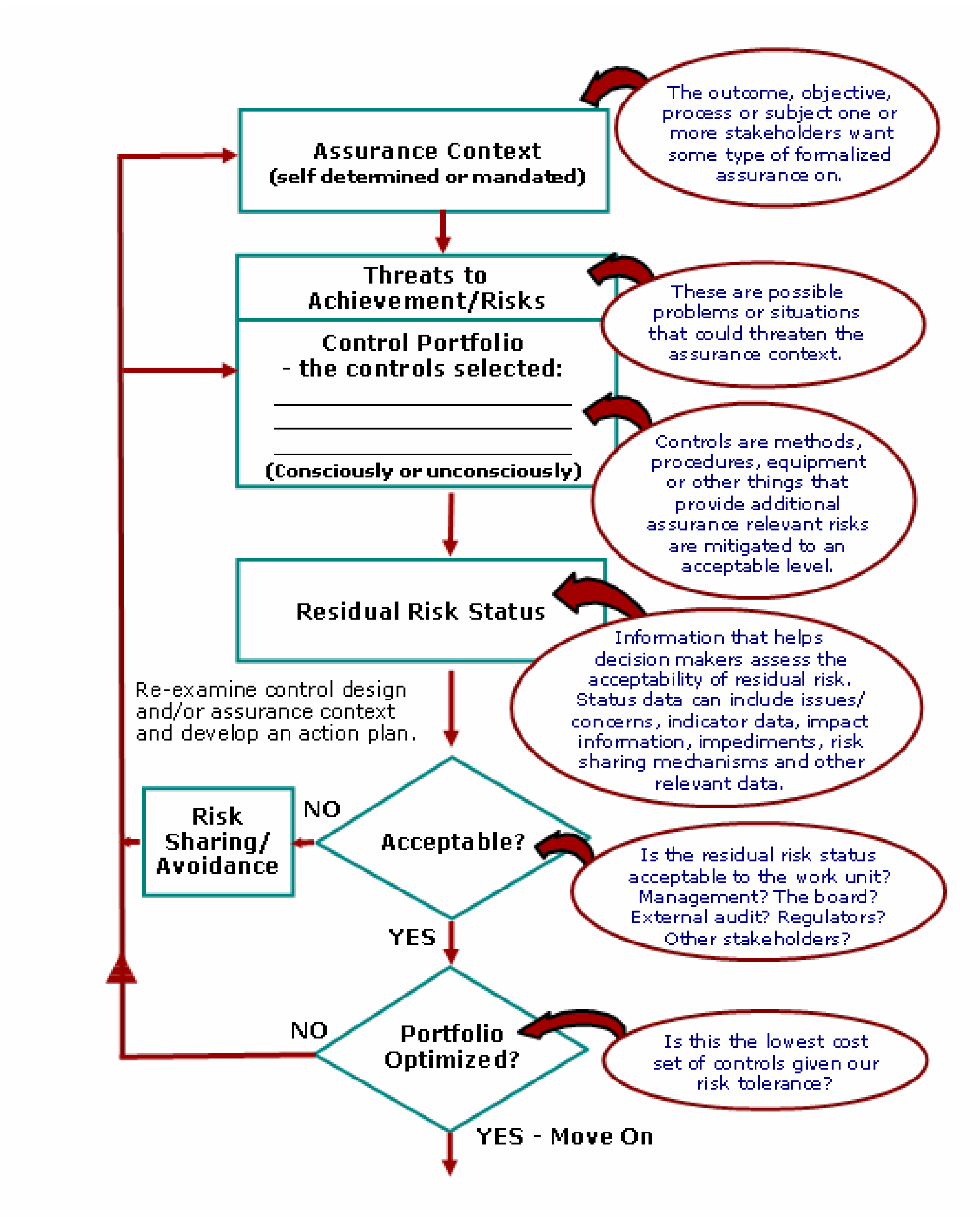
Attachment 1 – IMA Global Risk-Based Framework

Core Components of a Risk-Based Approach



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Attachment 2

IMA Technical Analysis & Commentary
SEC December 2006 Exposure Draft for Comment
Management's Report on Internal Control over Financial Reporting

Organized in ascending page order – IMA selected topic headings

PRIMARY AIM OF THE INTERPRETATION

SEC Draft Guidance:

Page 1 SUMMARY section states "The interpretive guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of internal control over financial reporting".

IMA Analysis/Comment:

With respect, this draft does not accomplish that aim, at least in terms of methods and terminology generally used and understood in risk management.

The words "top-down/risk-based" have been used frequently in guidance issued by the SEC and PCAOB over the past 3 years. A major problem appears to be definitional – what do the SEC authors actually mean by the term "top-down/risk-based"? What is clear from a detailed analysis of the document is that when the term "top-down/risk-based" is used, it is not consistent with globally accepted risk management assessment methods or standards, or in the sense described in the 2004 COSO ERM framework.

Although there are no references anywhere in the guidance that discloses the source of the SEC/PCAOB interpretation of the term "top-down/risk-based", the evidence suggests that the term has been interpreted primarily drawing from traditional U.S. audit literature and guidance issued over the past 30 years. If a guess was to be ventured as to the primary interpretation source, it appears to most closely align with notions espoused in how to evaluate "audit risk", the risk of giving an incorrect audit opinion, and the type of steps that should be done during the audit planning phase. Auditing methodologies in use today have not in any significant way adopted internationally accepted approaches to risk management, approaches that focus heavily on determining risk likelihood and consequence, and careful, formal monitoring of the status and acceptability of residual risk. Litigation risk related to adopting a true risk management approach to audits may be at the root of the non-adoption of true risk management methods.

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The IMA discussion paper filed in September 2006 in response to the SEC Concept Release proposes a specific market-tested, risk-based ICFR assessment approach that is scalable for organizations of all sizes. An extract from that document that describes the core elements of a risk-based approach that is aligned with global risk management standards appears as Attachment 1 of the primary IMA comment letter this detailed analysis supports.

SEC ON FLEXIBILITY ALLOWED

SEC Draft Guidance:

On page 4 it states "Instead of providing specific guidance regarding the evaluation, we expressed our belief that the methods of conducting the evaluation of ICFR will, and should, vary from company to company and will depend on the circumstances of the company and significance of the controls. We continue to believe that it is impractical to prescribe a single methodology that meets the needs of every company….Management must bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and provides reasonable assurance for its assessment. This proposed guidance is intended to allow management flexibility to design such an evaluation process."

IMA Analysis/Comment:

While the intent of this declaration to allow extensive flexibility and judgment is good, the reality is that, under the current SEC/PCAOB rules, it is the external auditor who decides whether a company's ICFR gets a "passing grade". As a result, the level of flexibility offered by either the current or proposed SEC rules is significantly undermined by the fact that management teams that want a pass on ICFR from their auditors must conform to the more granular and prescriptive PCAOB rules.

SUITABLE ICFR EVALUATION FRAMEWORK

SEC Draft Guidance:

On page 5 it states "In order to facilitate the comparability of the assessment reports among companies, our rules implementing Section 404 require management to base its assessment of a company's internal control on a suitable evaluation framework. ….the Commission identified the Internal Control-Integrated Framework created by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") as an example of a suitable framework". The SEC's Advisory Committee On Smaller Public Companies (SPCs) contradicted the SEC stated view that COSO 1992 is suitable, at least for smaller public companies, when they stated "unless and until a framework for assessing internal control over financial reporting is developed that recognizes their characteristics and needs" they requested an exemption from Section 404.

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As far as we are aware, subsequent to the release of the COSO SPC guidance in final in June 2006, the conclusion of the Advisory Committee members on the existence of a suitable assessment framework for SPCs has not changed.

IMA Analysis/Comment:

The IMA research report "COSO 1992 Control Framework and Management Reporting on Internal Control Survey and Analysis of Implementation Practice" concluded that COSO 1992 was not designed to meet, nor does it satisfy in a demonstrable way, the "suitability" criteria defined by the SEC. Those suitability criteria are consistent quantitative/qualitative conclusions, absence of bias, comprehensive coverage, and suitability for ICFR. The IMA is a founding member of COSO and has identified the "suitability" for SOX issue to the other members of COSO. Other companies and individuals that have responded to the SEC and PCAOB have also concluded that COSO 1992 is not suitable in isolation as a primary framework to conduct ICFR assessments for SOX.

Other countries around the world, including Canada, the UK and Japan, through their actions, have similarly concluded that existing tools and frameworks are not sufficiently advanced to support the requirements for management and auditor reporting on ICFR defined by the SEC. An FEI research study completed in 2005 on material weakness deficiency reporting also identified the fact that few, if any, registrants were reporting control deficiencies and specifically identifying the relevant COSO framework category or criteria that links to the material weakness or significant deficiency identified. It is important to note that nowhere in PCAOB AS 2 does it define specific audit steps to evaluate a management claim that their ICFR controls are effective in accordance with COSO 1992 or any other control framework. To date, there has been no official acknowledgement of the growing body of evidence, including the rigorous IMA research study, that refutes that COSO 1992 actually meets the specific assessment framework suitability criteria defined by the SEC.

WHO DECIDES WHETHER CONTROL IS "EFFECTIVE" OR NOT?

SEC Draft Guidance:

On page 8 it states "In response to this feedback, the Commission and its staff issued guidance on May 16, 2005, emphasizing that management, not the auditor, is responsible for determining the appropriate nature and form of internal controls for the company as well as their evaluation methods and procedures". On page 10 it states with respect to U.S. Government Accountability Office report "That report stated that management's implementation and evaluation efforts were largely driven by AS No. 2 because guidance was not available for management."

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IMA Analysis/Comment:

The intent of the May 16, 2005 SEC guidance is commendable. However, the reality is, under the current rules, auditors are responsible for providing an independent, subjective, parallel opinion on control "effectiveness", as well as an opinion on management's assessment. The new draft SEC and PCAOB rules recommend that the audit opinion on management's assessment be dropped, but the subjective, parallel direct report audit opinion on ICFR retained. This means that, in reality, if the approach used by management does not fully conform to the assessment approach prescribed in PCAOB AS 2, there is a significant risk that the auditor will arrive at a conclusion on control effectiveness which differs from that of management. IMA research clearly indicates the vast majority of companies used PCAOB AS 2 during the first three reporting periods as their primary assessment guidance. We are not aware of a single company in the world that attempted to complete their ICFR assessment using SEC guidance and COSO 1992 in isolation of the granular and prescriptive requirements in PCAOB AS2. The potential that parallel, but different, "how to" ICFR assessment guidance will produce unnecessary complexity and confusion has been identified as a major issue in the main body of our comment letter.

MANAGEMENT SHOULD USE ITS OWN EXPERIENCE AND JUDGMENT

SEC Draft Guidance:

On page 14 it states "Management should use its own experience and informed judgment in designing an evaluation process that aligns with the operations, financial reporting risks and processes of the company".

IMA Analysis/Comment:

Again, although this is good in theory, the reality is quite different. Management teams that want to minimize ICFR opinion variation risk will base their assessment and evaluation on PCAOB rules and the particular views on what controls must be in place.

MANAGEMENT FLEXIBILITY REEMPHASIZED

SEC Draft Guidance:

Pages 15 and 16 repeat the contention that management has significant latitude in deciding how to go about assessing and reporting on ICFR and states the approach should be "top-down, risk-based that allows for exercise of significant judgment so that management can design and conduct an evaluation that is tailored to its company's individual circumstances."

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It goes on to state "This guidance describes a top-down, risk-based approach to this principle, including the role of entity level controls in assessing financial reporting risks and the adequacy of controls."

IMA Analysis/Comment:

We reiterate that flexibility is, in reality, limited to whether management has followed the same steps their auditors will apply in arriving at their parallel, independent and subjective opinion on ICFR. Although the words "top-down, risk-based" are used, it does not state that the exercise should start by identifying and assessing the major risks that are already known to have resulted in materially wrong financial statements and specifically linking the controls in place in the company to mitigate those risks. Informal polls conducted in locations in the U.S. and other countries around the world with SEC registrants confirm that only a very few companies during the first two reporting cycles actually listed major risks at the entity level and specifically identified what controls, if any, were in place to mitigate them. This methodology deficiency was done with the full knowledge and support of their external audit firms on the basis that the current SEC and PCAOB rules do not require this step be done by either management or auditors. It is not clear that the new draft guidance corrects this major deficiency.

IDENTIFYING FINANCIAL REPORTING RISKS AND CONTROLS

SEC Draft Guidance:

Page 21 states "The evaluation begins with identification and assessment of the risks to reliable financial reporting (i.e. materially accurate financial statements), including changes in those risks." What is missing in the current draft guidance is any form of tangible guidance how this step should be done at the entity level, subsidiary level, and account/note levels. On page 23 it goes on to state "Management uses its knowledge and understanding of the business, its organization, operations and processes to consider the source and potential likelihood of misstatements in financial statement elements and identifies those that could result in a material misstatement to the financial statements."

IMA Analysis/Comment:

The importance of the entity level risk identification and assessment step, combined with the high frequency this step was not done by either management teams or auditors in many of the ICFR assessments performed to date, suggests that there is a still a major void in the draft SEC and PCAOB guidance. Risk management specialists have recognized that the experiential/brainstorming approach to risk identification that draws solely on participant experience and knowledge, in isolation, regularly produces seriously deficient lists of significant risks.

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Given that the dominant entity-level risk in the major scandals to date, including Enron, WorldCom, HealthSouth, Parmalat, Nortel and many others has been "CEO/CFO direct inappropriate accounting entries be booked", it would seem to make sense that regulators offer this as a specific example of a real-life, high probability/high impact risk. Other examples of significant entity level risks include "CFO/Controller not current on technical GAAP reporting rules", "CFO/Controller not technically current and up to date on all applicable tax rules", etc.

The SEC should, without too much work, be able to provide a list of the top ten statistically probable risks that have resulted in materially wrong financial statements. The guidance could then indicate that, at a minimum, these known statistically probable high consequence risks should be identified, assessed for applicability in the specific business sector, and documented as entity level risks. It isn't clear why the guidance appears to go to some lengths avoiding simply stating that statistically probable risks should be documented, likelihood/consequence assigned, and the controls in place, if any, that mitigate the risk identified and evaluated. There is no real guidance offered in the current exposure drafts on how this critically important step should be done, other than referencing management experience, a method which is globally known, if used in isolation, to produce incomplete risk assessments in a significant number of cases.

Some of the globally accepted methods to ensure the completeness and reliability of the risk identification step outlined in the September 15, 2006 IMA discussion paper "A Global Perspective on Assessing ICFR" filed with the SEC include the following:

1. **Loss/Incident Approach** – This uses internal error tracking to identify relevant risk or risks that were key to control failures that have been detected by management, internal and external auditors and others. This is now a mandatory step required by the Basel II reforms for all banks around the world. In practice this would mean systematically creating 3 to 5 years of situations where errors were identified in draft financial statements by the compay's auditors – both material and immaterial. These "defects" are analyzed for patterns and trends and root cause and correlated factors identified. There is a huge body of experience globally emerging how to execute this critical risk-based step. The quality movement has an impressive body of knowledge on how defect analysis is key to process improvement.

2**. Risk Source Approach** – This method uses a "risk source" framework that helps the people doing the assessment to ensure they have considered all the key risk sources and evaluated applicability to their circumstances. Examples of risk sources include such things as suppliers, technology, employees, human behavior, customers, economics, contractual, regulators, and others. The September 15, 2006 IMA Discussion Paper "A Global Perspective on Assessing ICFR" provides specific illustrations of a risk source framework. Attachment 1 to this comment letter provides a process summary of IMA's risk-based framework.

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3. **Inverse Control Approach** – This method focuses on risks that flow from the non-use of particular controls. An example in accounting would be "employees lack the necessary knowledge/skill" or "employees have not completed a reliable risk assessment". Control frameworks like COSO and CoCo in Canada identify capability controls as part of an integrated framework. The absence of a particular type of control may be a risk. An example of an inverse control approach in the home environment related to fire safety would be "No smoke detectors are installed". The real root risk is that a fire in the house has started but occupants are not aware of it.

4. **Brainstorming/Experiential Approach** – This approach is unstructured and draws on the experience and knowledge of participants. The broader and more complete the experience the better the list of risks that have already happened. The approach when used in isolation has a high failure rate in terms of producing reliable lists of all significant risks.

5. **Visualization/process mapping** – This approach requires participants to formally trace the steps involved in an activity/process and to use that knowledge to identify points or steps that may involve risks. This is a very time/labor intensive method but can yield good results.

6. **External Research** – This approach draws on identifying what has already been learned about risks and risk vulnerability in a particular business sector or activity. Vendors such as Audit Analytics and Compliance Week provide detailed tracking of material weakness disclosures of all U.S. listed companies. Problems that impact on more than a few companies in a specific business sector should be specifically examined for applicability in others. Again, the Basel II reforms for banking have made external benchmarking a mandatory risk management process for all major banks around the world.

WHAT DOES "ADEQUATELY ADDRESS" MEAN?

SEC Draft Guidance:

On page 25 the guidance states "the objective of this evaluation step is to identify controls that adequately address the risk of misstatement for the financial statement element that result in a material misstatement in the financial statements."

IMA Analysis/Comment:

Although the statements in this section are technically correct they could be stated in a clearer way and better convey just how difficult this step is in practice. An example to illustrate the challenge follows:

Risk: The CFO directs improper entries to manage period profits in order to maximize personal gains under the company's stock option/bonus system. Risk likelihood rating – low (over the entire population of public companies but not necessarily in specific companies); Risk consequences rating – severe.

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Mitigating Controls:

1. Audit committee reviews financial statements prior to release.
2. Company maintains a concerns reporting hotline that is reviewed and responded to by internal audit.
3. Company has a code of conduct that stresses the obligation of the company to report reliable financial statements.
4. Internal audit department completes an audit of the financial statement close process on a 3 year cycle.

Extending this example to the "residual risk" step a hypothetical residual risk status for a sample company could be as follows:

External auditors identified 3 to 6 material errors in the draft financial statements prepared under the direction of the CFO in each of the previous four fiscal periods. These errors had to be corrected prior to the auditors signing the financial statements. 30% of the errors identified by the auditors were attributed to controllership GAAP knowledge/skill deficiencies, 30% were attributed to flawed transaction processing control design at the subsidiary level, and 40% were attributed to conscious acts and decisions on the part of senior management to manage profit to meet earning forecasts through selective and, at least in the opinion of the company's auditors, inappropriate interpretation and application of GAAP rules. No process is currently used by management or auditors to document, track, and analyze errors detected over time. Management has regularly reported in response to a range of internal audit findings that they are prepared to accept the risk. Few, if any, external audit firms have formal IT systems in place that systematically log and analyze cause of accounting errors detected during the substantive audit phase of the audit over multiple fiscal years.

It is important to note that neither the SEC or PCAOB current or draft guidance indicates that there is any requirement for management or auditors to formally document and monitor residual risk status. Residual risk is a key element of virtually all generally accepted risk management standards in use around the world.

In practice, the ICFR controls in place always result in some level of residual risk which is more or less acceptable to any given combination of stakeholders. The "RISK-BASED" illustration above would be a fairly common status description, especially in non-accelerated filers. In many cases, subjective views by management and/or auditors on whether a given combination of controls will produce the desired results are proven by the passage of time to be wrong.

There is at least preliminary evidence that many of the companies that are under investigation for accounting errors related to stock option accounting have CEOs and CFOs who have regularly certified that the company has effective disclosure and ICFR controls and at least some received "effective" control ratings from their auditors prior to the disclosure of the problem. Monitoring of changes in residual risk status, including detected error rates found by external audit and management,

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reduces the enormous subjectivity in the vast majority of ICFR assessment methods in use today for SOX.

IT GENERAL CONTROLS AND RISK

SEC Draft Guidance:

On pages 27 and 28 there is a discussion of the role of IT general controls and it states on page 28 "For purposes of evaluation of ICFR, management only needs to evaluate those general IT controls that are necessary to adequately address financial reporting risks."

IMA Analysis/Comment:

Although there is a general reference to risk and risk-based, the reality is that IT general controls in the context of SOX should be defined as controls in place to address a specific class of risks that do, or could potentially, threaten the reliability of the financial statements. Relevant IT general controls risks include "Fraudulent modification of program code", "Unauthorized modification of data used in the calculation/preparation of accounting entries", and "Logic and/or calculations performed by computerized accounting systems are technically flawed and/or wrong". The main reason to evaluate what are generally known as IT General Controls is to determine if there are specific controls in place and functioning that are effective enough to mitigate the type of risk described above below a level of residual risk that is currently set in AS 2 at "less than a remote likelihood" and is proposed to be in the draft guidance less than "reasonably possible".

The guidance makes no reference to how to apply a "risk-based" approach to evaluating the effectiveness of IT general controls. In reality, a simple but radical way to test IT general controls is to have a person with strong computer skills attempt to modify key accounting programs and/or data and assess if he/she is successful and whether the controls are strong enough to detect the change. Risks in this area should include the risk that a person working in the IT department that has high level access rights attempts to make unauthorized changes to data or program code undetected. Very few companies submit their IT general controls to this level and harsh type of effectiveness evaluation. In the absence of this type of "real life risk" evaluation, conclusions arrived at as to whether controls are, or are not, effective, while still useful, are inherently subjective.

GUIDANCE DOES NOT EXPLICITELY REQUIRE RISK OR RESIDUAL RISK INFORMATION BE DOCUMENTED

SEC Draft Guidance:

On page 28 it outlines documentation requirements and states that "management must maintain reasonable support for its assessment". Nowhere in this section does it explicitly state that management needs to document relevant risks to reliable financial statements at the entity, subsidiary or account/note levels, or maintain any documentation related to management's assessment of the likelihood or consequence of the risks identified.

Considerable attention is paid in the draft guidance to the need to document controls. The words "risk characteristics" are used but there is no direct requirement to document risks that threaten the reliability of the accounts at the entity or subsidiary levels. It goes on to state on page 30 "Evidence about the effective operation of controls may be obtained from direct testing of controls and on-going monitoring activities".

IMA Analysis/Comment:

Although there is a reference to "monitoring activities" nowhere does it state that management needs to determine the current actual detected error rate related to specific accounting line items or note disclosures in the company's draft financial statements. Control evaluation in the total absence of a focus on the actual error or defect rate is inherently subjective. Current ICFR assessment methods in use during the first three rounds of SOX reporting have shown a high effectiveness conclusion failure rate.

The IIA in its guidance on issuing audit opinions indicates that auditors should be very cautious issuing pass/fail audit opinions in areas where the assessment criteria are open to wide interpretation by knowledgeable experts. A Glass & Lewis study clearly indicated that literally thousands of companies reported having effective ICFR controls right up to the time of their first 404(b) audit report under effective disclosure reporting rules. At that time the auditors determined during their audit that there were material errors in the financial statements that required correction.

Under the current PCAOB rules detection of a material error in the draft statements generally forces management to indicate ICFR controls are ineffective and disclose one or more material weaknesses. It is assumed that in the hundreds of cases identified in the Glass & Lewis research study neither management or auditors had concluded based on their ICFR assessment prior to the time the financial statement defects were found that there were any reportable control deficiencies.

DETERMINING THE SUFFICIENCY OF EVIDENCE

SEC Draft Guidance:

The diagram on page 32 provides a useful guide in terms of where the most persuasive evidence should be obtained by management. It uses the term "misstatement risk of financial reporting element". Presumably this diagram can apply to the whole of the financial statement filings with the SEC or specific accounts and notes. The x axis is labeled "risk of control failure". If this table was applied to the very real risk that the CEO and CFO often, if not always, have significant financial incentives to manage and/or manipulate profit, it would suggest this risk should be scored as a top right quadrant risk. The controls to manage this very real and significant risk include the audit committee diligence and competency, confidential concerns hotlines, likelihood and severity of sanctions if caught, and others.

Although SEC ICFR rules do not allow it to be counted in control assessment work or evaluated as to its sufficiency, in reality, the highest impact control to mitigate this specific risk is the ethics and competency of the specific external audit team assigned to audit the financial statements prepared by management.

IMA Analysis/Comment:

This table is, in fact, at the root of a significant amount of inefficient work done to date. The table correctly suggests that the most evidence should be obtained on the controls in place to manage the really serious, statistically probable, entity-level risks that are already known to have been at the root of major financial scandals and auditor opinion failures. It is not a stretch to conclude that this means that the most persuasive evidence should be gathered on the diligence and competency of the audit committee, and the competency, ethics, and quality assurance controls of the company's external audit firm.

Research done by FEI on control deficiency reporting during 2004 and 2005 indicates that either 1) virtually all audit committees of U.S. public companies are "effective" as key controls, or 2) explicit SEC and PCAOB requirements to complete this step and sound risk management principles that call for the most rigorous assessment and most persuasive evidence should be gathered on the truly key controls are not being complied with. Given numerous studies undertaken around the world over the past 20 years cast serious doubt on the 100% effective audit committee option, the evidence points to the conclusion that audit committees are not being rigorously assessed in terms of their role as a key control. The reason is simple - it is too dangerous from a career perspective for insiders to complete the step in a rigorous way and it requires external auditors evaluate the very people that have hired them – the audit committee.

In the case of evaluating the likely effectiveness of the external auditor as a control, the current rules do not allow this form of assessment to be completed or counted in SOX reviews. Because it is the external auditor that is currently being asked to form an independent subjective view on management's controls, this would also mean that the external audit would be required to report on management's assessment of their own competency, ethics and quality assurance system. This of course would be a major conflict of interest and under the current rules is impossible to complete as a step for a variety of reasons. This point means that by definition, the current rules do not adequately address, at least in a true risk-based way, one of the most significant risks that have lead to major financial misstatements – senior executive directed financial statement fraud.

ASSESSING CONTROL EFFECTIVENESS – SUBJECTIVE/OPINION-BASED VS FACT-BASED ASSESSMENT

SEC Draft Guidance:

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On pages 35-38 there is considerable discussion of examining the operation of controls but very little discussion of evaluating and measuring risks as a key precondition to deciding on the likely effectiveness of the current control design and operation. The words “residual risk” are not used anywhere during this discussion. A key element of residual risk is the current “defect or error rate” or, stated another way, the frequency and magnitude detected where the controls in use did not result in reliable financial statements.

IMA Analysis/Comment:

In any true risk-based approach the process starts by identifying and assessing risks that threaten the specific “assurance context” being evaluated. For SOX, the macro assurance context is that the financial statements at the consolidated entity level are reliable. This must then be cascaded down to account and note level at the consolidated level and on down to the entity level at significant subsidiaries, if any, that make up the consolidated statements. Only after this step is completed should the controls, or “risk treatment” mechanisms in risk management vernacular, be identified. Once controls in place have been identified and tested to confirm a correct understanding of the risk mitigation strategy it is essential to then take steps to determine the residual risk status. Residual risks are risks that remain after considering the risk treatment steps taken.

For ICFR this is comprised of risks where there were either no controls identified or the controls are not expected to fully mitigate the risk(s) identified in whole or part, as well as the current performance level and error rate being produced by the controls in place. In the case of ICFR, this is comprised of errors, both large and small, detected by external auditors during their audit, errors detected by management both before and after public release of the statements, errors detected by tax authorities and others after financial statements are released, results of comparisons of management estimates made to actual results that occurred in subsequent periods, and other key information.

This approach to evaluating control effectiveness is considered to be “fact-based” as opposed to approaches that are primarily “subjective/opinion-based”. Unfortunately, under the current rules, the vast majority of ICFR assessments being done currently are regulator endorsed subjective/opinion-based. One way to get a sense of the current failure rate of ICFR assessment methods currently in use is to measure the frequency that both management and auditors conclude ICFR control for a specific account or note disclosure is “effective” during their ICFR assessment, versus the frequency that auditors identify material defects in the accounts and notes during their audit of the financial statements provided by management.

Research conducted by the FEI and Glass & Lewis indicates that current subjective/opinion-based ICFR assessment methods have a relatively high failure rate. Limited research, if any, is being done to carefully and systematically identify and track management or auditor ICFR effectiveness prediction accuracy.

EVIDENTIAL MATTER TO SUPPORT THE ASSESSMENT

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SEC Draft Guidance:

Pages 38 and 39 outline the evidential matter necessary to support a conclusion.

IMA Analysis/Comment:

Although flexibility in the required assessment approach is a positive attribute from a management perspective, this section, in light of the considerably more granular requirements in the PCAOB standard, provides limited practical help. If management does not approach the ICFR assessment in the same way required by the PCAOB standard the possibility of a control effectiveness conclusion different than that arrived at the company's external auditor increases. The guidance would be greatly improved if it simply stated minimum expectations at the entity, account, note and subsidiary levels. A table for this purpose would be a much better vehicle to communicate this information. It should be possible for the authors to simply review each of the "how-to" sections in the guide and summarize the minimum data that is expected to be assembled. There is no indication that there is any expectation that fact-based residual risk/ICFR system performance data should be obtained and stored on file to provide fact-based conclusions on ICFR effectiveness.

MATERIAL WEAKNESS EVALUATION

SEC Draft Guidance:

Pages 41 to 46 discuss how to grade control deficiencies including specific guidance on what constitutes "strong indicators" of a material weakness.

IMA Analysis/Comment:

While this guidance is a major improvement over what was previously available for management, it still misses a key point that is relevant to users of the information. Research done by the FEI and Glass & Lewis indicates a considerable number of the material weaknesses are being disclosed as a result of auditors finding material errors in drafts prepared by management. This situation is classed as a strong indicator of a material weakness. The list on page 45 includes the following strong indicator:

Identification by the auditor of a material weakness in financial statements in the current period under circumstances that indicate the misstatement would not have been discovered by the company's ICFR.

A simple way of expressing where the draft financial statement quality bar is currently set is to simply indicate that "The ICFR controls in place must be capable of preventing a material error in the draft financial statements provided to the company's external auditors. If your assessment indicates that there is at least a reasonable possibility that a material error will be present in the draft financial statements provided to the auditors, the situation must be identified and reported as a material weakness."

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The issue of where the draft financial statement quality bar is set for all companies currently is identified as a major issue in the main body of the IMA comment letter. The current rules in use and those contained in the SEC and PCAOB exposure drafts require management produce draft financial statements with zero material defects or face the consequences that flow from publicly reporting that the company has an ineffective ICFR system. This is a quality level that is far beyond that in any other country in the world today and a far more stringent level of internal financial reporting quality than is currently being produced by the majority of smaller public companies. The fact that current and proposed SEC and PCAOB rules require zero material defects in financial statement draft or be labeled as having an ineffective ICFR system will, in all probability, continue to fuel objections from U.S. SPCs, and add fuel to the movement to de-list and/or list securities in countries with lower draft financial statement quality requirements (i.e. lower than zero material defects). At this point there is no empirical research that examines whether the current U.S. rule of zero material defect in draft financial statements or publicly disclose an ineffective ICFR system produces a higher audit opinion reliability rate than that in other countries.

PROPOSED RULE AMENDMENTS

SEC Draft Guidance:

On page 51 it states "an evaluation conducted in accordance with the interpretative guidance issued by the Commission, if the Commission adopts the interpretative guidance in final form, would satisfy the annual management evaluation required by those rules. The proposed amendments would not limit the ability of management to use its judgment to determine the method of evaluation that is appropriate for its company. The proposed amendments would be similar to a non-exclusive safe-harbor in that they would not require management to conduct the evaluation in accordance with the interpretative guidance, but would provide certainty to management that choose to follow the guidance that it has satisfied its obligation to conduct an evaluation for purposes of the requirements in Rules 13a-15(c) and 15d to-15(c)."

IMA Analysis/Comment:

Given that the proposed guidance calls for the auditors to do a separate and independent assessment of ICFR following the procedures in the new PCAOB standard, it would appear to make little practical sense for management to do their analysis in accordance with any rules other than the assessment rules the auditor must follow. We are very concerned that this situation may make the entire SEC document largely redundant. This point is identified as a major issue in the main body of IMA's comment letter.

INDEPENDENT AUDITOR OPINION ON ICFR

SEC Draft Guidance:

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On page 52 it states "Therefore, we are proposing to revise Rule 2-02(f) to require the auditor to express an opinion directly on the effectiveness of ICFR".

IMA Analysis/Comment:

There is no discussion in the draft of the significant groups, including the IMA and IIA and small accelerated filers (e.g., Alamo Group response letter January 3, 2007), that have publicly disagreed with the SEC's interpretation of section 404(b). IMA research indicates that current ICFR assessment frameworks are inherently subjective and that no control frameworks currently available meets the four specific suitability criteria defined by the SEC. The SEC's own SPC advisory board indicated "unless and until a framework for assessing control over financial reporting for such companies is developed that recognizes their characteristics and needs, provide exemptive relief from Section 404 requirements of the Sarbanes-Oxley Act". The SEC position that the Act calls for a subjective and public opinion from external auditors on whether a company's ICFR framework should be assigned a pass/fail rating amplifies the negative impacts flowing from the current rules. This issue is identified in the IMA primary response letter this detailed analysis supports as a major issue.

SIGNIFICANT ALTERNATIVES

SEC Draft Guidance:

On page 64 it indicates that "The Regulatory Flexibility Act directs us to consider alternatives that would accomplish stated objectives, while minimizing any significant adverse impact on small entities."

IMA Analysis/Comment:

There is no evidence at this point that the SEC has considered in any serious way two major alternatives that are open to it.

These are:

1. Actually allow and encourage companies to use globally accepted risk management assessment methods such as those outlined in international risk standards, COSO ERM and the discussion paper the IMA filed with the SEC in September to meet the requirements of Section 404 (see Attachment 1 to this comment letter for a process summary of IMA's risk-based framework). Such an approach would focus on entity level risk identification and assessment and residual risk monitoring to significantly greater extent than the current SEC/PCAOB control-centric rules. This type of approach would require "fact-based" evaluation of control effectiveness as opposed to current criteria which are predominantly subjective, particularly as they relate to analysis of "entity-level controls", fraud prevention/detection controls and IT general controls.

2. Require that auditors provide an opinion on the reliability of management's assessment process drawing on well developed and accepted process auditing

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methodology used in the quality profession instead of the current path of requiring a subjective, independent auditor opinion on ICFR using different assessment guidance than that offered to management.

It is not clear why these alternative approaches have been rejected as no explanation for rejecting them has been offered to date.

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Attachment 3

IMA Technical Analysis and Commentary
PCAOB RELEASE No. 2006-007 (ASX/5) 12/19/06

Organized in ascending page order – IMA selected topic headings

PROCESS EFFICIENCY

PCAOB Draft Standard:

Page 3 states "the Board has evaluated every significant aspect of the audit of internal control to determine whether the existing standard encourages auditors to perform procedures that are not necessary in order to achieve the intended benefits".

IMA Analysis/Comment:

We appreciate the paragraphs in the draft standard that are devoted to explaining the position taken on whether the Act calls for an audit of management's ICFR assessment versus an independent and subjective audit opinion on ICFR. However, there is no indication that the PCAOB or SEC have examined the impact of their choice on the overall cost of compliance. There is also limited indication that the PCAOB has formally considered what a "top-down/risk-based" ICFR approach would look like based on globally accepted risk management standards such as those in AS/NZ 4360 or COSO ERM.

GENERAL IMPROVEMENTS TO THE STANDARD

PCAOB Draft Standard:

Page 4 states that the proposals are designed primarily to:

Focus the audit on the matters most important to internal control
Eliminate unnecessary procedures
Scale the audit for smaller companies
Simplify the requirements

IMA Analysis/Comment:

To achieve these laudable goals, IMA suggests that the current draft be changed to require that management and auditors identify, document and assess the statistically probable macro level risks that are already known to be the cause of materially wrong financial statements. If the goal is to eliminate unnecessary procedures it would seem reasonable to focus on the highest likelihood/biggest consequence risks to unreliable accounts and notes.

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If the draft standard is intended to scale for smaller companies one can question why this revision retained a standard that requires management produce draft financial statements with zero material defects or face having to report they have ineffective controls over financial reporting overall. If a key goal is to simplify the requirements one has to question why the draft standard does not simply direct auditors to use the same "how to guidance" management must use to assess and report on ICFR.

PCAOB ON TOP-DOWN

PCAOB Draft Standard:

Page 5 states "When using a top-down approach, the auditor identifies the controls to test by starting at the top – the financial statement and company-level controls – and linking the financial statement elements and company-level controls to significant accounts, relevant assertions, and, finally, to the significant processes where other important controls reside. Following the top-down approach helps the auditor focus the testing on the right controls – those controls that are important to the auditor's conclusion – while avoiding those that are outside of the scope of the audit of internal control. In a top-down approach, if company-level controls are strong and link directly to process-level controls, or if they are sufficiently precise to prevent or detect material misstatements to relevant assertions, the auditor **will likely** be able to reduce the testing of controls at the process level."

IMA Analysis/Comment:

This paragraph is indicative of a fundamental problem in the guidance – it is not, in reality, risk-based or top-down by globally accepted risk management standards. Nowhere in the words above does it say the auditor should start by identifying the high level risks that are already known to be the major causes of major financial statement errors in U.S. listed companies and then, only after that step is done, identify the high level controls in place, if any, to mitigate them. Without first identifying and documenting entity level risks, any attempts to document company level controls will be less focused and efficient than it could be. Key entity level risks include CEO/CFO directed manipulation of earnings, CFO/controller staff not current/knowledgeable on GAAP treatment, a senior management reward system that offers massive incentives to falsify earnings, CFO/controllership knowledge of applicable tax rules, etc.

PCAOB ON RISK-BASED

PCAOB Draft Standard:

Page 7 states "The proposed standard on auditing internal control, therefore, requires risk assessment at each of the decision points in a top-down approach. The auditor's identification of significant accounts and relevant assertions requires an understanding of the related risks and how those risks should affect the auditor's decision making.

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Importantly, the proposed standard makes clear that the evidence necessary to persuade the auditor that a control is effective depends on the risk associated with the control."

IMA Analysis/Comment:

Although this paragraph admirably gives credence to the notion of "risk-based" assessment, it doesn't actually say that the auditor should either evaluate the completeness of the risks identified and documented by management. Nor does it indicate that the auditors themselves **must** identify and document relevant risks together with their assumptions regarding the likelihood and consequence of those risks and then document and test the specific controls in place, if any, to mitigate the risks identified.

PCAOB ON RISK TOLERANCE

PCAOB Draft Standard:

Page 12 states "Sometimes, however, the auditor may find that the company evaluated the significant deficiencies and reasonably determined under the circumstances not to correct them. When that is the case, the proposed standard would allow the auditor to conclude the control environment is effective and that no material weakness exists."

IMA Analysis/Comment:

In smaller public companies this comment begs the question "What if the deficiency is that the accounting staff lack the technical knowledge or skill to properly account for the transaction and management is fully aware of this deficiency and has previously relied on their external auditor to compensate?" An analogy would be a GP doctor that recognizes he or she is not qualified for brain surgery and refers their patient to a specialist. Many small and even large companies identify areas and transactions that they don't feel confident dealing with to their external auditor. The auditors source the necessary expertise to provide direct assistance up to, and including, identifying the necessary accounting entries to handle the transaction properly. If this paragraph is taken literally, what does the auditor do when there are dozens of risk acceptance decisions that have been made and communicated to him/her by management where management knows and candidly acknowledge that their controls in certain defined areas will not prevent a material error in their draft statements?

PCAOB ON ELIMINATING "UNNECESSARY" PROCEDURES

PCAOB Draft Standard:

Page 14 states **"the proposals would eliminate the requirement to evaluate the process management used to evaluate its internal control"**.

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Page 16 states "The Board also believes that the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process." On page 17 it states "The proposal eliminates the opinion on internal control on management's assessment because it is redundant of the opinion internal control itself and because the latter opinion more clearly conveys the same information – specifically, whether the company's internal control is effective."

IMA Analysis/Comment:

The Act states in section 404(b) that "each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer." It is a question of law whether the SEC and/or PCAOB have the legislative authority to eliminate a step called for by the law on the basis it is "an unnecessary procedure". The issue of regulatory authority is outside the scope of this comment paper. What is relevant is that the paragraph on page 15 of the draft standard does not acknowledge that a growing number of practitioners, including those represented by the IMA and IIA (nearly 200,000 members combined) have questioned whether the Act intended that auditors provide an independent and subjective opinion on ICFR.

From a technical standpoint it is difficult to understand how sound and fully defensible decisions on how much to rely on management's ICFR work can be made without doing a reasonably thorough evaluation of whether management's work can and should be trusted. The draft standard recognizes this when it states on page 16 ***"Although the removal of the evaluation requirement should eliminate unnecessary work, the quality of management's process is inherently linked to the amount of work the auditor will need to do. For example, the extent of the auditor's ability to use the work of others will depend on the quality of the company's annual evaluation process and its ongoing monitoring activities, as well as on the competence and objectivity of those performing the work. For this reason, it will continue to be necessary for the auditor and management to coordinate their respective efforts."*** One must assume that the PCAOB has decided "coordinate" is quite different from completing audit work to determine if management's work is reliable and should be relied on. Later in the draft it goes on to emphasize the importance of auditors relying on management's work and calls for steps to be taken to evaluate how much reliance to place. It is fair to say that our conclusion is that the logic in this area should be revisited.

USING THE WORK OF OTHERS

PCAOB Draft Standard:

Page 22 states "the proposed standard would establish a single framework, based on the nature of the subject matter being tested and competence and objectivity of the

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personnel performing the testing, for the auditor's decisions about using the work of others (including, but not limited to, internal auditors) as audit evidence....

The proposed standard on using the work of others first directs the auditor to **obtain an understanding of the work performed by others** to identify the activities relevant to the audit. Relevant activities are defined as those that provide evidence about design and operating effectiveness of control over financial reporting or that provide evidence about potential misstatements of the company's financial statements. .... The proposed standard would require the auditor to obtain an understanding of the work undertaken by others to determine how that work might alter the nature, timing, and extent of the work the auditor otherwise would have performed."

IMA Analysis/Comment:

It would seem that "obtaining an understanding" is quite different from evaluating and auditing management's assessment process but the distinction in this case appears questionable. It would also seem to imply that at no time does the auditor need to test whether the work product produced by management is reliable. Later the standard talks about evaluating objectivity and competence of the individual staff involved in preparing management's assessment but the draft would appear to suggest that this step can be done without actually verifying the reliability of the work produced.

SCALING THE AUDIT FOR SMALLER COMPANIES

PCAOB Draft Standard:

Page 28 states "Under the proposed standard, the auditor can use strong company level controls and **financial statement audit procedures** to reduce the level of testing for smaller companies."

IMA Analysis/Comment:

What we infer from this statement is that the auditor can count their year end audit work done as a control for purposes of ICFR assessment. This runs counter to core premises in SOX and the SEC and PCAOB standards. The current regulations do not allow management to count virtually anything done by the external auditor as an ICFR control and the AICPA recently issued guidance on that point. This statement also sets the stage for situations where, if the financial statement audit procedures are allowed to be counted as a control by the external auditor in their control evaluation, the auditors would be auditing their own work in arriving at an independent opinion on ICFR, counter to core globally accepted auditing principles.

Our experience is that smaller public companies often rely on and utilizes the expertise and knowledge of their external auditors in areas such as tax provisions, foreign exchange, consolidations, application of complex GAAP (e.g., the new rules on tax provisions), drafting of note disclosures and other difficult/complex areas.

Many smaller companies can ill-afford to retain staff or outside consultants capable of dealing with all complex elements of financial statement accounting and note disclosure.

Another problem is that there is currently an absence of generally accepted methodology to consistently and reliably evaluate company level controls. If there was a reliable entity level ICFR approach it should be capable of producing a specific and repeatable grade on company level controls (i.e., different assessors would arrive at the same conclusions independently). The grade on entity level controls should then drive specific reductions in substantive audit testing, analogous to insurance underwriting wherein the controls in place are evaluated and, subject to the result, premiums are accordingly adjusted (e.g. use of smoke detectors, driver education training for young drivers, etc.). No such reliable and repeatable entity level control evaluation system currently exists anywhere in the world that we are aware of.

SIMPLIFYING THE REQUIREMENTS

PCAOB Draft Standard:

Page 30 states "Taken as a whole, the proposals are intended to simplify the requirements and make them easier to apply while retaining the core principles necessary for an effective audit of internal control."

IMA Analysis/Comment:

While simplification is a laudable goal, the standard should be changed such that the PCAOB directs the external auditor to apply the same SEC ICFR assessment guidance management is instructed to use in arriving at their opinion on ICFR. Using this approach it should be possible to reduce the PCAOB auditing standard to 20 pages or less in length. If this was to occur and external auditors then claim that the SEC guidance is not sufficiently clear for them to arrive at an opinion on control effectiveness, how can management be expected to use the SEC ICFR guidance in isolation? Currently many specialists that have studied the December SEC and PCAOB exposure drafts agree that ASX/5 is considerably more detailed and granular than the SEC guidance for management. Given that auditor must use the PCAOB standard to arrive at their pass/fail opinion on ICFR, it is very likely that PCAOB standard will retain its position as the de facto guidance for management.

ASX TABLE OF CONTENTS – CONTROL TESTING DOMINATES; RESIDUAL RISK NOT MENTIONED AT ALL

PCAOB Draft Standard:

Page A1-2 references in the planning section the topic of "Role of Risk Assessment", however, when the steps to be applied in a Top-Down approach are listed the requirement to identify macro level risks to reliable financial disclosures is absent.

Nowhere in the draft standard is the concept of the auditor identifying and assessing residual risk status ever mentioned.

IMA Analysis/Comment:

The new guidance makes no reference to any requirement directing the auditor to identify, using a 3-5 year history, the accounts and notes that have required adjustment prior to audit sign-off to document the history and pattern of prior failures in the company's ICoFR. The draft standard does not emphasize that during the planning stage the auditor should formally analyze and document the company and industry sector's history of restatements and financial statement audit opinion errors. These steps merit being listed as stand alone content topics. When the steps to be taken for a Top-Down approach are articulated, identifying macro level risks is absent as is the requirement that the auditor take steps to identify and assess the residual risk status being produced by the current control design. This would include identifying and assessing "repair entries". Repair entries are accounting entries booked by management after a quarter or year end disclosure related to transactions or balances already publicly disclosed. This includes analysis of such things as comparing the provision for law suits against the actual settlement amounts, provision for taxes against the amounts filed and/or reassessed by tax authorities, provisions for bad debts against actual bad debt experience, etc.

THE AUDITOR'S OBJECTIVE

PCAOB Draft Standard:

Page A1-4 states "The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the company's internal control over financial reporting."

IMA Analysis/Comment:

IMA respectfully believes that the SEC and PCAOB have misinterpreted the true intent of Congress in section 404 (b) of the Sarbanes-Oxley Act of 2002. The Act passed by Congress does not state that external auditors should publicly express an independent, subjective opinion on the company's ICFR. It is also important to note that, at least to the date of this analysis, no other country in the world has accepted the premise that an independent audit opinion on ICFR effectiveness is a practical and viable approach to more reliable auditor certified financial statements.

THE FRAMEWORK AUDITORS SHOULD USE

PCAOB Draft Standard:

Page A1-5 states "The auditor should use the same suitable, recognized framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting."

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IMA Analysis/Comment:

If the intent of this section is to direct the auditor to use the framework used by management, there should be no need for the PCAOB document to describe how auditors should complete their parallel independent ICFR assessment. Since the PCAOB has put considerably more granular detail in the draft audit standard than is currently in the SEC exposure draft, it is almost certain management will use the PCAOB guide as the primary guidance. In terms of the use of frameworks like COSO 1992, CoCo, or Cadbury, the IMA research study on the use of COSO published in 2006 provides conclusive evidence that companies have not actually been using COSO 1992 as a primary framework for SOX ICFR assessments.

PLANNING THE AUDIT

PCAOB Draft Standard:

Page A1-5/6 lists items to be covered including "knowledge of the company's internal control over financial reporting obtained during other engagements."

IMA Analysis/Comment:

This section does not explicitly require the auditor to create and analyze the pattern of mandatory audit adjustments identified during the last 3-4 audits to provide objective information on where ICFR has failed in the past. Nor does it explicitly require that the auditor obtain information on which financial statement line items and/or notes where other companies in the same business sector experienced major problems, up to and including restatements. Another omission is that the draft does not require the auditors to make inquiries and execute procedures to identify "repair entries" – entries that are correcting account balances or impact on note disclosures that have already been issued. Both types of information are relevant to fully understanding residual risk and are now widely available at a modest cost as a result of technology advances (e.g., use of software like ACL, data bases offered by Auditanalytics.com, Compliance Week and other sources).

ROLE OF RISK ASSESSMENT

PCAOB Draft Standard:

Page A1-7 states "the auditor should focus the majority of his or her attention on the areas of greatest risk to substantially decrease the opportunity for a material weakness to go undetected".

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IMA Analysis/Comment:

Using a risk based approach derived from globally recognized risk management standards this statement should read "the auditor should focus the majority of his or her attention on the biggest risks that threaten the objective of materially reliable auditor certified financial statements".

By far the biggest single risk that caused SOX to be enacted is that senior management's reward system provided massive incentives to distort short-term profits. Although there is no reliable statistical data in this area, a reasonable guess on the second biggest risk is that key accounting personnel lack the necessary skills to produce draft financial statements with zero material deficiencies without external assistance. A third major risk would be that the audit team assigned to complete the audit is not competent and/or objective. A more granular risk than #1 would relate to management initiated frauds related to stock options. A list of the top ten risks that have caused major errors in financial statements could be assembled fairly quickly from what has occurred in the past. Although a list of only the top ten risks wouldn't be enough for a comprehensive ICFR assessment exercise it would focus attention and resources on the really major risks at a fraction of the current costs.

SCALING THE AUDIT FOR SMALLER COMPANIES

PCAOB Draft Standard:

Page A1-8 states " the auditor should recognize that a smaller and less-complex company often achieves many of its control objectives through the daily interaction of senior management with company personnel rather than through formal policies and procedures."

IMA Analysis/Comment:

This may be a statement that recognizes the need for different approaches for SPCs but it doesn't really help an auditor to sign an opinion indicating that, in his or her professional opinion, ICFR control is effective. Our interpretation is that the auditor is staking his or her reputation and that of their firm that there is less than remote chance that management will produce draft financial statements with zero material defects. The reality is that smaller public companies often are less standardized in terms of business processes, contracting, and accounting policy and have a number of other attributes that can make assessing ICFR very difficult.

USING A TOP-DOWN APPROACH

PCAOB Draft Standard:

Page A1-11 states "A top-down approach begins at the financial statement level and company-level controls, and then works down to significant accounts and disclosures, relevant assertions and significant processes."

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IMA Analysis/Comment: A true top-down approach should begin with formal identification and documentation of the major risks to the overarching objective of issuing materially reliable auditor certified financial statements.

IDENTIFYING COMPANY-LEVEL CONTROLS

PCAOB Draft Standard:

Page A1-11 states "The auditor must test those company-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting."

IMA Analysis/Comment:

We applaud the PCAOB's efforts to improve the guidance in this area relative to AS2. The emphasis, however, appears to be on creating and testing a checklist of "company-level" controls. This may result in relatively junior audit firm staff equipped with standard questionnaires making inquiries about the company's strategic planning process, budget review process, code of conduct, audit committee performance, etc. Even a fully accredited CPA at the manager level is still relatively inexperienced in terms of assessing the effectiveness of a company's audit committee to detect management malfeasance, the impact the company's performance measurement/reward structure has on financial statement fraud vulnerability, and the company's risk assessment process. The current CPA examination body of knowledge has very little coverage of core risk management principles and global standards or focus on assessing ICFR using risk-based methods. The standard external audit does not generally include much involvement of the audit partner, the most experienced member of the audit team, in the actual field work. Without assessing likelihood and consequence of specific risks and then asking what company-level controls exist to mitigate it, evaluating company level controls lacks focus and can result in inaccurate conclusions on effectiveness.

IDENTIFYING SIGNIFICANT ACCOUNTS

PCAOB Draft Standard:

Page A1-14 states "the auditor should start by considering financial statement line items or captions. When identifying significant accounts, the auditor should evaluate both qualitative and quantitative **risk factors**."

IMA Analysis/Comment:

To be consistent with the intent of this statement, IMA believes that the auditor should identify and document the most significant risks to reliable disclosure (note: the level of risk significance is determined from specific combinations of likelihood and consequence) that threaten the reliability of accounts and notes to the financial statements.

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Identifying "risk factors" is not the same as explicitly writing down significant risks and then considering the ability of one or more controls to mitigate the risk. For a risk-based approach to "resonate" with practitioners (SEC/PCAOB approaches), the use of standard risk management principles and generally accepted ISO risk terminology in the proposals is necessary.

Not employing "generally accepted risk principles" may be because so many accelerated filers have already completed their SOX ICFR assessments in the first 3 rounds without much emphasis on formal risk identification, documentation and measurement. There is no indication in SEC or PCAOB guidance that a company using a risk framework like AS/NZ 4360 or COSO ERM would be considered by the SEC or PCAOB to be using a "suitable" framework to assess the reliability of their ICFR system.

The risk identification and measurement step at the entity, subsidiary and account/note levels is a component that should be mandatory, not discretionary, in a true risk-based approach.

IDENTIFYING RELEVANT ASSERTIONS

PCAOB Draft Standard:

Page A1-15 states "For each significant account, the auditor should determine which of these financial statement assertions is a relevant assertion. – Existence or occurrence, Completeness, Valuation or allocation, Rights and obligations, Presentation and disclosure". It later states "The auditor should determine the likely sources of potential misstatements by asking himself or herself "what could go wrong"? within a given account."

IMA Analysis/Comment:

The word "assertion" is a traditional accounting term in use for many decades that has no meaning or relevance in the world of risk management. Even experienced auditors, when confronted with a note disclosure like the stock option disclosure, struggle trying to decide which "assertions" are the key ones. The emphasis on "assertion" identification results in the methodology used to assess ICFR being only relevant to accounting. Because the methodology can only be used to assess accounting reliability, companies cannot use the substantial investment they are making to implement SOX as a sound foundation for broader ERM efforts in other relevant areas that require formal assurance (e.g., safety, product quality, customer service, disaster preparedness, etc.).

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IDENTIFYING MAJOR CLASSES OF TRANSACTIONS AND SIGNIFICANT PROCESSES

PCAOB Draft Standard:

Page A1-16 states "The controls over major classes of transactions exist within the company's significant processes. Accordingly the auditor should identify the significant processes affecting the major classes of transactions." It goes on to state that the auditor should "Identify the points within the process at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material; Identify the controls that management has implemented to address these potential misstatements….".

IMA Analysis/Comment:

At no point in the bullets that follow this statement does the draft standard explicitly state that the auditor should identify the controls in the processes that mitigate the risks they have identified. The use of the word risk in the guidance is missing.

PERFORMING WALKTHROUGHS

PCAOB Draft Standard:

Page A1-18 states "At the points at which important processing procedures occur, the auditor should question the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions are essential to the auditor's ability to gain a sufficient understanding of the process and be able to identify important points at which a necessary control is missing or not designed effectively."

IMA Analysis/Comment:

This is another illustration where the authors have not explicitly stated that during the walkthrough the auditor should have a list of the key risks clearly in mind that must be mitigated and focus on identifying where in the process or elsewhere those risks are mitigated, if at all. It isn't clear how an auditor can effectively focus only on key controls in the absence of specifically and visibly measuring risks and making the risk/control linkage.

SELECTING CONTROLS TO TEST

PCAOB Draft Standard:

Page A1-18 states "The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the addressed risk of misstatement to each relevant assertion."

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IMA Analysis/Comment:

This is a good example of the impact on terminology by requiring the use of the term "assertion". Another way of stating this in a risk based approach is to simply state "The auditor should test the dominant controls that play an important role mitigating the significant risks to the account or note disclosure being evaluated".

PCAOB Draft Standard

Page A1-19 states "The auditor should focus on whether the selected controls, individually or in combination, sufficiently address the assessed risk of misstatement of a given relevant assertion rather than on how the control is labeled….".

The auditor should link the controls selected to test with the relevant assertions to which they relate."

IMA Analysis/Comment:

To properly assess the effectiveness of the controls in use using a risk management approach one must look at the "RESIDUAL RISK STATUS" that is being produced. A key element of this step is examining the current PERFORMANCE INDICATORS including detected account/note error rate. The standard makes no mention of residual risk identification or analysis as an explicit required step. These are central principles in all globally recognized risk management standards and the Basel II rules related to management of operational risk in banks around the world.

Attachment 1 to this comment letter provides IMA's risk-based framework, with more details contained in the 9/15/06 filing to the SEC.

TESTING DESIGN EFFECTIVENESS

PCAOB Draft Standard:

Page A1-20 states "The auditor should test the control design effectiveness of controls by determining whether the company's controls, if operating properly, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements."

IMA Analysis/Comment:

This guidance introduces the term "control objective" which sometimes means mitigating a relevant risk but sometimes means an objective to execute a control. The term "control objective" like the term "account assertion" is part of traditional accounting vernacular in use for many decades that has resulted in generally poor predictive results when assessing the true effectiveness of control design.

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This paragraph could read "The auditor should assess control design effectiveness by determining whether, in his or her opinion, the controls in place/use are likely to mitigate the risks that could result in a material error in the accounts to a level that precludes even a reasonable chance of a single material error".

RELATIONSHIP OF RISK TO THE EVIDENCE OBTAINED

PCAOB Draft Standard:

Page A1-21 states "For each control selected for testing, the auditor should assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result."

IMA Analysis/Comment:

In globally accepted risk management terms this statement would read something like: "The auditor must first determine whether the control(s) as described/understood is/are capable of mitigating the significant risks identified. Having completed that step, the auditor must test to verify that the control(s) is/are, in fact, being performed as described/understood. The auditor must then evaluate the residual risk status, or the degree the relevant risks are in fact being mitigated and form a conclusion whether the resulting residual risk position could allow a reasonable possibility of even a single undetected material account/note misstatement in draft financial statements."

STRONG INDICATORS OF A MATERIAL WEAKNESS

PCAOB Draft Standard:

Page A1-29/30 states: "The auditor should treat each of the following circumstances as a strong indicator that a material weakness in internal control over financial reporting exists – An ineffective control environment......
-Restatement of previously issued financial statements to reflect the correction of a misstatement...
- Identification of the auditor of a material misstatement in the financial statements in the current period in circumstances that indicate the misstatement would not have been detected by the company's internal control over financial reporting.
- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

IMA Analysis/Comment:

The IMA research study completed in 2006 indicates that the ability of auditors to assess and assign pass/fail grades to a company's control environment is not at a level capable of producing repeatable conclusions. The absence of agreed pass/fail criteria at a level of detail capable of producing repeatable conclusions is the key reason.

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The large number of restatements and companies under investigation for stock option accounting errors supports this conclusion. Further research should be done to determine how many of these companies that have to restate their accounts had received a passing grade on their "control environment" from their external auditors under AS2 rules.

This is the section of the standard that indicates that if the auditor's examination of the accounts and note disclosures reveals even a single material error (NOTE: this could be defined as an error big enough the auditor will not sign-off on the accounts unless management makes the adjustment) they must, with few exceptions, indicate that the company has "ineffective control" in their SEC filing. This zero material defect standard is a level of quality that is more stringent than that applied in any other country in the world and is well beyond the level currently being delivered by literally thousands of U.S. listed non-accelerated filers.

The goal of zero material defects is laudable but may not be practical, especially in smaller public companies. The zero material defect rule in financial statement drafts and throughout the ICFR process is likely at the root of why smaller companies have sought and will continue to seek listings on exchanges in Canada, London and elsewhere. Both exchanges are considered to have generally good corporate governance requirements but neither has a standard that indicates a single material error in draft financial statements require management and/or auditors publicly indicate the company has an ineffective control system.

REPORTING ON INTERNAL CONTROL

PCAOB Draft Standard:

Page A1-36/37 calls for "The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria …"

IMA Analysis/Comment:

This is at the heart of the debate whether Congress asked for an opinion on management's assessment or whether the auditor, personally, believes that ICFR is "effective". Reduced to the lowest common denominator, the auditor, under the current draft standards, is putting his or her name on the line, stating that they believe that the current controls will not allow even a single material error in the draft financial statements prepared by management. We believe that a significant percentage of U.S. non-accelerated companies that have not yet reported under Section 404 would fail this test. A large percentage of these companies are currently stating under section 302 rules that they have effective "disclosure controls". It is also virtually certain that if the zero material defect in the draft financial statements standard was applied rigorously in Canada, the UK and Europe, thousands of companies would be forced to publicly report they have ineffective internal control systems.

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Whether a zero material defects in the financial statement drafts prepared by management is too stringent a quality standard should be carefully researched, including empirical evidence as to whether investors are better protected.

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February 26, 2007

Mr. Christopher Cox
Chairman
Securities and Exchange Commission

Mr. Mark W. Olson
Chairman
Public Company Accounting Oversight Board

RE: IMA SECOND SUBMISSION SEC FILE No. S7-24-06 and PCAOB Rulemaking Docket No. 21 (Focus on Risk-Based)

EXECUTIVE SUMMARY

The Institute of Management Accountants (IMA) has carefully reviewed the current SOX proposals put forth by the SEC and PCAOB in December, 2006 and we respectfully believe that they constitute a material weakness for investors, businesses and U.S. global competitiveness**.** As used in the proposals, the term "risk-based" is not consistent or in accordance with generally accepted global risk management principles. IMA bases its conclusions on 2 years of practical research, an exposure process with its 65,000 members, a review of comment letters already filed by organizations representing large investor and business communities, and testimony at the February 22, 2007 PCAOB Standing Advisory Group (SAG). The IMA is very concerned that the SEC and PCAOB are not taking advantage of global risk management approaches and are not complying with the ISO standards for national regulators. This is not an academic concern – misuse or lack of use of market-tested risk management approaches will perpetuate materially incorrect financial statements, high costs, increased profits and potentially crippling litigation risk for the audit firms, and continued reluctance of high growth smaller companies to participate in U.S. capital markets.

It is possible to correct this situation if the SEC and PCAOB are willing to consider and incorporate true risk-based disciplines and frameworks put forth by IMA, COSO, ISO and other globally recognized organizations with significant investor and business constituencies. With respect, the PCAOB proposed standard is still fundamentally audit and control-centric (relying on decades old audit perspectives) and perpetuates the power imbalance for auditors. The SEC proposed guidance is not risk-based by any existing global risk management standard and is too ambiguous to be practical for assessment purposes, especially for smaller public companies.

BACKGROUND/TECHNICAL COMMENTARY

IMA filed its primary comment letter with the SEC and PCAOB on February 13, 2007. On February 20, IMA senior staff met with nine SEC and PCAOB staff who participated in the drafting of the exposure drafts to answer questions on our comment letter. On February 22 we listened carefully to the PCAOB Standing Advisory Group Meeting in Washington via webcast.

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INSTITUTE OF MANAGEMENT ACCOUNTANTS
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Upon reflecting on the research we have completed, research done by Glass, Lewis & Co, the meeting with your staff last week, and comments made during the PCAOB SAG webcast, it has become very clear to us that the use of the term "risk-based" is a major problem. This is a problem that will, if not addressed, lead to continuation of massive unnecessary SOX compliance costs, resistance to the adoption of section 404(b) from non-accelerated filers, continued inability to properly address senior executive directed fraud, erosion of U.S. competitiveness, and continuation of an unacceptably high incidence of audit opinion failure.

IMA's February 13, 2007 comment letter on the exposure drafts takes the position that the term "risk-based" should be interpreted in the context of globally understood risk management terminology and use. In the current regulations and the exposure drafts the meaning attributed to "risk-based" is not consistent with what the risk management community considers to be "risk-based". The meaning and application of the term risk-based is, in the words of a number of the speakers at the PCAOB SAG meeting, "the same thing we've had for the last two decades" – the same audit approaches that have failed in an alarmingly high number of instances over the past two decades.

Lynn Turner, Managing Director of Research, Glass Lewis and former SEC Chief Accountant indicated at the PCAOB SAG meeting that the current interpretation of "risk-based auditing" is one that it is written "by auditors, for auditors". His conclusion appeared to be that the current interpretation in the SOX regulations of "risk-based" is pretty much "the same thing we've had for the last two decades". Mr. Turner's summary conclusion on the current PCAOB interpretation of "risk-based" is that it represented "a gaping hole in this particular document" (PCAOB ASX/5).

The ISO Guide 73: *Risk Management - Vocabulary – Guidelines For Use In Standards* is specifically intended to be used by regulators when creating standards that relate to risk management.

> *The Guide provides standards writers with generic definitions of risk management terms. It is intended as a top-level generic document in the preparation or revision of standards that include aspects of risk management.*

The aim of this Guide is to promote a coherent approach to the description of risk management activities and the use of risk management terminology. Its purpose is to contribute towards mutual understanding amongst the members of ISO and IEC rather than provide guidance on risk management practice.

The term "risk-based", as interpreted over the past 30 years by external auditors and audit standard setters, has focused on audit risk and techniques to minimize the chance of providing a wrong audit opinion. The emphasis is on subjectively identifying "risky" locations, processes and accounts. With respect, we don't believe that this brand of "risk-based" auditing methods has been effective at a level consistent with stakeholder expectations, particularly in the area of fraud prevention and detection.

A number of participants in the PCAOB SAG meeting last week remarked on the generally negative perception of the term "risk-based" created by some auditors, auditors that interpreted in the late '80s and '90s the term to be a ticket to reducing audit work and permitting the acceptance of the premise that all senior management teams are honest and well-intending.

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The audit community lexicon for the term "risk-based" and, most importantly, the interpretation in the current SEC and PCAOB exposure drafts, does not require that management or auditors explicitly identify and measure known risks that threaten the reliability of the financial statements.

Specific examples of fraud-related risk that should be explicitly identified and assessed include:

1. CEOs and CFOs have significant financial incentives to falsify and/or inappropriately manage financial results.
2. Management has major financial incentives to direct backdating of stock options.
3. Senior management directs improper/fraudulent post-close journal entries to manage profits.
4. Management override of controls.
5. Audit Committees have financial incentives not to ask the tough questions.

The list can easily be extended using examples from thousands of recorded instances where auditors were misled by unethical and fraudulent senior management. A true risk-based analysis of ICFR would be expected to specifically identify the controls in place to mitigate these types of risks, as well as the more benign simple error type risks and assess their likely effectiveness. The emphasis to date, and a large percentage of the costs, has been on the benign risks - not on the truly dangerous risks that led to the enactment of SOX and erosion of investor confidence.. Separate and expensive forensic fraud audits of every public company are not necessary. Correct interpretation of the term “risk-based” and application of true “risk-based” assessments using tried and tested risk management methods by both management and auditors is necessary.

The evidence IMA has gathered during its research indicates that very few registrants, and even fewer auditors, are explicitly identifying, documenting and directly assessing the controls in place to mitigate the type of very predictable fraud-related risks listed above. The regulations also do not require that management and auditors explicitly identify and monitor the acceptability of what is known in globally accepted risk management vernacular as "residual risk", the risk remaining after risk treatment. In the context of ICFR, this is the error rate detected by management and external auditors in all accounting and disclosure processes that feed public financial disclosures.

Measurement of error rate is a key component of any good risk management system, a cornerstone of the global quality movement, and widely associated with the well known expression “WHAT GETS MEASURED GETS DONE”. In the quality profession, whether you apply the principles of the ISO 9000 system, the U.S. Malcolm Baldrige quality system, the core principles of Six Sigma, or the core operational requirements of the Basel II reforms in banking, not tracking and analyzing detected errors would be tantamount to a material weakness in a quality system.

IMA research confirms that a significant percentage of accelerated filers during the first two SOX reporting cycles did not identify and evaluate specific risks that threaten the financial statements at the entity level, and, perhaps most importantly, did not identify fraud specific risks. These research findings are contained in the IMA 2006 research study *Internal Control: COSO 1992 Control Framework and Management Reporting on Internal Control: Survey and Analysis of Implementation Practices*.

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THE PATH FORWARD

IMA strongly believes that a more "investor friendly" approach relative to current proposals is for the SEC and PCAOB to seriously address what Lynn Turner termed a "gaping hole" in the current exposure drafts. Proper understanding and application of market-tested global risk approaches will better protect investors and give businesses of all sizes the flexibility and accountability to grow investor wealth.

IMA, as a not-for-profit organization devoted to providing professional development and the CMA certification to the global management accounting community, will continue to provide a solutions-orientation to assist the SEC, PCAOB and other bodies in improving SOX compliance. We have provided the following resources to the SEC, PCAOB, U.S. Chamber of Commerce, the Small Business Administration, COSO, corporations, and other organizations which are also available at no charge on the IMA website www.imanet.org: 9/15/06 IMA Comment Letter to the SEC which describes in detail a risk-based framework and other solutions; 1/17/07 SMA (Statement on Management Accounting) which describes the fundamentals, global frameworks and principles underlying Enterprise Risk Management; and, the 2/13/07 IMA Comment Letter to the SEC and PCAOB which describes our "five point plan" to improve SOX compliance for investors and businesses of all sizes.

Sincerely,

Paul A. Sharman

Paul Sharman
President & CEO

Jeffrey C. Thomson

Jeffrey Thomson
Vice President of Research

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February 22, 2007

Via Email: comments@pcaobus.org
Via U.S. Postal Service

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

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

Teamster-Affiliated Pension and Benefit funds hold roughly $100 billion in equity assets representing the retirement security of roughly 1.4 million active and 600,000 retired members of the International Brotherhood of Teamsters (IBT). On their behalf, I am pleased to comment in regard to the Public Company Accounting Oversight Board (PCAOB) proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Other Related Proposals* ("Proposal").

As investors, we expect the Securities and Exchange Commission to uphold the rights of investors and facilitate increased corporate accountability. In our view, Section 404 of the Sarbanes-Oxley Act of 2002 ("Section 404") has been a critical component of restoring investor confidence and the overall integrity of our capital markets in the wake of the Enron and WorldCom scandals. Although effective internal controls have long been required of public companies under the Foreign Corrupt Practices Act of 1977, Section 404 has reinforced this basis for high-quality financial reports. We believe that public companies of all sizes must have appropriate controls in place and that management should be responsible for assessing those controls with a thorough review by external auditors.

Glass Lewis & Company, a leading research and professional services firm that assists institutions with investment, financial or reputational exposure to public companies, has found that the scrutiny of internal controls under Section 404, "is what uncovered the weaknesses at the heart of the current rash of financial misstatements."[1] Indeed, Glass Lewis research analysts warn that, "The smallest companies are where strong internals control arguably are needed most, because they are where the risk of restatement is highest."[2] David Reilly, of the Wall Street Journal, has also reported that the number of restatements by public companies, that have not adopted Section 404 yet, increased by 42 percent in 2006.[3]

Teamster members and retirees, through their benefit funds and individual accounts, have significant equity holdings in the Russell 3000 stock index. Consequently, management's review and report on internal controls of financial reporting at smaller public companies, which currently lack oversight, is as important to our members as the checks and balances already provided by Section 404 at larger public companies.

We, therefore, support the prompt adoption and implementation of the Proposal, which, we respectfully request, will:

1. Explicitly require a rigorous audit process, as a final rule. We would also respectfully request that the final rule clarify that the auditor should evaluate the size and complexity of their company when determining whether a company is a "smaller public company" in implementing the interpretive guidance;

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[1] Glass Lewis & Co., *Getting It Wrong the First Time: A look at 2005's record-breaking year for corporate restatements shows why investors can't afford a return to pre-Enron securities regulation*, March 2, 2006.
[2] Ibid
[3] David Reilly, Restatements Still Bedevil Firms, Wall Street Journal, February 12, 2007, p. C7.

2. Include a framework, under "Considering and Using the Work of Others in an Audit," for evaluating the persons performing the work that is no less restrictive than that currently contained in the Proposal;
3. Not include any form of rotational testing of sections of internal control that would allow auditors to assume that a company's controls are functioning each year without testing them under "Special Considerations for Subsequent Years' Audits"; and,
4. Not establish a rules-based numerical formula, such as five percent of net income, for assessing materiality in the audit of internal control, under "Materiality".

We greatly appreciate the PCAOB efforts in developing a thoughtful proposed standard that is responsive to our members' investment needs. If we can be of further assistance, please do not hesitate to contact Noa Oren, Projects Manager, Teamsters Capital Strategies Department, at (202) 624-8990 or noren@teamster.org.

Thank you for the opportunity to present our views on this important matter.

Sincerely,

James P. Hoffa

James P. Hoffa
General President

JPH/no

INVESTMENT COMPANY INSTITUTE

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202/326-5800 www.ici.org

February 26, 2007

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

Re: Audits of Internal Control Over Financial Reporting;
PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

The Investment Company Institute[1] appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements.*[2] As investors in securities, funds have a significant interest in ensuring the integrity of corporate financial reporting on which their investment decisions are based. Accordingly, the Institute supports the Proposal in that it seeks to retain the benefits associated with audits of internal control over financial reporting while reducing the related costs. We urge the PCAOB to state more strongly that restatement of previously issued financial statements does not necessarily constitute a material weakness in internal control over financial reporting. Finally, we seek clarification on that portion of the Proposal that delineates the circumstances that should be regarded as a strong indicator of a material weakness in internal control over financial reporting.

Retain Benefits While Reducing Costs

Strong internal control over financial reporting has long been recognized to be important to the reliability of financial reporting. Companies have been required to have such controls since the passage of the Foreign Corrupt Practices Act in 1977. The requirement for issuers to assess and auditors to report on internal controls was mandated by Section 404 of the Sarbanes-Oxley Act of 2002. In June of 2003, the Securities and Exchange Commission implemented Section 404 by adopting rules requiring issuers to include in their annual reports an assessment

[1] The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter.

[2] PCAOB Release No. 2006-007 (December 19, 2006) (the "Proposal").

of the company's internal control over financial reporting as well as an auditor's report on that assessment. Soon thereafter, the PCAOB adopted Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS No. 2").

Various commenters have recognized the benefits associated with audits of internal control over financial reporting. These benefits include, for example, improved governance, enhanced transparency, and higher quality financial reporting.[3] Others have indicated that enhancements to internal control over financial reporting could drive gains in corporate productivity and profits.[4] Other commenters, however, have noted that the mandated audits of internal control over financial reporting have required greater effort and resulted in higher costs than originally anticipated. Often, these commenters indicate that internal control audits require allocation of significant resources to transaction level testing and the identification of errors, as opposed to the identification and prevention of the kinds of financial fraud and manipulation of accounting rules that led to the adoption of the Sarbanes-Oxley Act.[5]

The Proposal is intended to maintain the benefits associated with an audit of internal control over financial reporting while reducing associated costs. In particular, the Proposal would: focus the audit on the matters most important to internal control; eliminate unnecessary procedures; scale the audit for smaller companies; and simplify requirements by reducing detail and specificity. Recognizing that shareholders ultimately bear costs associated with audits of internal control over financial reporting, we strongly support the PCAOB's efforts to improve the efficiency of internal control audits without sacrificing their effectiveness. Further, we urge the PCAOB to monitor implementation of the Proposal to ensure that the anticipated reduction in unnecessary effort and cost is realized.

Restatement of Previously Issued Financial Statements as Indicator of Material Weakness

AS No. 2 describes circumstances that should be regarded as at least significant deficiencies and as strong indicators of a material weakness in internal control.[6] AS No. 2 identifies restatement of previously issued financial statements for the purpose of correcting a misstatement as one such circumstance. AS No. 2 provides that identification of one of the strong indicators should bias the auditor toward a conclusion that a material weakness exists but does not require the auditor to reach that conclusion. Instead, the auditor may determine that these circumstances do not rise to the level of a material weakness and that only a significant deficiency exists.

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[3] *See* comments of Michael J. McConnell, Managing Director, Shamrock Capital Advisors at Roundtable Discussion on Second-Year Experiences with Internal Control Reporting and Auditing Provisions (May 10, 2006).

[4] *See* Duncan W. Richardson, Chief Equity Investment Officer, Eaton Vance Management, *Businessweek* (January 29, 2007).

[5] *See* comments of William E. Keitel, Executive Vice President and Chief Financial Officer, QUALCOMM Incorporated; Comments on Second-Year Experiences with Implementation of Sarbanes-Oxley Internal Control Reporting and Auditing Provisions (April 27, 2006).

[6] *See* AS No. 2, paragraph 140.

Paragraph 140 contains an explanatory note regarding restatements that indicates: "The correction of a misstatement includes misstatements due to error or fraud; it does not include restatements to reflect a change in accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle."[7]

Significant Deficiency

The Proposal notes that, in practice, auditors have encountered circumstances that are strong indicators of a material weakness under AS No. 2, where there is, in fact, no significant deficiency. To ensure that the auditing standard does not force the auditor to conclude that a deficiency exists when one does not, and to reaffirm the degree of judgment involved in making these determinations, the Proposal would eliminate the requirement to conclude that the presence of one of the strong indicators is necessarily a significant deficiency. The Institute supports the proposed change. We believe it will enable auditors to exercise their professional judgment based on the particular facts and circumstances and result in more faithful characterizations of the control system.

Material Weakness

We urge the Board to more strongly state that the presence of one of the strong indicators included in paragraph 79 of the Proposal does not necessarily require the auditor to reach a conclusion that a material weakness exists. We are concerned that, in practice, any restatement of previously issued financial statements is deemed to be a material weakness, notwithstanding extenuating circumstances that should enable the auditor to conclude no material weakness exists. For example, certain restatements may be attributable to the complexity of generally accepted accounting principles, rather than poor controls. Accounting standards that are difficult for issuers and auditors to apply can give rise to differences in interpretation that are not necessarily indicative of control failures.

We note that SEC staff statements have indicated that neither Section 404 nor the Commission's implementing rules require that a material weakness in internal control over financial reporting must be found to exist in every case of restatement resulting from an error. Rather, both management and the external auditor should use their judgment in assessing the reasons why a restatement was necessary and whether the need for restatement resulted from a material weakness in controls. Such an evaluation should be based on all the facts and circumstances, including the probability of occurrence in light of the assessed effectiveness of the company's internal control, keeping in mind that internal control over financial reporting is defined as operating at the level of "reasonable assurance."[8]

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[7] Errors in financial statements result from mathematical mistakes, mistakes in the application of generally accepted accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. *See* FAS 154, paragraph 2.h.

[8] *See* Securities and Exchange Commission Staff Statement on Management's Report on Internal Control Over Financial Reporting (May 16, 2005). *See also* S.E.C. v. World-Wide Coin Investments, Ltd., 567 F.Supp. 724, 751 (D.C.Ga.,1983) ("The definition of accounting controls does comprehend reasonable, but not absolute, assurances that the objectives expressed in it will be accomplished by the system. The concept of "reasonable assurances"

Restatement of Previously Issued Financial Statements

The Proposal carries forward the explanatory note contained in Paragraph 140 of AS No. 2 indicating that correction of a misstatement includes misstatements due to error or fraud and excludes restatements due to retrospective application of a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another.[9] We seek clarification that restatement of previously issued financial statements in the circumstance described below would not be deemed a material weakness and would be treated the same as a restatement due to retrospective application of a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another under paragraph 79 of the Proposal.

Where an issuer is required to restate previously issued financial statements as a result of a change in the application of an accounting principle, the issuer should not be deemed to have a material weakness in internal control, *so long as*: i) the issuer's controls over the selection and application of accounting policies in the period to be restated provided reasonable assurance[10] regarding the reliability of its financial reporting; and ii) the auditor opined that the prior period's financial statements were prepared in conformity with generally accepted accounting principles. In other words, provided the issuer had reasonable controls over the application of accounting policies, and the auditor agreed with the issuer's application of the accounting principle, the need to restate previously issued financial statements would be excluded from those circumstances that are strong indicators of a material weakness in internal control over financial reporting. A change in the application of an accounting principle necessitating restatement could result, for example, from a new or evolving interpretation of an accounting standard, particularly where the accounting standard is unusually complex and difficult for issuers and auditors to apply.

* * * * *

The Institute appreciates the opportunity to comment on the Proposal. If you have any questions about our comments or would like any additional information, please contact me at 202/326-5845 or Greg Smith at 202/326-5851.

Sincerely,

/s/

Donald J. Boteler
Vice President – Operations

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contained in section 13(b)(2)(B) recognizes that the costs of internal controls should not exceed the benefits expected to be derived.").

9 *See* the Proposal, paragraph 79.

10 Exchange Act Section 13(b)(7) defines reasonable assurance and reasonable detail as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."

cc: Andrew J. Donohue, Director
Division of Investment Management
U.S. Securities and Exchange Commission

About the Investment Company Institute

The Investment Company Institute's membership includes 8,795 open-end investment companies (mutual funds), 658 closed-end investment companies, 325 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $10.279 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.

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26 February 2007

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

Via e-mail to comments@pcaobus.org

RE: Rulemaking Docket Matter No. 021

Dear PCAOB Board Members:

We very much appreciate the opportunity to provide comments and recommendations to the Public Company Accounting Oversight Board (PCAOB) for the proposed Auditing Standard—An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements—**PCAOB Release No. 2006-007, December 19, 2006; Docket Matter No. 021**.

These comments and recommendations are offered on behalf of both ISACA and the IT Governance Institute (ITGI), international, independent thought leaders on IT governance, control, security and assurance. A brief description of the organizations is provided at the end of this letter.

General Comment

ISACA is responding to the PCAOB questions principally from an information technology (IT) perspective. COSO and similar overall control frameworks provide very limited guidance regarding IT risks and controls. Meanwhile, the role and impact of information technology on risks and controls related to financial reporting has grown in importance since COSO was developed. Further, there is very limited guidance regarding the application of a risk-based, top-down approach in environments where IT is important. Accordingly, we believe that significant additional emphasis on such matters related to IT should be included in the PCAOB standard for it to be even more useful.

Responses to Primary PCAOB Questions of Interest

Based on our review of the proposed PCAOB guidance, and the core focus of ISACA and ITGI, PCAOB questions 1 to 6, 13 and14 are the primary focus of our comments:

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

   We believe that the description of the top-down approach as it relates to IT application and IT general controls could be enhanced. This need could be met by providing more detailed guidance, particularly for IT general controls.

   We suggest adding descriptive material regarding IT risks and controls under a new separate heading titled "Effects of Information Technology on Internal Control over Financial Reporting." This section could be placed after paragraph 8. Content from AU 319.16 - .20 should be included in this section and modified to illustrate how the top-down approach would apply to IT.

   A brief case study describing the interaction of manual controls and IT controls using a top-down approach and how it could impact the overall evaluation of internal control would be useful.

   References to helpful external material also would be beneficial (such references would be suggestive only and would not imply any endorsement of the material by the PCAOB). One such reference could be ITGI's *IT Control Objectives for Sarbanes-Oxley*, particularly the IT compliance road map (pages 27 to 45) and IT general controls (appendix C – pages 57 to 81).[1]

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

   We believe that some examples of IT controls designed to prevent and detect fraud should be included. These might include the following:
   - A user has access to programmed functions that are incompatible with the user's duties and responsibilities and could then process transactions that result in potential misstatement to financial statements (such as an unrecorded funds transfer or misappropriation). This risk can be reduced by the proper implementation of controls over access to such programmed functions and related data (i.e., access to programs and data).
   - A programmer in a telecommunications company makes an unauthorized change to a computer program that causes revenues to be miscalculated and materially misstated. This risk can be mitigated by using security controls to restrict access to programs and ensuring that all program changes are reviewed and tested.

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

   We believe that a top-down approach will better focus the auditor's attention on the most important controls. A top-down approach will provide a better understanding of how an assessment of company-level controls could decrease risk and reduce the nature and extent of testing of controls at the control activity level. A bottom-up approach generally identifies a larger number of key controls and results in more detailed testing than a top-down approach. For example, a top-down approach may identify key controls that do not rely on IT. In this situation, IT general controls may not need to be tested. If key

[1] *IT Control Objectives for Sarbanes-Oxley* is openly available to the general public from the ISACA and ITGI web sites, *www.isaca.org* and *www.itgi.org.* The document, now in its second edition, has been downloaded more than a quarter of million times and referenced globally. The second edition was issued in 2006 after a public exposure process.

application controls are performed by IT or are IT-dependent, consideration can then be given to which IT general controls are important in the circumstances and the level of tests needed for such IT general controls.

Additional IT general control top-down considerations are discussed in the ITGI publication *IT Control Objectives for Sarbanes-Oxley*, particularly the IT compliance road map (pages 27 to 45) and IT general controls (appendix C, pages 57 to 81).

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?*

We believe that a top-down approach, including consideration of company-level controls, will better focus the auditor's attention on the most important controls. We have addressed this issue in question 3 above. However, it would be helpful to discuss the impact that very effective IT general controls would have on the need for testing other controls where the use of IT is very pervasive and such other controls are likely to be dependent on IT. For example, in a centralized IT environment with very effective program change controls, operations controls and access controls, reliance on IT application controls and IT-dependent applications controls across most applications may be possible. Accordingly, testing of IT general controls could significantly reduce the extent of testing of the related application controls across these applications.

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?*

We believe that the description of the risk assessment as it relates to IT application and IT general controls could be enhanced. As noted in our response to question 1, we suggest adding descriptive material regarding IT under a separate heading titled "Effects of Information Technology on Internal Control over Financial Reporting." Consideration could be given to modifying the language from AU 319.19 and AU 319.20 for purposes of this guidance, to focus on how risk assessment would apply to IT and include it in this new section.

We have included "Illustrations of the Extent of Auditor Testing of the Operational Effectiveness of Controls" as an attachment to this letter. This table indicates how the auditor's assessment of risk might relate to the extent of testing of operating effectiveness of controls, including assessments in which no testing or a walkthrough only would be appropriate.

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

Yes, in most cases we would agree that a walkthrough would be sufficient. For example, a walkthrough may be sufficient to assess the computer operations controls supporting a low-risk system with no history of problems. See also the attachment.

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

The auditor can perform an audit of internal controls without performing an "evaluation" of the quality of management's process. However, the auditor will be able to perform a more efficient audit of the internal control system if the auditor has an overall understanding of the process management followed and the results of the management process. The guidance should indicate that the audit may be more efficient by obtaining an understanding of management's process, without necessarily making an evaluation of the process.

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

As noted in question 13 above, the auditor will be able to perform a more efficient audit of the internal control system if the auditor has an overall understanding of the process management followed and the results of the management process.

In addition, the guidance should include discussion addressing how management and the public accounting firm could jointly plan their work to increase the effectiveness and efficiency of the entire process.

Other areas the PCAOB might want to consider expanding for additional clarity include:

- Question 5—The release emphasizes the importance of the risk assessment. It would be useful to provide an example(s) of a risk assessment methodology, including examples of quantitative and qualitative risk factors.

- Questions 9 and 10—The draft states, "…any individual control does not necessarily have to operate without any deviation to be considered effective." (See PCAOB Release, Testing Controls, Relationship of Risk to the Evidence to be Obtained, point #53, p. A1-22.) Guidance would be helpful to assist in the determination of what level of deviation would be acceptable and still evaluate the control as effective.

* * * * *

With more than 50,000 members in more than 140 countries, ISACA is a recognized worldwide leader in IT governance, control, security and assurance. Founded in 1969, ISACA sponsors international conferences, publishes the *Information Systems Control Journal*, develops international information systems auditing and control standards, and administers the CISA designation, earned by more than 50,000 professionals since inception, and the CISM designation, a groundbreaking credential earned by 6,000 professionals in its first three years.

The IT Governance Institute (ITGI) was established by ISACA in 1998 to advance international thinking and standards in directing and controlling an enterprise's information technology. ITGI developed *Control Objectives for Information and related Technology* (COBIT), now in its fourth edition, and offers original research and case studies to assist enterprise leaders and boards of directors in their IT governance responsibilities.

Thank you for this opportunity to relay our comments regarding the PCAOB Guidance**.** Because ISACA and ITGI represent many of the individuals engaged in Sarbanes-Oxley compliance efforts and much of the guidance informing those efforts, we believe we are uniquely positioned to bring value to any future projects to address our recommendations. Please feel free to call on us if we can be of assistance to the PCAOB in any way including task forces, committees, work groups or just for reference purposes.

Respectfully submitted,

Everett C. Johnson, CPA
2006-2007 International President
ISACA (*www.isaca.org*)
IT Governance Institute (*www.itgi.org*)

Attachment

Illustrations of the Extent of Auditor Testing of the Operational Effectiveness of Controls

Consequences of a Control Failure ↑	Low	Medium	High
Possible Material Weakness	Moderate Testing	Moderate to High Testing	High Testing
Possible Significant Deviation	Minimum Testing	Moderate Testing	Moderate to High Testing
No Significant Deviation	No Testing	Minimum Testing	Minimum Testing

Risk of a Control Failure

Definitions[2]

No Testing—No testing or evidence of operating effectiveness is necessary.

Minimum Testing—Ordinarily, this would consist of walkthrough and inquiry, without further testing or evidence of operating effectiveness.

Moderate Testing—Ordinarily, this would consist of obtaining evidence of operating effectiveness in addition to performing a walkthrough and inquiry. Such additional evidence could be obtained by performing monitoring procedures or examining the results of such monitoring procedures, by observing the operation of the control, by reviewing the evidence of the operation of controls (such as follow-up on exception reports), and similar activities. Such activities ordinarily would be performed on a test basis.

High Testing—Ordinarily, these tests would be more extensive than those described under Moderate Testing and would include tests as of period-end dates for controls that operate at that time.

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[2] These definitions apply to the registrant's annual assessment for complying with the provisions of the Sarbanes-Oxley Act of 2002 for financial reporting purposes. They do not apply to the normal, periodic review, assessment and testing of the internal control systems for operational efficiency and for compliance with laws and regulations.

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RECEIVED
JAN 25 2007

January 19, 2007

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

RE: PCAOB Rulemaking Docket Matter No. 21, Release 2006-007

Dear Sir/Madam:

This letter is in response to the above-captioned release and the opportunity to submit comments on the Proposed Auditing Standard: "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements." Specifically I would like to suggest a change to paragraph, 79, under the heading "Strong Indicators of Material Weaknesses."

The last bullet of this paragraph states

"For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective regulatory compliance function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting."

A better formulation would be:

"An ineffective compliance and ethics function, especially in complex entities in highly regulated industries. This relates to those aspects of the ineffective compliance and ethics function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting."

These changes cover several important points. First, the reference to a "regulatory compliance program" uses an outdated term. The Federal Sentencing Guidelines, chapter 8, now define the term as an "ethics and compliance program," and provide a definition that is generally accepted throughout industry. There is nothing to be gained by using an undefined, outdated term in this context.

Second, while it makes sense for the PCAOB to keep to its mission of addressing accounting issues, there is really no basis in logic or experience for limiting the focus to "complex entities in highly regulated industries." While it is certainly true that financial fraud has hit entities meeting this description, such fraud has also shown up in industries without such regulation (e.g., numerous high technology companies, small home appliances – Sunbeam comes immediately to mind), and there can be no doubt that even simple entities can engage in financial fraud. Compliance and ethics programs are key elements in any entity's efforts to prevent fraud.

Third, the use of the word "solely" is overkill. If a compliance and ethics program is ineffective this may show up in many ways. The auditor may not know which of these defects will relate to financial fraud until after the harm has occurred. Better just to ask the auditor to point out where weaknesses occur, without being tied to an unrealistically circumscribed standard.

Thank you for this opportunity to comment and I hope this comment is useful.

Sincerely,

Joseph E. Murphy

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

January 15, 2007

PCAOB Rulemaking Docket Matter No. 021:

The purpose of this memo is to provide response to the 34 questions posed by the PCAOB related to the proposed change in AS 2, as well as to provide general feedback on the pending revisions.

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

   No. It is our belief that the top-down approach is not clearly defined. The proposed standard makes reference to a focus on company-level controls and an overall risk-based approach, indicating that you should "begin with financial statement level and company-level controls, and then work down to significant accounts and disclosures, relevant assertions, and significant processes." However, it is not clear how this top-down approach would be applied in practice. Some public accounting firms may not be comfortable eliminating detailed process level controls based solely on risk and the existence of effective company-level controls. Additionally, it is important to note that this top-down risk-based approach is not new guidance. It was first recommended by the PCAOB in the May 16, 2005 Staff Question and Answer. Since this method was first formally documented in May 2005 there have been no noticeable changes in the public accounting firm's approach to identifying and/or testing key controls. Although this guidance is being reiterated in the proposed standard, it seems that in order to ensure that the top-down risk-based methodology is consistently applied across all public accounting firms, further practical guidance is needed.

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

   Yes. It is our belief that there is an appropriate emphasis on the importance of anti-fraud controls.

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

   If the top-down approach is applied consistently it could help to focus the auditor's attention on controls that are perceived to carry the most risk. However, as mentioned in response #1 above, we have not seen any noticeable change in the auditor's focus since the release of the May 16, 2005 guidance. It is our belief that without further practical guidance the risk-based top-down approach will not be consistently applied across all public accounting firms, and *there will be no noticeable change in the auditor's focus. Refer also to the comments outlined in response #1 above.*

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?
   No. Refer to the comments outlined in response #1 above. Although the standard places a clear emphasis on company-level controls by mentioning that the audit should focus on company-level controls and work down to significant accounts, it is not clear how this approach could be carried out in practice. More specific guidance is needed on when the testing of detailed process level controls can be reduced as a result of effective company-level controls. As it stands now, it appears that company-level controls can provide only indirect assurance and will therefore not be sufficient to provide the external auditor comfort at the transaction level.

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?
   It is clear from the standard that controls with lower risk would require a lower level of evidence to support their operating effectiveness. However, acceptable methods of reducing evidence should be clearly defined. For example, if a control is considered low-risk, does this imply that it can be tested solely through inquiry or observation? Additionally, can the overall sample-size be reduced for low-risk controls? Without clear definitions of "low-risk" and "reduced evidence" the standard will not be applied consistently across public accounting firms.

6. Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?
   Yes. Performing a walkthrough of the control process one time should provide sufficient evidence that low-risk controls are operating effectively. However, it is also important to note that it is our belief that walkthroughs should only be performed over key controls (not over every type of transaction within each key sub-process). Performing a walkthrough of each key control can be carried out in connection with the testing, and would identify any significant changes in controls from prior years as well as any processes that are not working as intended.

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 revised wording of "significant" appears to be better defined and easier to understand. However, more guidance is needed on how to determine what is "significant" in practice. For example, is "significant" defined in both

qualitative and quantitative terms? If so, what quantitative factor must be used? In the past, any deficiency with a potential impact greater than 1% of interim EBT was required to be classified as significant. It is our belief that the updated guidance should allow for more qualitative factors to be considered in assessing the significance of a deficiency.

8. Are auditors appropriately identifying material weaknesses in the absence of a 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?

   Yes. It is our belief that auditors are appropriately measuring material weaknesses based on the potential impact of a deficiency rather than the actual impact.

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?

   No. No changes in guidance were noted that would reduce the level of effort required for evaluating deficiencies. An auditor will still have to post all deficiencies identified, regardless of perceived significance, to the "Summary of Aggregated Deficiencies" and run each deficiency through a framework to formally assess its significance. As such, no reduction in effort is anticipated.

10. Should the standard sallow 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?

    Yes. The presence of a "strong indicator" of a deficiency is not necessarily evidence that a control is not operating effectively. As such, the auditor should be allowed some level of judgment in assessing whether or not a deficiency exists. It is true that incorporating judgment into the process may lead to inconsistency in the evaluation process. However, with uniform guidance for all public accounting firms, the inconsistency should be kept to a minimum.

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

    Yes. Refer to the comments related to the top-down approach outlined in response #1 above. Additionally, note that guidance between external auditors and management needs to be consistent. Specifically, management and the external auditor must use the same approach to selecting key controls and selecting testing methodologies. If they do not use consistent methodologies, companies will not see any benefits from the changes in the SEC guidance as external auditors will increase procedures (thereby increasing cost) if management does not follow the same guidance.

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?

    Yes. The reference to interim statements should be removed from the definitions of significant deficiency and material weakness in order to prevent the auditor from excessive testing. By taking out any reference to interim materiality, the audit would focus on identifying deficiencies within accounts and controls that are significant on an annual basis.

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

    No. The auditor's review of management's testing was never considered time consuming or cumbersome. In fact, the opinion on management's testing effectiveness was somewhat redundant. As such, cutting out the requirement for the auditor to provide this additional opinion will not reduce the overall workload of the auditor.

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

    Yes. As outlined in response #13 above, it is our belief that the opinion on management's testing effectiveness was not needed for the auditor to perform an effective audit of internal control. The procedures performed by the auditor will change very little, if at all, as a result of the elimination of this opinion.

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?

    Yes. See responses #13 & #14 above.

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

    Yes. Relying on cumulative audit knowledge and experience should reduce the extent of some of the auditor's procedures. However, it would be helpful to have some examples provided that would outline how cumulative knowledge could lead to an adjustment of testing scope.

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?

    The auditor should rely on walkthrough procedures as sufficient evidence for any control that is classified as "low-risk" in addition to any application controls. However, in order to ensure uniform application of the term "low-risk," further guidance might be required. See also response #5 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?

Yes. At large companies, the standard's approach to scoping using a risk-based methodology should allow for significant efficiencies to be gained. However, at small multi-national companies, the use of quantitative metrics may be one of the easiest ways to distinguish risk among various 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?

    Yes. The standard for using the work of others should be the same regardless of the type of audit being performed. Different frameworks are not necessary and would cause confusion.

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?

    Yes. The definition of relevant activities appears to adequately capture the scope of activities.

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

    No. It is important for the auditor to be aware of and understand any deficiencies identified through the work of others. However, this is not a new step to the audit engagement. Reviewing results of work performed by others (such as internal audit or consultants) was already a requirement on most public accounting engagements. As such, there will be no new improvements to audit quality by making this requirement a part of the standard.

22. Is the principal evidence provision that was in AS 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?

    No. The auditor is already aware that prior to signing the opinion they are required to obtain sufficient evidence to support their opinion. The principal evidence requirement may cause the auditor to feel that they are unable to make full use of the work of others on the integrated audit engagement.

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?

    Yes. The framework for evaluating the competence and objectivity of persons performing testing appears adequate to prevent inappropriate reliance on the work of others. The framework does not appear to be too restrictive in nature.

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

Refer to response #23 above. The factors proposed for assessing competence and objectivity appear appropriate.

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?

    It is important that the auditor consider compensation arrangements when assessing objectivity. However, the factors that would impact a person's objectivity are likely to be contained in an individual's goals and objectives, rather than in a high-level compensation policy. As such, a simple review of overall compensation policies and procedures might not provide the level of detail needed. Instead, it might be necessary for the auditor to perform a more thorough review of each individual's personal performance file. This may be perceived as intrusive to some individuals.

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

    No. It is our belief that, in practice, auditors were already limiting their walkthrough to transactions that would address key controls within significant processes. As such, the revised wording of the standard, which allows the auditor to avoid testing every transaction in every key process, is not a significant change from the current practice – it will not reduce the number of hours required to perform walkthroughs, nor will it change the overall quality of the audit.

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?

    Yes. It is appropriate for "others" to provide direct assistance in performing walkthroughs. However, the benefits gained by using the work of others may be limited depending on who the "others" are. For example, if internal audit or management is used to assist in walkthroughs, both the company and the auditor may gain in both knowledge and efficiency. However, if outside consultants who are unfamiliar with the company or do not have ongoing involvement in the company are used to perform walkthroughs, the benefits gained may be minimal.

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?

    Yes. The standard appears to appropriately address ways in which the audit should be modified based on size and complexity. However, the modified requirements for documentation may be confusing to some companies and auditors. For example, if smaller companies are not required to produce formal documentation as evidence of a control's operating effectiveness, how will the auditor prove that a control is operating as stated? Additionally, how will you measure the involvement of senior management in smaller companies? Further practical guidance may be required.

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

    No. We noted no additional attributes of smaller companies that should be considered in the standard.

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. We noted no other differences related to internal control at smaller companies that should be considered in the standard.

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

    While size is easily quantifiable, the discussion of complexity incorporates some degree of judgment into the scalability provision. It will be important for clear guidelines to be to ensure that all auditors interpret complexity in the same way. Clear guidelines on assessing complexity should prevent any inappropriate limitations to the scalability provision.

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?

    The market capitalization and revenue thresholds outlined in the standard do not appear to be consistent with SEC guidance and previous guidance used in assessing the size of companies. Additionally, under the PCAOB definition, several companies that were not previously considered "small" would fall into the category of small, which could cause confusion. PCAOB guidance should be consistent with SEC guidance and previously issued guidance.

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?

    No. We noted no additional information that the auditor should provide to the audit committee in its pre-approval process for internal control-related service.

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?

    Regardless of the effective date of the standard, early adoption of the standard should be allowed for all companies in their FY 2007 reporting cycle.

Overall, the revised guidance proposed by the PCAOB will, at a minimum, cause both the external auditor and management to perform a re-evaluation of their approach to 404 testing. However, it is important that the PCAOB consider the SEC guidance for management in the proposed revision. For example, page 59 of the SEC's guidance ("Management's Report on Internal Control over Financial Reporting") states that:

> "..The benefits of the proposed amendments may be partially offset if the company's auditor obtains more evidence directly itself rather than using evidence generated by management's evaluation process, which could lead to an increase in audit costs."

The PCAOB guidance should be closely aligned with management's approach to add efficiencies and reduce any potential cost increases that the auditor would incur by performing more direct testing on its own.

Cassandra Scozzie
Internal Audit
Keithley Instruments, Inc.

Shelly Trochemenko
Internal Audit
Keithley Instruments, Inc.

Cees Klumper RA MBA CIA
Amsterdam, The Netherlands

Matthew Shepherd, CPA
Boston, MA USA

February 26, 2007

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

re: PCAOB Rulemaking Docket Matter No. 021

Dear Board Members:

We herewith submit for the Board's consideration our comments on the Proposed Auditing Standard "Considering and Using the Work of Others in an Audit" ("the Proposed Standard"). The views expressed in this letter are our personal beliefs and opinions. These views have not been considered or endorsed by any company or organization

The Proposed Standard contains a provision that appears to contradict one of the principal concepts contained in the SEC's proposed interpretive guidance for management, namely the reliance on testing performed by management in the ordinary course of business. Specifically, in paragraph 15, the Proposed Standard states that, in order to be objective, individuals who have supervisory responsibility over an area cannot be independent in terms of testing the performance of controls in that area. In the appendix to this letter, we present our view that control testing performed by functional management (i.e., the manager directly responsible for the process) can be designed and executed in such a manner as to provide strong evidence of control operation. Testing of a control's effective operation that has been established as part of the day-to-day business routine in a functional area that is coupled with a periodic quality assessment by a highly competent and independent function (for example, by a company's Internal Audit department) can result in a quality of evidence akin to that produced in management testing completed by that independent function, directly. In our view, functional management can also effectively test controls in higher-risk areas. This approach is also addressed in the February 22, 2006 comment letter by the Committee of Sponsoring Organizations of the Treadway Commission,("COSO") in which it is stated "Our objective is to have organizations recognize that monitoring can be built-in and that management's assessment of internal control is not necessarily an addition to, or layered on top of, the entity's system of internal control over financial reporting."

In order to achieve better alignment, we suggest that the SEC and the PCAOB consider recommending companies employ an evaluation process to determine the level of testers' independence and objectivity. This evaluation could include the following criteria:

- Extent of supervision, guidance and review provided by independent "SOx experts", including development of test procedures, review of workpapers, training, quality assurance, etc.,
- Existence of policies governing SOx compliance,
- Competence of tester in the subject matter,
- Policies linking timely and accurate control testing to the employee's job functions,
- Existence of a control environment that supports and fosters timely and accurate SOx compliance activities.

The appendix to this letter is our comment letter to the SEC on its proposed interpretive guidance for management. We highly recommend reading it for further clarification. It contains an article that was co-authored by one of the authors of this comment letter and was published by 'Compliance Week' on January 30. On February 9, we had the privilege of meeting with representatives from the SEC in Washington to discuss our views.

We appreciate the opportunity to provide our comments and would very much like to discuss them in a face-to-face meeting; we will contact the person identified for this purpose in the Proposed Standard.

Sincerely,

Cees Klumper RA MBA CIA & Matthew Shepherd, CPA

Appendix: Comment letter to the SEC

Cees Klumper RA MBA CIA
Amsterdam, The Netherlands

Matthew Shepherd, CPA
Boston, MA USA

January 23, 2007

Nancy M. Morris, Secretary, Securities and Exchange Commission
100 F Street, NE,
Washington, DC 20549-1090

re: File Number S7-24-06

Dear Secretary:

We herewith submit for the Commission's consideration our comments on the proposed interpretive guidance for management regarding its evaluation of internal control over financial reporting pursuant to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 ("SOx 404").

The Commision's proposed guidance is in our view well thought-out and practical. It comes very close to supporting the efficiency improvements of 50% or greater that are achievable through the application of what we consider to be best practices in the implementation by companies of SOx 404, while at the same time increasing the effectiveness of management's SOx 404 compliance process.

The proposed interpretive guidance discusses methods that management can use to obtain evidence of the operating effectiveness of ICFR and categorizes them into on-going monitoring, including self-assessment, and direct testing. The reference in the definition of "self-assessment" provided in footnote no. 64 to "…tests of controls performed by persons who are members of management, but are not the same personnel who are responsible for performing the control" broadens the scope of activities that are now considered self-assessment. We believe that this could result in the unintended consequence of reduced reliance in the work completed by management for the auditor's assessment, as this body of evidence is now defined as on-going monitoring and not considered direct control testing.

Control testing performed by functional management (the manager directly responsible for the process) that is designed and executed in such a manner as to provide strong evidence of control operation would be akin to that derived from what in the guidance is referred to as 'direct testing' of controls. To avoid the risk of external auditors deeming reduced value derived from control testing by management, it would be beneficial if the guidance would include testing performed by all levels of management not directly executing the control with established criteria for competence, objectivity and independent verification and quality assurance, as direct testing. Testing of a control's effective operation that has been established as part of the day-to-day business routine in a functional area that is coupled with a periodic quality assessment by a highly competent and independent function (for example, by a company's Internal Audit department) can result in a quality of evidence akin to that produced in management testing completed by that independent function directly.

In our view, functional management can also effectively test controls in high-risk areas. Under its current wording, this view could be perceived to be at odds with the proposed guidance and could conflict with the views of external auditors, which would be undesirable since it might indirectly lead to a sub-optimal testing approach.

In the attached appendices, we have described the amendments to the proposed guidance that we believe would be helpful. We highly recommend reading them for further clarification.

Appendix A is an article on the embedded testing approach that was co-authored by Klumper (one of the authors of this comment letter) that is scheduled to be published by 'Compliance Week' on January 30, 2007. The concepts underlying the embedded testing approach have been discussed by us over the past year with numerous partners and staff of the large accounting firms, as well as with officials from many companies required to be SOx compliant, both in the United States and in Europe. Klumper has during that period presented the embedded testing approach at six different public and private seminars on Internal Control, Internal Audit and/or Corporate Governance, both in the United States and in Europe. In virtually each of these contacts, the embedded testing approach was considered to be better than the current approach employed by most companies (which we refer to as the 'add-on' test approach), both in terms of efficiency as well as effectiveness.

In Appendix B, we compare the elements of the embedded testing approach to the SEC's proposed guidance, and include more detailed comments about the adjustments to the guidance that we believe would be beneficial.

We appreciate the opportunity to provide our comments. We would also very much like to discuss our comments with the SEC in a face-to-face meeting, and will contact the person(s) identified for this purpose in the Release.

Sincerely,

Cees Klumper RA MBA CIA & Matthew Shepherd, CPA

Appendix A: Article scheduled for publication in 'Compliance Week' on January 30, 2007

Appendix B: Suggested modifications to the SEC's proposed guidance

The following text is scheduled to be published as a Guest Column article in Compliance Week on January 30, 2007

Embedded Testing: A Cure For SOX Blues

By Cees Klumper
and Stephan Geuzebroek

Contrary to what you might think in the depths of an internal controls audit, it is possible to develop an approach to assess the effectiveness of controls that is both highly effective as well as efficient. The approach we developed at Ahold, which we call 'embedded testing', is founded in the most fundamental of internal control principles. External auditors should be able to place a high degree of reliance on embedded testing. Implementation of embedded testing can by itself reduce SOX 404 compliance costs by as much as 50 percent, while at the same time increasing the amount of competent evidence.

The concept of embedded testing is straightforward: testing of the operating effectiveness of a control is performed as an ongoing, natural part of the process that the control belongs to. As such, oftentimes it is executed by the manager or supervisor of the person performing the control. Test performance is adequately documented and exceptions are followed up appropriately. Internal audit departments still conduct some testing, but only to verify that managers are executing their assigned tests properly, and not to provide the principal evidence that controls are operating effectively.

With all its simplicity and effectiveness, embedded testing is nevertheless a fundamentally different approach to what almost all Sox-compliant companies do today—an approach we call "add-on testing." In add-on testing, persons who are *not* part of the regular process perform the testing. For example, these persons could be internal auditors, other internal control specialists, or persons from other departments ('peer review testing').

Embedded testing has several characteristics that make it more appealing than add-on testing or peer-review testing. Among them:

- embedded testing is far more natural;
- the cost of complying with SOX 404 is reduced by as much as 50 percent;
- significantly more evidence typically is recorded;
- control weaknesses are identified by the persons best positioned to do so;
- control weaknesses will usually be identified more quickly;
- only value-added testing activities are carried out;
- managers' control awareness is enhanced.

The Folly Of Add-On Testing

When, say, an accounting clerk performs a reconciliation of a general ledger account, typically this reconciliation is subjected to review by the clerk's supervisor in the ordinary course of business. Such a review typically wants to ensure that: the reconciliation was performed and documented in accordance with established guidelines; reconciled items could be adequately explained; possible exceptions were adequately followed up.

When the supervisor performs the review, in essence he is not adding any new information; he is simply checking—in effect, "testing"—whether the person performing the reconciliation did his job properly, ensuring that the control (that is, the reconciliation) operated effectively. In contrast, with add-on testing, someone else (for example, an internal auditor) tests the reconciliation. Essentially, that person reconfirms the supervisor's work.

Currently, many controls designated as 'key' for SOX 404 purposes are of a review, monitoring nature. As such, they would be labeled more appropriately as "tests". Managers routinely test controls because they want to be sure that the persons reporting to them are doing their jobs, that the information coming out of the process they oversee is reliable, that mistakes are caught before they cause problems, and that process improvements can be implemented to avoid future mistakes.

All this is natural; it was done long before Sarbanes-Oxley, and always will be done. It is part of the normal "Plan-Do-Check-Act" management cycle. The "check" in this management cycle is the test and it should be given appropriate credit in the SOX 404 process.

When looking at the control framework this way, having the key control tested again by an outsider (through add-on testing) is unnecessary. In fact, there is no need to do *any* add-on testing—so long as management does in fact test the key controls, in accordance with the requirements for proper management testing.

So Why The Add-On Craze?

Almost all companies have management testing performed by persons other than management: add-on testing. And since estimates are that on average, more than half of companies' SOX 404 compliance costs are spent in executing add-on management testing, it quickly becomes a very costly exercise.

So why, if embedded testing does the trick, do companies still devote so much time and resources to add-on testing?

To answer this question, recall when SOX 404 was implemented. In issuing guidance, the regulators chose to focus on the *external* auditors, who were tasked with executing their own assessments. One trait specific to external auditors is that they are very … external. They will have no way of knowing themselves, firsthand, from their own observation, whether controls are operating as described. They must come in and test. This is the clear and fundamental difference between auditors and management: management *is* in a position (indeed, the *best* position) to know about the effective operation of controls because they are there, watching controls operate all day long, every day. They are *paid* to make sure controls operate effectively, and to take corrective action in case controls fail.

It is not as if, prior to Sarbanes-Oxley, managers were clueless, only hoping that controls were in fact working. Yet, by executing add-on testing, we are assuming exactly that: that without someone from the outside coming in, management would never know whether controls are operating as intended. Clearly this is not the case. Management has more than a clue—so why not take credit for all of the monitoring-type testing that management is already doing?

Other reasons exist why companies all went to add-on testing, some of them good. For one, without having documented all of the key controls, and having gone through to check whether they actually operated, companies were generally not too sure about where their control weaknesses were, and which managers were doing a good job of verifying this. Everything was *implicit* rather than *explicit*. Now that all key controls, including those that also qualify as management tests, as well as their operation, have been properly documented, this process has finally become *explicit*. One of the key requirements for management testing is that it must be documented adequately, since it has to be re-performable by third parties such as the external auditor. Prior to SOX 404, this was hardly ever the case. So to be able to start taking credit for the testing that management already does in the ordinary course of business, first we had to have the proof that this was actually happening. By the initial implementation of SOX, we now have that proof, managers have grown accustomed to documenting when they perform their controls (including controls that also qualify as tests), and we can start taking credit for those tests.

Another, not so good reason for why companies have generally adopted add-on testing is simply because the external auditor, unaware of a different approach, advised or even required it. From the external auditor's perspective, it makes perfect sense. To the company, however, it is a costly and inefficient way of getting the required assurance.

Finally, the add-on method is deceptively simple; typically, the approach to implementation was "first we document, then we test". So, first, all of the controls (whether they were 'just' controls or whether they were tests) were documented. Then testing plans would be drawn up for each control, and off we went—thus missing the point that many of the controls that we documented were already the tests! One positive outcome of this: where managers were inadequately documenting the performance of their tests, this was identified and remediated (in a process often called "evidence gap remediation").

Being Objective And Competent

Yes, a manager can be both objective and competent; this is the fundamental principle of segregation of duties. What would be the point of having a supervisory review, if the person performing it is not seen to be independent from the control executor? In fact, if a manager is not objective of the persons that he or she hires and fires, and cannot be counted upon to judge his subordinates' performance objectively, he should not be a manager in that position. The same goes for competence: The direct line manager should be the person most competent to judge the work of his subordinates (or certainly at least as good as any outsider coming in currently to perform 'add-on' testing). Still, to be sure, the quality of the testing performed by management should be assured through sample tests performed by internal auditors as noted before.
So while external auditors will always have to perform a measure of add-on testing, companies should not. There are two notable exceptions:

1. Where management testing would be more efficiently carried out by specialist testers. An example of this would be the store-level audit function that operates within larger retail companies. At those retailers, regional managers could be tasked with checking up on the (key) control operators, but it's just not efficient;

2. Where the knowledge required to evaluate control execution properly is so highly specialized that the company has decided it is more efficient to not have that expertise in-house , and to leave the checking up to an external party. Examples of this are the insurance company's in-house actuary, whose work is double-checked from time to time by an outside agency, or the treasury department, where a specialist could be engaging in exotic strategies and products. Some form of external oversight is often employed in this situation as well.

But these are the exceptions to the rule: that managers should perform their own management tests.

Preconditions To Remember

The first important condition is that the company's internal audit function should verify that management is performing and documenting all testing done properly.

The second condition is that managers will need to be supported on an ongoing basis in defining the appropriate testing activities (including the extent of testing, the documentation required, and so on) and in interpreting and responding to the test results. This support could be provided by the same persons tasked with all of the other required SOX 404 activities such as scoping and risk assessment, control documentation, evaluation of design effectiveness, and so on.

A third condition is that recording test activities should be made as easy as possible for management. In this regard, an effective software tool, which will also enable the company to monitor the progress and outcome of tests performed by management, may be indispensable. Where companies can still get by without an appropriate tool when using the 'add-on' testing approach—principally because the whole process is executed by relatively few 'experts'—getting many managers involved will undoubtedly change that.

The SEC, The PCAOB, And Embedded Testing

With respect to test approaches, a fundamental point that the Securities and Exchange Commission has included in its proposed new guidance for management in its execution of a SOX 404 compliant process is the recognition of the relevance and value of embedded test activities. As such, the SEC's proposed guidance provides the first (and strong) official support for embedded testing.

Meanwhile, new guidance from the Public Company Accounting Oversight Board contains one provision that in some ways appears to contradict what the SEC is proposing: namely, that the external auditor cannot make use of tests performed by managers with supervisory responsibility over the area that the control tested is part of. In our opinion, this is an unnecessary provision that could have the (possibly unintended) effect of hampering the efficiency of companies' SOX 404 compliance processes.

Shifting The Paradigm

Now that the (relatively simple) concept of embedded testing is out there, how does a company go about achieving it? Moving to embedded testing is indeed not easy. It does require the entire control framework to be re-evaluated and viewed in a different perspective. The distinction between 'mere controls' and 'control/tests' has to be defined. Controls that are not currently being tested in the ordinary course of business have to be evaluated: why is a manager not checking that this control is being performed adequately already? New controls will have to be implemented if it turns out the SOX 404 management testing was the first and only assurance we got over important controls.

And it is all worth it!

element	embedded testing approach	SEC exposure draft	comment	suggested modifications
A.	The 'embedded testing' evaluation process described herein gives consideration to all factors relevant to the effectiveness and efficiency of companies' SOx 404 compliance process.	"Management must bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and that provides reasonable assurance for its assessment. This proposed guidance is intended to allow management the flexibility to design such an evaluation process." "management, not the auditor, is responsible for determining the appropriate nature and form of internal controls for the company as well as their evaluation methods and procedures." "the proposed guidance ... allows for management and the auditor to have different testing approaches."	Although the guidance allows management and external auditors to apply different approaches, if the guidance for external auditors and for management is not well-aligned, there is a significant risk that companies will find themselves effectively being forced to adopt a sub-optimal (less effective and less efficient) assessment approach, solely in order to reduce external audit costs. This is most relevant in the area of reliance by external auditors on the work of others.	Improve alignment of SEC and PCAOB guidance affecting the auditor's use of the work of others as further described in the next point.
B.	Periodic written affirmation by the control executor, through a self-assessment program, of his or her responsibility to: 1. Execute the control as described; 2. Suggest updates to control documentation as necessary; 3. Suggest control improvements.	"These [evaluation] procedures may be integrated with the daily responsibilities of its employees or implemented specifically for purposes of the ICFR evaluation." "... activities performed to meet the monitoring objectives of the control framework will provide evidence to support the assessment."	Where the exposure draft groups self-assessment performed by a control executor together with test activities carried out by functional management, in the embedded testing approach these two are viewed as being clearly separate and distinct. In the embedded testing approach, the testing performed by functional management is designed and executed in such a manner as	Include as direct testing, testing performed by functional management (provided certain criteria for competence, objectivity and independent verification and quality assurance, are met), also for controls in high-risk areas

[1] source: SEC exposure draft footnote no. 64 "Self-assessment is a broad term that refers to different types of procedures performed by various parties. It includes an assessment made by the same personnel who are responsible for performing the control. However, self-assessment may also be used to refer to assessments and tests of controls performed by persons who are members of management but are not the same personnel who are responsible for performing the control. In this manner, an assessment may be carried out with varying degrees of objectivity. The sufficiency of the evidence derived from self-assessment depends on how it is implemented and the objectivity of those performing the assessment. COSO's 1992 framework defines self-assessments as "evaluations where persons responsible for a particular unit or function will determine the effectiveness of controls for their activities."

element	embedded testing approach	SEC exposure draft	comment	suggested modifications
C.	Execution of independent and objective testing by the control executor's functional manager in accordance with established test procedures (see also E.)	"The evidence management evaluates may come from a combination of on-going monitoring and direct testing of controls. On-going monitoring includes activities that provide information about the operation of controls and may be obtained, for example, through self-assessment[1] procedures and the analysis of performance measures designed to track the operation of controls. Direct tests of controls are tests performed periodically to provide evidence as of a point in time and may provide information about the reliability of on-going monitoring activities."	to, in general, provide strong evidence of control operation, akin to that derived from what in the guidance is referred to as 'direct testing'[2] of controls. To avoid the risk of external auditors deeming the value derived from management testing by managers to be more limited than appropriate, it would be very beneficial if the guidance would include as direct testing, testing performed by functional management (provided certain criteria for competence, objectivity and independent verification and quality assurance, are met). In addition, in our view, also controls in high-risk areas can be effectively tested by functional management. Under its current wording, this view could be perceived to be at odds with the proposed guidance and could clash with the views of external auditors, which would be highly undesirable since it could lead to a testing approach that is sub-optimal (less effective and less efficient).	
D.	Making use of other available sources of evidence of control operation.	"Evidence that is relevant to the assessment may come from activities that are performed for other reasons (e.g., day-to-day activities to manage the operations of the business)."	The proposed guidance is in line with the embedded testing approach.	n/a
E.	Internal control experts[3], reporting to the highest levels of management, assist functional management with: 1. designing, implementing and maintaining fit-for-	The proposed guidance is silent about how companies should organize the support for the organization and execution of their SOx 404 compliance process.	It would be beneficial if the guidance were augmented. In our view, the in-depth involvement of a separate function within the organization, reporting to the highest levels of management, consisting of highly skilled	Augmenting the guidance about how companies should organize the support for the organization and

[2] The term 'direct testing' is introduced in the proposed guidance, however described only very succinctly. It is likely referring to the current 'add-on' testing approach of most SOx compliant companies. We would consider it to be a missed opportunity if it would not also encompass the concept of independent testing by line management.
[3] In many companies, an Internal Control or a similar function has been created which, among other things, has the responsibility for supporting, and executing portions of, the SOx 404 compliance process.

element	embedded testing approach	SEC exposure draft	comment	suggested modifications
	purpose internal controls, including the appropriate documentation thereof; 2. designing, implementing and maintaining fit-for-purpose tests of internal controls designated as 'key' for purposes of complying with the requirements of SOx 404, based on a top-down, risk based[4] evaluation and selection of the required controls to be tested (key controls); 3. evaluating the outcome of the self-assessment and independent (direct) testing and other sources of evidence of control operation by internal control experts in conjunction with management and control executors as appropriate.		internal control professionals, in the manner described, adds significant value to achieving an effective and efficient management assessment process in general, and robustness to the embedded testing process specifically. An Internal Control or similar function can monitor the timely and thorough execution of the tests of controls on an ongoing basis, possibly through the use of an automated tool that provides insight into such execution and the recorded results thereof. They can also 'own' the process of evaluating and concluding on, and responding to, all test results as well as to the findings from Internal Audit's assessment process (see under F.).	execution of their SOx 404 compliance process.
F.	Internal Audit independently verifies the execution of each of the above elements to gain assurance about the robustness and quality of the process executed by, and on behalf of, management.	According to the proposed guidance, this activity would be considered 'direct testing': tests performed periodically to provide evidence as of a point in time that may provide information about the reliability of on-going monitoring activities.	In our approach, Internal Audit's verifications would not be designed to provide the primary evidence of control operation (although that would be a side-benefit) but, rather, is executed primarily to "provide information about the reliability of on-going monitoring activities". Nevertheless, Internal Audit's verification activities could be stratified to also include some testing of the highest-risk controls, if that would lead to appreciably less work	See comment under B.

[4] this would take into account all of the relevant factors concerning inherent and residual risks; results of assessments executed in previous years; results of evaluation of company-level controls; results of other relevant monitoring activities; multi-location considerations and others.

element	embedded testing approach	SEC exposure draft	comment	suggested modifications
			having to be performed by the external auditor[5]. Again, it would be good if the guidance would specifically mention that testing performed by management could qualify as 'direct testing', provided that there is an additional check performed of the reliability of such testing as provided for in the embedded testing approach through the involvement of an Internal Control function and/or Internal Audit. A robust quality assurance process, which is executed by an independent function, significantly improves the persuasiveness of the evidence gathered through control testing completed by management.	
G.	External Audit conducts their own assessment, making optimal use of the three levels of independent assessment executed on behalf of management, in addition to the self-assessments performed by the control executors: 1. independent testing by line managers; 2. evaluation of the test execution and results by internal control experts reporting to the highest levels of financial management; 3. independent verification and quality assurance of (1) and (2) by Internal Audit.	While the SEC's proposed guidance is intended for management, clearly it would be counterproductive if anything therein would be contradictory to what the PCAOB is requiring from companies' external auditors. Unfortunately, such a contradiction at least appears to be present in the current proposal from the PCAOB (see comment box to the right).	The PCAOB's proposed guidance contains a provision that appears to contradict one of the principal concepts contained in the SEC's proposed guidance, namely the reliance by management on testing performed in the ordinary course of business. Specifically, in paragraph 15 of the Proposed Auditing Standard *'Considering and Using the Work of Others in an Audit'* states that, in order to be objective, individuals who have supervisory responsibility over an area cannot be independent in terms of testing the performance of controls in that area. As will be clear from our other comments, we fundamentally disagree with this notion. We consider it to be in direct contradiction to what the SEC is suggesting companies do. In order to achieve better alignment, the SEC	[For the PCAOB: allowing the auditor to make use of control testing performed by individuals who have supervisory responsibility over the area that they test.]

[5] Ironically, in the practice to date, internal audit testing efforts have often been directed at the **lower**-risk areas because, typically, external auditors at least place some reliance on that work where they typically have been unwilling to do so in higher-risk areas. This has then prompted companies to have their Internal Audit functions test the lower-risk areas.

Appendix B to Klumper and Shepherd's comments on the proposed SEC guidance for MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING as contained in RELEASE NOS. 33-8762; 34-54976; File No. S7-24-06.

element	embedded testing approach	SEC exposure draft	comment	suggested modifications
	The embedded testing approach was developed with feedback from external auditors to emphasize a reduction in the total compliance cost to companies.		and the PCAOB should consider recommending companies employ an evaluation process to determine the level of independence and objectivity. This evaluation should include the following criteria: • Extent of supervision, guidance and review provided by independent "SOx experts", including development of test procedures, review of workpapers, training, quality assurance, etc. as described herein under E. • Existence of policies governing SOx compliance, • Competence of tester in the subject matter • Policies linking timely and accurate control testing to the employee's job functions, • Existence of a control environment that supports and fosters timely and accurate SOx compliance activities. We will also direct this point separately to the PCAOB.	

Comments on

SEC File Number S7-24-06:
"Management's Report on Internal Control over Financial Reporting"

and

PCAOB Rulemaking Docket Matter No. 021:
"Proposed Standard on Auditing Internal Control over Financial Reporting"

Dear Sirs and Madams,

1. It is a pleasure and privilege to offer these comments on the SEC's proposed interpretation and the PCAOB's proposed standard regarding the evaluation and auditing of internal controls. My comments on these documents are combined because those comments are essentially the same and apply equally to both documents and because the SEC and PCAOB indicated that timing of your releases has been coordinated to allow for coordinated public comment. **Answers to specific questions from the SEC are in Appendix A, and answers to questions from the PCAOB are in Appendix B.**

2. I hope these comments will be helpful and provide insights that might not otherwise have been made available to the Commission and Board since my career experience with internal controls has been unusual in its length and concentration. Briefly, that career has focused on internal controls for over 32 years, the first seven with a major public accounting firm and the following twenty-five years with large public companies in several industries where I created, reorganized and directed internal audit departments.

3. It is my firm belief that good internal controls lead to greater operating efficiency, lower overhead, lower administrative and regulatory costs, and better information for management and for financial decision makers. It is therefore unfortunate that the implementation of Sarbanes – Oxley section 404 has thus far resulted in significant and in some cases burdensome costs. These costs arise from a limited understanding of internal control that can and should be corrected with this latest management guidance and revision to audit standards.

4. To understand internal controls, it is important to focus not so much on *what they are* but more importantly on *what they do*. What they ***are*** is a "process" or "activity" as stated in virtually every definition of internal control over the last 100 years. What they ***do*** is accomplish business, financial and compliance objectives. Since "process" and "activity" are catch-all terms, *virtually any purposeful action within an organization is a control*. The challenge is finding the ***few*** actions, activities or processes *that make a real difference in accomplishing the objectives in question* -- Pareto's law applies here.

5. In virtually every organization or human enterprise there are essentially two processes that form the core of organizational behavior and goal accomplishment. Neither of these has been adequately addressed in the SEC's proposed guidance or in the PCAOB's proposed rules. These processes are *motivation and measurement*. Of the two,

motivation is primary. Motivational controls answer the questions, “What’s in it for me?” and “Why should I do it in the first place?” Measurement controls answer the question, “How do I know whether I accomplished what was intended?” and “How do I know when to adjust my actions in order to get closer to achieving the goal?”

6. In most modern organizations people are primarily motivated by three things: 1) keeping their job, 2) making more money, and 3) getting promoted (so they can make more money). Of course intangibles like peer pressure and public recognition are also motivating, but the primary three motivations come first for most people. The processes (and therefore controls) that directly affect these three primary motivations are reporting relationships and compensation systems. In other words, most people are motivated to 1) keep their job by keeping their boss happy and 2) make more money by keeping their boss happy and meeting individual and organizational performance goals.

7. While the last paragraph may be stating the obvious, it is the obvious that has been overlooked in the implementation of Sarbanes-Oxley section 404 and its related rules and guidance. The motivational controls of reporting relationships and incentive/compensation systems more than anything else determine whether financial statements are fairly stated. These controls have not been addressed in the SEC’s proposed interpretation or the PCAOB’s proposed standard.

8. Motivational controls are all the more important in areas where appropriate performance depends upon objective and unbiased judgment. This is the case in financial reporting. As any accountant knows, good accounting is dependent upon objective and impartial judgment. Judgment is required in almost every balance sheet and income statement account. These judgments may take the form of the accounting rules and principles elected, the timing of transactions recorded, the policies, procedures and systems used in recording transactions, the establishment of reserves, the size of reserves, periodic adjustments to reserves, and countless other forms. Each of these judgments should be measured by one standard, “What is the fairest representation of underlying reality?”

9. Unfortunately, current motivational controls, including reporting relationships, compensation systems and incentive systems, force these judgments to be made on an entirely different standard, namely, “What is the representation that *reflects best on management* and company performance (and that we can get away with)?” This judgment bias introduced by current motivational controls is at the root of virtually all financial reporting errors, irregularities and frauds. It was certainly at the root of Enron, WorldCom and other recent financial reporting failures.

10. While motivational controls are entity level controls and key drivers of the control environment, they also can and should be applied on a specific basis to specific control objectives. In the case of financial reporting, they should be applied to the key players in financial reporting. These players are not the auditors, but rather the Chief Accounting Officer, the accounting staff and the members of the Audit Committee. These individuals are most directly responsible for producing fair and accurate accounting and financial

reports. Regulators, auditors and management must begin to recognize that the odds are stacked against fair financial reporting as long as motivational controls introduce bias into the accounting system. Those who are directly responsible for accounting should have motivational controls that ***require*** their independent and objective judgment in accounting and financial reporting matters. This means that reporting relationships (formal and informal) as well as compensation and incentive systems for these key players should be completely independent of company management and impartial as to company performance.

11. The selection, evaluation, retention and compensation of Audit Committee members should be insulated from management influence either real or perceived and also independent of organizational performance. The Chief Accounting Officer and his/her accounting organization should likewise be independent from management influence either through reporting relationships, hiring, firing, compensation, evaluation or incentives. Instead they should report to the Audit Committee who would be responsible for these activities. Measurements and incentive systems must be developed for both the Audit Committee and the accountants that encourage and reward them for fair, accurate, ***objective and impartial*** accounting and financial reporting. Only when these basic motivational controls are in place will we have a system that consistently produces fair financial reporting. Until then, we will have periodic financial reporting scandals and numerous errors, restatements and corrections to company financial statements. It should be recognized that companies without appropriate motivational controls have a *material control weakness* in financial reporting.

12. When such controls are established in public and private organizations, surprising things will happen. First, because fair financial reporting will be a naturally occurring activity within our economic system, the cost of effective external auditing, external regulation and external legal proceedings will be significantly reduced. Secondly, the cost of internal accounting will also be reduced and the effectiveness, accuracy and usefulness of this accounting information will significantly increase. Thirdly, we will have achieved a simplified “principles based” rather than “rules based” accounting system, since excessive rulemaking is only necessary when people are motivated to find ways around the rules. Principles based accounting depends upon two things, agreement as to the principles involved (fair and accurate reporting) and the *motivation* to pursue those principles.

13. Finally, my assertion that “good internal controls lead to greater operating efficiency, lower overhead, lower administrative and regulatory costs, and better information for management and financial decision makers” will come to pass in the area of financial reporting. No longer will there be complaints that Sarbanes – Oxley 404 regulations and auditing is too costly. Instead Sarbanes – Oxley internal control requirements will be recognized as a major boon to the free enterprise system, making it more reliable, more trustworthy, more efficient, and more effective in the allocation of capital and in financial and management decision making.

Thank you for your thoughtful consideration of these comments and concepts.

Respectfully submitted,

Thomas E. Damman
Chief Executive Officer
Koexco – Control Excellence Company

Appendix A
Responses to SEC questions regarding the proposed interpretive guidance:

The following are responses to the specific questions raised by the SEC in its proposed interpretive guidance:

- Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process?
  Answer: Elements of the proposed guidance are helpful such as top down assessment; decoupling management assessment from auditor assessment, comments on evidentiary matter required, etc.

- Does the proposed guidance allow for management to conduct an efficient and effective evaluation?
  Answer: No.

- If not, why not?
  Answer: A key element of an effective and efficient control system is not discussed, specifically, motivational controls. See paragraphs 5-10 above.

- Are there particular areas within the proposed interpretive guidance where further clarification is needed?
  Answer: Yes.

- If yes, what clarification is necessary?
  Answer: Insert guidance regarding the importance of motivational controls. For example, the following might be inserted at the end of the section discussing Entity Level controls:

  > "Entity level controls that should receive particular attention in the evaluation process are those having to do with the motivation of individuals responsible for financial reporting. These motivation controls include reporting relationships, compensation systems and incentive systems as they apply to these individuals. Fair accounting and financial reporting demands objective and unbiased judgment. Questions such as the following should be evaluated carefully:

  - Are Audit Committee members fully independent from management in fact and appearance and independent of company performance in their compensation?
  - Is the Chief Accounting Officer and staff independent from management in reporting relationships and incentive systems? Are they also impartial and objective relative to company performance?"

- Are there aspects of management's annual evaluation process that have not been addressed by the proposed interpretive guidance that commenters believe should be addressed by the Commission?
  Answer: Yes.

- If so, what are those areas and what type of guidance would be beneficial?
  Answer: Same as the answer to the "clarification" question above. Also see Paragraphs 10-12 above.

- Do the topics addressed in the existing staff guidance (May 2005 Staff Guidance and Frequently Asked Questions (revised October 6, 2004)) continue to be relevant or should such guidance be retracted?
  Answer: No opinion.

- Will the proposed guidance require unnecessary changes to evaluation processes that companies have already established?
  Answer: I do not believe so.

- Considering the PCAOB's proposed new auditing standards, <u>An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements</u> and <u>Considering and Using the Work of Others In an Audit</u>, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance?
  Answer: None noted.

- Are there any definitions included in the proposed interpretive guidance that are confusing or inappropriate and how would you change the definitions so identified?
  Answer: Clarification and simplification of three definitions would help:
  1. **Internal Controls (and Internal Controls for Financial Reporting).** The *essence* of these definitions should be pointed out to the reader, which is that internal controls are simply any "process, action or activity" undertaken to ensure fair financial reporting (ICFR) or, more generally, to ensure efficiency and effectiveness of operations and compliance with laws and regulations. Controls are defined more by their ***objectives*** than by the "process, action or activity" in question since these are broad, all encompassing terms. Thus any process, action or activity that takes place in an organization that has a purpose

is a control of something. The key is identifying those ***few*** processes, actions or activities that have *the most impact* on accomplishing the relevant objective(s). In this respect motivational controls and measurement controls usually top the list.

2. **Motivational Controls.** This concept should be defined, explained and illustrated for the reader. Motivational controls are simply processes, actions or activities that effect the motivation of an individual or organization. They include reporting relationships, compensation systems, incentive systems, performance measurement systems, promotions (and related reasons stated and non stated), terminations (and related reasons stated and non stated), job descriptions, long term and short term goals, company bonus and stock option programs, etc.
3. **Material Control Weakness.** This definition is dependent upon the definition of a material error in the financial statements which is no where defined in this document. I believe it should be defined here and pointed out to the reader that since a material misstatement is any misstatement or omission that "makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement," a lack of controls preventing biased accounting judgments of any kind should be considered a material weakness. The reason for this is that biased accounting judgments (no matter how large or small and whether within GAAP or not) are presumably made to influence the judgment of a reasonable person towards the viewpoint of the biased individual(s). Thus motivational controls which insure the independence, impartiality and objectivity of those making accounting judgments and controlling financial reporting are essential to avoiding a material control weakness.

- Will the guidance for disclosures about material weaknesses result in sufficient information to investors?
  Answer: No.

- If not, how would you change the guidance?
  Answer: See discussion on the clarification of the definition of Material Control Weaknesses above and also paragraphs 10-11.

- Should the guidance be issued as an interpretation or should it, or any part, be codified as a Commission rule.
  Answer: Eventually it should be codified as a Commission rule if above comments are addressed due to the fundamental nature and impact of these issues on fair financial reporting.

Appendix B
Responses to PCAOB questions regarding the proposed standard:

The following are responses to the specific questions raised by the PCAOB in its release of the proposed standard:

1. Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?
   Answer: Yes, with the exception that the most important controls are not mentioned – motivational controls.

2. Does the proposed standard place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud?
   Answer: No, because the most important controls for detecting and preventing fraud are not discussed – motivational controls.

3. Will the top-down approach better focus the auditor's attention on the most important controls?
   Answer: Only if the auditor understands the importance of motivational controls and includes these in the analysis.

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?
   Answer: It is important to consider company level controls but motivational controls should be recognized as the most important company level controls.

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?
   Answer: Yes.

6. Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?
   Answer: Yes, but a walkthrough should be understood to be simply the identification and verification of key controls in the process and not necessarily every control. As such a discussion with one employee who is responsible for the operation of that key control may be a sufficient walk through in some cases.

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?
   Answer: Yes.

8. Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or the auditor?
   Answer: No. Auditors are not currently recognizing the importance of motivational controls and the material weaknesses inherent in their absence or inappropriate application.

   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?
   Answer: Since inappropriate motivational controls are at the heart of most material misstatements, a discussion of what they are and how they work to prevent material misstatements should be included in AS2.

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?
   Answer: The proposed definitions will help. However, auditors must learn to identify the root causes of material misstatements and the control mechanisms that remediate these root causes.

10. Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present?
    Answer: Yes, however auditors should be required to document why they believe no deficiency exists in these cases. Also an indicator should be added to this list, specifically: "The absence of appropriate motivational controls or the presence of inappropriate motivational controls for the Audit Committee, Chief Accounting Officer, accounting staff and anyone else directly responsible for making accounting judgments, setting accounting policy, making accounting entries or preparing financial statements."

    Will this change improve practice by allowing the use of greater judgment?
    Answer: Yes, **if** the justification for that judgment is documented, and the motivational control criteria discussed above is added.

    Will this change lead to inconsistency in the evaluation of deficiencies?
    Answer: Perhaps some but these inconsistency can be corrected through the PCAOB audit review process as long as judgments are documented.

11. Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?
    Answer: Yes, refer to all of the discussions above regarding motivational controls, particularly paragraphs 6-12. Once these controls are in place, audit risk, work and testing will be significantly reduced. For that reason a discussion of the importance of effective motivational controls to prevent material misstatements and produce fair and informative financial reporting should be included in AS2.

12. Should the reference to interim financial statements be removed from the definitions of significant deficiency and material weakness?
    Answer: No, accurate interim financials are just as important as accurate year end statements. However, it is appropriate that the materiality standard is set at full year reporting levels.

    If so, what would be the effect on the scope of the audit?
    Answer: No opinion.

13. Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?
    Answer: Yes, some. It is appropriate for auditors to do their own assessment of controls without being required to evaluate management's process, though such an evaluation may be part of the auditor's process if it is likely to lead to less testing and less work for the required level of assurance.

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?
    Answer: Yes, I believe so, but see answer to the last question.

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?
    Answer: Yes, it will reduce confusion regarding what they are auditing and what they are providing an opinion about.

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

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?
    Answer: In lower risk accounts/processes as stated in the proposed rule and in highly automated controls where the computer/system can be relied upon to function the same way every time.

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?
    Answer: Yes.

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?
    Answer: A single framework is appropriate.

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?
    Answer: Yes.

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

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

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?
    Answer: The framework is appropriate and not too restrictive.

24. Has the Board identified the right factors for assessing competence and objectivity? Are there other factors the auditor should consider?
    Answer: The right factors have been identified. The same factors should be applied to anyone who has responsibility for accounting or producing financial statements.

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?
    Answer: It is an extremely relevant factor to be considered, but practically speaking it will likely have a limited effect here. Auditor review and supervision of the work performed can have a strong compensating effect for those individuals whose compensation does not encourage objectivity and independence.

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

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?
    Answer: Yes, except in those areas where the walkthrough is also the **primary** means of verification and testing that the controls exist.

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?
    Answer: Yes.

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

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?
 Answer: These seem appropriate**.**

31. Does the discussion of complexity within the section on scalability inappropriately limit the application of the scalability provisions in the proposed standard?
 Answer: Not in my opinion.

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?
 Answer: It is useful that they are consistent with the SEC categorizations and reporting requirements.

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?
 Answer: They should describe how the service is NOT in conflict with the requirements of the Act, Board or SEC since it is difficult to conceive of financial related internal control work that doesn't have a potential conflict of interest for auditors.

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?
 Answer: No opinion.

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February 26, 2007

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

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*

Dear Mr. Secretary:

KPMG appreciates this opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) Release No. 2006-007 that includes the following Appendices (collectively, the Proposals):

- Proposed Auditing Standard - *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*
- Proposed Auditing Standard - *Considering and Using the Work of Others in an Audit*
- Proposed Rule 3525 - *Audit Committee Pre-approval of Services Related to Internal Control Over Financial Reporting*
- Auditing and Related Professional Practice Standards - *Proposed Amendments to PCAOB Interim Standards* (Conforming Changes Proposal)

We would like to take this opportunity to formally recognize the significant effort of the PCAOB and its staff in development of the Proposals. Overall, we believe that the changes reflected in the Proposals relative to auditing internal control over financial reporting (ICFR) will serve to enhance auditors' effectiveness and efficiency in conducting an integrated audit and, combined with the Securities and Exchange Commission's (SEC) proposed guidance, will result in a reduction of the total Section 404 compliance effort. We do, however, have concerns relative to the Board's proposed standard on considering and using the work of others that are addressed later in this letter.

Fundamentally, we believe that compliance with the provisions of Section 404 of Sarbanes-Oxley provides needed protections to investors of all companies, regardless of size or complexity. We believe that internal control reporting pursuant to Section 404 has made, and will continue to make, a significant contribution toward improving financial reporting, corporate governance and audit quality, all serving to further the public interest and restore confidence in our capital markets.

Since adoption of the initial rule requiring reporting on ICFR pursuant to the provisions of Section 404, significant improvements have been made to issuers' financial reporting and disclosure processes and the effectiveness of their internal controls. In addition, the benefits realized by compliance with Section 404 extend beyond improved internal control and financial reporting. Many issuers that have implemented robust management evaluation and assessment processes initially designed to support Section 404 compliance have realized enhancements in operations, regulatory compliance, communications and documentation.

We fully support the direction of the Board evidenced in the proposed standard requiring a single model of auditor reporting on ICFR; specifically, that the auditor obtain reasonable assurance relative to the operating effectiveness of internal control. In addition, we support the Board's emphasis on the importance of sound professional judgment and believe that the exercise of appropriate auditor judgment is fundamental to the execution of an effective and efficient audit.

We also fully support the Board's ongoing project to develop practical guidance for auditors in conducting integrated audits of smaller, less complex organizations. Our participation in this project should benefit our engagement teams when addressing the particular challenges encountered in smaller, less complex environments. We look forward to our continued participation in this project, which we believe will further facilitate scalability of the proposed standard in an effective and efficient manner. This project, and the Proposals and the SEC's proposed guidance, have the potential to drive the greatest benefits, in terms of efficiencies and cost-effectiveness, for the non-accelerated filers and new public companies that have yet to comply with the provisions of Section 404.

Compliance with the provisions of Section 404 has placed important responsibilities on issuers and auditors that, in many instances, have required the dedication of significant resources. We believe that the Proposals, taken together with the SEC's proposed guidance, will result in a reduction of total Section 404 compliance effort. We support the enhancements to the auditing standards emphasizing or providing for (i) the increased use of professional judgment, including the assessment of audit coverage; (ii) the ability to use cumulative knowledge obtained during prior audits in considering the nature, timing and extent of current year audit procedures; and (iii) the elimination of the requirement to evaluate management's assessment process. We also believe that the proposed standard on auditing ICFR has the ability to allow for increased use of the work of others, assuming certain conditions are met, notwithstanding our concerns relative to the proposed standard on considering and using the work of others, which we address below.

The extent of these reductions in effort will vary significantly based on each issuer's particular facts and circumstances. The quality of an issuer's control structure and processes, the relative complexity and business risks of an issuer, and the quality of management's evaluation and assessment process, including relevant documentation, all are factors that will affect reductions to the overall Section 404 compliance effort and the relative balance of such reductions between management and the auditor.

Because of the myriad factors involved, we do not believe that reductions in the total Section 404 compliance effort can be synthesized into specific or across-the-board reductions in Section 404-related compliance costs for all issuers. While the reductions in effort will vary, a constant in the equation is the acknowledgement that maximum benefits will be achieved when management and the auditor work in a coordinated manner, and when the auditor can make effective use of the work of others. For example, the quality of management's evaluation and assessment of internal control, including relevant documentation, directly impact the effectiveness and efficiency of the external audit.

We are committed to supporting continued improvements in the effectiveness and efficiency of Section 404 compliance and believe that the Board's Proposals facilitate progress in that direction and uphold investor protections that are critical to the effective functioning of our capital markets.

We encourage the Board to expedite issuance of its Proposals in final form to allow sufficient time for auditors to be trained and methodologies to be developed evidencing the revised requirements and guidance. This accelerated consideration and issuance of the Proposals in final form is important to ensure that the Board's final standards will impact integrated audits performed for the year ending December 31, 2007.

This letter is organized by first providing a number of general observations and comments on the proposed standard on auditing internal control over financial reporting, followed by observations and comments on the proposed standard on considering and using the work of others. Less significant and editorial comments and suggestions are included in the Appendix to this letter.

General

We note that the Proposals include a number of presumptively mandatory provisions directing the auditor to perform procedures for the purpose of identifying potential sources of audit efficiencies. As previously noted, we fully support the Board's objective to enhance the effectiveness and efficiency of integrated audits. However, we firmly believe that the auditor's objective is to perform effective, high-quality audits, and that highly effective audits promote process efficiencies. The precedence set by including such presumptively mandatory provisions relative to efficiencies is inconsistent with the nature of professional standards and may detract from the objective of enhancing audit quality and protecting investor interests.

Proposed Standard on Auditing Internal Control Over Financial Reporting

We believe that the proposed standard on auditing internal control over financial reporting evidences the Board's commitment to simplify the requirements of Auditing Standard (AS) No. 2 and focuses the auditors' attention on matters most important to ICFR. In addition, we believe that the proposed standard strikes an appropriate balance between effectiveness and efficiency relative to performance of an integrated audit. We fully support the Board's objective to improve the effectiveness and efficiency of integrated audits and hope that the comments and observations provided in this letter assist the Board in achieving that objective.

Company-level controls. Paragraph 17 of the proposed standard states that, "[t]he auditor must test those company-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting," and that "[t]he auditor's evaluation of company-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on controls at the process, transaction, or application levels." Company-level controls that operate at a sufficient level of precision and may be linked directly to financial statement assertions represent a concept that has not been fully developed in practice.

We note that paragraphs 43 and 44 of the proposed standard address the linkage of company-level controls to financial statement assertions and the level of precision at which company-level controls operate. We believe that this guidance will serve to clarify the evaluation of company-level controls and the implications on process or transaction level controls and suggest that the concepts included in paragraphs 43 and 44 be reiterated in paragraphs 17 and 18 of the proposed standard. In addition, we believe that the final standard should specifically acknowledge that, in many instances, company-level controls relate only indirectly to relevant financial statement assertions and do not operate in a manner sufficient to address risk of material misstatement to specific accounts and disclosures in the financial statements.

Recognizing the emphasis the proposed standard places on identifying and relying upon effective company-level controls, we believe that the Board should consider advising the auditor of the audit evidence limitations and challenges associated with relying on company-level controls. For example, we believe that the final standard should indicate that testing company-level controls ordinarily does not obviate the need to test some process or transaction level controls. The effective operation of company-level controls may be dependent upon the completeness and accuracy of data generated by transaction processes. In such instances, it may be necessary for the auditor to test process or transaction level controls associated with data utilized in the performance of company-level controls.

In addition, we believe that company-level control examples illustrating the consideration of sufficient precision and direct linkage to financial statement assertions would assist auditors in planning and executing an effective and efficient integrated audit. We recommend that the Board consider including such examples in an appendix to the final standard.

Scaling the audit for smaller companies. Paragraph 9 of the proposed standard states that, "[t]he auditor should evaluate the size and complexity of the company when planning and performing the audit of internal control." This evaluation requirement appears to apply to issuers of all sizes and complexity. However, the Note included in paragraph 9 refers to definitions included in the final report of the SEC Advisory Committee on Smaller Public Companies.

The requirements and guidance in paragraphs 10 through 12 of the proposed standard are directed to the auditors' evaluation of how the audit of internal control is affected by the attributes of a smaller, less-complex company. If the Board's intention is for these requirements and related guidance to be applicable only to smaller, less-complex companies, we believe that the final standard should include a definition of "smaller, less-complex." Alternatively, if the intention is for these requirements and related guidance to be applicable to companies of all sizes and complexity, we believe that intention should be clearly stated.

An auditor considers company size and complexity when planning and performing an integrated audit. However, we believe that a requirement to "*evaluate*" size and complexity contemplates auditor performance beyond one to "*consider*." We believe that the guidance in paragraphs 10 through 12 of the proposed standard, if applicable, is helpful for the auditors' consideration in planning and performing an effective and efficient integrated audit. Accordingly, we suggest that the auditor performance emphasis in these paragraphs be recharacterized as matters to consider rather than evaluation requirements.

Controls that address fraud risk. Page 6 of the Board's Summary Memorandum indicates the Board's intention "to encourage an appropriate focus on controls important to the prevention and detection of fraud." We believe that the proposed standard could be more definitive in outlining auditor performance expectations relative to evaluation of internal controls designed to address the risk of fraud, specifically internal controls associated with the risk of management override. Also, we believe that the discussion of risk assessment in the proposed standard should be expanded to require the auditor to consider whether information obtained about the entity and its control environment indicates that one or more fraud risk factors may be present and, if so, to consider the adequacy of the company's controls to address the identified fraud risks.

Roll-forward procedures. Paragraphs 63 and 64 of the proposed standard indicate that additional testing to update evidence regarding the operating effectiveness of controls obtained at an interim date may not be necessary. However, PCAOB interim auditing standards regarding substantive audit procedures state that the auditor should design substantive audit procedures "to cover the remaining period in such a way that the assurance from those tests and the substantive tests applied to the details of the balance as of an interim date…achieve the audit objectives at the balance-sheet date."[1]

We believe that it is equally important in an integrated audit to perform roll-forward procedures to provide a reasonable basis for extending to the as-of date conclusions regarding control effectiveness reached at the interim date. Accordingly, we believe that the Board's final standard should be aligned with guidance relative to roll-forward procedures necessary to extend interim-date conclusions to the as-of date in existing interim auditing standards.

Walkthroughs. Paragraph 36 of the proposed standard states "[i]n performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records." Acknowledging the significance of effective company-level controls in the conduct of an integrated audit, we believe that the Board's final standard should provide guidance on how the existence of effective company-level controls impacts the requirement in paragraph 36. For example, if the auditor plans to evaluate the operating effectiveness of company-level controls that directly address relevant assertions associated with the financial statement amount reported for interest expense, is a walkthrough of the interest expense process required? This matter is particularly relevant in a multi-location environment where the auditor may evaluate the effectiveness of company-level controls executed at a regional level and find such controls to be operating effectively and at a sufficient level of precision, yet be required to visit individual remote locations solely to perform walkthroughs of significant processes at those locations.

Paragraph 50 of the proposed standard indicates that a walkthrough may be used as a procedure to test the operating effectiveness of controls. Paragraph 37 of the proposed standard outlines the objectives of a walkthrough as follows:

- Verify that the auditor has identified the points in the process at which significant risk of misstatement to a relevant assertion exists (i.e., risk assessment);
- Verify the auditor's understanding of the design of controls, including those related to the prevention or detection of fraud;

[1] See paragraph .08 of AU 313, *Substantive Tests Prior to the Balance Sheet Date,* and PCAOB Release No. 2007-001, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud*.

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- Evaluate the effectiveness of the design of controls; and
- Verify whether controls have been placed in operation.

It is not clear to us how the auditor performs risk assessment procedures directed toward determining the nature, timing and extent of other audit procedures to perform and, at the same time satisfies performance of those other audit procedures. In other words, it seems somewhat illogical for a risk assessment procedure to also serve as another audit procedure intended to respond to an assessed risk when the results of the risk assessment procedure are relevant to determining the nature, timing and extent of other audit procedures to perform. In order to reconcile this apparent inconsistency, we believe that the Board should acknowledge that the auditors' risk assessment may be concluded without performing a walkthrough.

Proposed Standard on Considering and Using the Work of Others in an Audit

We do not believe that extant AU 322 should be superseded by the proposed standard on considering and using the work of others. Further, we do not believe that the provisions of the proposed standard will result in measurable integrated audit efficiencies and may result in the dilution of audit effectiveness through the inappropriate use of the work of others in conducting an audit. We believe that extant AU 322, combined with the changes outlined in the Board's proposed standard on an audit of internal control over financial reporting, introduces the flexibility necessary to expand use of the work of others by auditors in an appropriate and responsible manner.

If the Board concludes that it will move forward with a final standard to supersede extant AU 322, we offer the following comments:

High risk of material misstatement or high degree of subjectivity. We note that the proposed standard does not include guidance currently in extant AU 322 relative to the auditors' ability to use the work of others where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high. In these circumstances, extant AU 322 indicates that the "internal auditors' work cannot alone reduce audit risk to an acceptable level to eliminate the necessity to perform tests…directly by the auditor." Paragraphs 21 and 22 of extant AU 322 illustrate this important concept and we recommend that these paragraphs be included in the Board's final standard.

Principal Evidence. We note that explicit reference to "principal evidence" has been eliminated from the Board's Proposals. Elimination of the principal evidence terminology, currently included in AS No. 2, could result in an expectation that the auditor no longer is required to obtain principal evidence to support his or her opinions. We believe that a fundamental tenet to expressing a reasonable assurance opinion on management's assertions involves the auditors' requirement to obtain principal evidence. In addition, we recognize that the determination of what constitutes principal evidence is not formulaicrather, it is a qualitative determination based on professional judgment. We believe that the fundamental concept of principal evidence was implicit in the Board's interim standards prior to the issuance of AS No. 2.

We do not object to the elimination of the terminology, "principal evidence," and acknowledge that paragraph 8 of the proposed standard indicates that the responsibility to report on financial statements and ICFR rests solely with the auditor. However, we believe that a final standard on use of the work of others should make it very clear, particularly in light of the verbiage in the Summary Memorandum (pages 23 - 24), that judgments about sufficiency of procedures performed and evidence obtained are *solely* those of the auditor, and caution against inappropriate use of the work of others in an audit.

Identification of relevant activities. Paragraphs 3 through 6 of the proposed standard describe the auditors' responsibility to determine whether there are activities performed by others that can be used in connection with the audit. We are concerned with the practicality and cost effectiveness of requiring the auditor to search for "relevant activities" performed by company personnel or others working under the direction of management or the audit committee.

Further, we believe that compliance with the provisions of these paragraphs likely will lead to unnecessary effort expended searching for activities significantly removed from those of internal auditors and similar groups described in AU 322 that, upon consideration, will not be useable due to competency or objectivity constraints, or do not represent tests that provide audit evidence as described in the proposed standard. In addition, we believe that management has a responsibility to adequately inform the auditor of those activities performed by management, or those under the direction of management, that may be relevant to the auditor. Accordingly, we believe that the auditor's obligation in the Board's final standard should be to consider whether there are activities performed by others that may be relevant to the audit.

If the Board decides to retain these paragraphs in its final standard, then we recommend that the discussion of competence and objectivity precede the consideration of relevant activities in order to more appropriately reflect the thought process of the auditor in considering the work of others.

Performance of substantive audit procedures. Auditing standards have long provided for use of the work of internal auditors in conducting a financial statement audit. AS No. 2 expanded this concept, for purposes of auditing the effectiveness of ICFR, to provide for the use of work of third parties and company personnel, other than internal auditors, working under the direction of management or the audit committee. We support the position in the proposed standard that tests of internal control performed by management and those under the direction of management or the audit committee may be used in conducting audits of financial statements (consistent with use of the work of others in an integrated audit). However, we believe that it is inappropriate to use the work of management and those under the direction of management or the audit committee for performance of audit procedures directed toward identifying financial statement misstatements (i.e., substantive audit procedures).

Auditors frequently use the work of internal auditors in performing substantive audit procedures in an audit of financial statements. Ordinarily, internal auditors are proficient in auditing, are well-versed in the relevant professional auditing and accounting literature and are subject to the internal auditing profession’s formal standards and code of conduct. We believe that proficiency as an auditor is essential to the performance of substantive audit procedures.

If the final standard provides for use of the work of management and others under the direction of management or the audit committee in the performance of substantive audit procedures, auditors may spend significant time evaluating the competence and objectivity of non-internal audit personnel and debating those conclusions with management, only to result in conclusions that these individuals lack competency and/or objectivity relative to the performance of substantive audit procedures. Accordingly, we recommend that the auditors’ use of the work of non-internal audit company personnel and third parties be limited to tests of controls.

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We fully support the Board's efforts to simplify the requirements associated with performing integrated audits and focus the auditors' attention on matters most important to internal control over financial reporting. We share the Board's goal of enhancing auditors' effectiveness and efficiency in conducting an integrated audit, without diluting investor protections. If you have any questions about our comments or other information included in this letter, please do not hesitate to contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or Craig W. Crawford, (212) 909-5536, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP

cc: PCAOB Board Members

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Mr. Conrad Hewitt, Chief Accountant – SEC
Mr. John W. White, Director, Division of Corporation Finance - SEC
Dr. Zoe-Vonna Palmrose, Deputy Chief Accountant for Professional Practice - SEC

Appendix

The following comments and other suggestions considered less significant or editorial in nature are presented for your consideration.

Proposed Auditing Standard – *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*

Scoping Matters

1 We believe that the proposed standard appropriately incorporates the value of cumulative knowledge by enabling the auditor to consider the results of previous testing in performing risk assessments. We also fully support the Board's decision to not permit rotation of testing of controls and to emphasize effectively altering the nature, timing and extent of related audit procedures.

2 The term "significant process" as used in the context of performing walkthroughs is not adequately defined in the proposed standard. We believe that walkthroughs should be performed at the level necessary to understand the flow of major classes of transactions captured in the financial statements. Introduction of the term "significant process" implies that walkthroughs may be performed at an aggregated level, consolidating major classes of transactions that are subject to varying processes and controls. We believe that major class of transaction flows that are subject to the same processes and controls may be consolidated in performance of a process walkthrough and that this concept should be clarified in the final standard.

Evaluation Matter

3 "Restatement of previously issued financial statements to reflect the correction of a misstatement" is one of the strong indicators of material weaknesses in paragraph 79 of the proposed standard. We recommend that the indicator refer to "material misstatement" or, alternatively, commentary be added to address restatements of previously issued financial statements that result from immaterial error corrections that might occur under the provisions of SEC Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*.

Reporting Matter

4 Paragraph C6 of the proposed standard indicates that "[t]he auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion." We are unclear as to whether the guidance in paragraph C6 would permit the auditor to issue a report disclaiming an opinion on internal control if the auditor is able to conclude, without having performed any procedures, that a scope limitation will prevent the auditor from obtaining

reasonable assurance necessary to express an opinion. We believe that this paragraph should be clarified to address this possibility.

Proposed Auditing Standard – *Considering and Using the Work of Others in an Audit*

1. AU 322.27 in the PCAOB's interim standards includes the following guidance regarding direct assistance:

   > The auditor should inform the internal auditors of their responsibilities, the objectives of the procedures they are to perform, and matters that may affect the nature, timing, and extent of audit procedures, such as possible accounting and auditing issues. The auditor should also inform the internal auditors that all significant accounting and auditing issues identified during the audit should be brought to the auditor's attention.

   We believe this guidance is helpful and pertinent and should be retained in the Board's final standard.

2. Paragraph 21 of the proposed standard states, "[w]hen direct assistance is provided, the auditor should supervise, review, evaluate, and *test* the work performed by others as described in AU sec. 311, *Planning and Supervision*" [emphasis added]. AU 311 specifically addresses supervision and review, and implicitly addresses evaluation, but does not, implicitly or explicitly, address *testing* others' work. Therefore, it appears that there is no requirement in the proposed standard to test the work performed by others in a direct assistance arrangement.

   Paragraph 27 of extant AU 322 indicates that, "[w]hen direct assistance is provided, the auditor should assess the internal auditors' competence and objectivity (see paragraphs .09 through .11) and supervise, review, evaluate, and *test* the work performed by internal auditors to the extent appropriate in the circumstances" [emphasis added]. We believe that the provisions of the proposed standard do not appropriately address testing the work of others in a direct assistance arrangement and that the auditors' requirement to test the work of others in such arrangements should be explicitly referenced in the final standard.

3. Paragraph 15 of the proposed standard indicates that, in assessing the objectivity of others performing tests, the auditor should consider "[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." While we believe compensation is an appropriate factor to consider relative to objectivity, we recommend that the Board provide further guidance regarding its related expectations. For example, guidance regarding the following would be helpful:

   - the types of compensation arrangements that may be problematic;

- whether participation in such arrangements should be considered in conjunction with all other factors relative to objectivity; and
- the nature of compensation arrangement policies designed to maintain objectivity auditors should consider.

Proposed Rule 3525 - *Audit Committee Pre-approval of Services Related to Internal Control Over Financial Reporting (Proposed Rule)*

1. Proposed Rule 3525 requires the auditor, among other things, to "describe, in writing, to the audit committee of the issuer the scope of the service." We recommend that auditors be required to describe the nature as well as the scope of the internal control services to be provided and the related proposed fee arrangement. These changes would align the requirements of Proposed Rule 3525 with the Board's requirements for disclosures and related discussions with a client's audit committee regarding the pre-approval of tax services in accordance with PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services* (Rule 3524).
2. We suggest that the Board consider establishing a transition period for audit committees that pre-approve services on the basis of policies and procedures. Such a transition period would facilitate orderly implementation of this Proposed Rule and would be consistent with the provisions of Rule 3524.

Auditing and Related Professional Practice Standards – *Proposed Amendments to PCAOB Interim Standards*

1. The note to paragraph 65 of AU 319, *Consideration of Internal Control in a Financial Statement Audit*, should be deleted to conform to the PCAOB's proposed change to paragraph 83 of that standard.
2. The reference to AS No. 2 should be replaced with a reference to PCAOB Proposed Auditing Standard, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements, in paragraph 11 of AU 332, *Auditing Derivative Instruments*, and in the footnote to paragraph 1 of AU 380, *Communication with Audit Committees*, to be consistent with other proposed amendments.
3. We concur with the Board's proposed amendment to AU 530, *Dating of the Independent Auditor's Report*, that would require the auditors' report to be dated no earlier than the date on which the auditor has obtained sufficient competent evidential matter to support the opinion. We recommend that the Board provide guidance regarding when sufficient competent evidential matter has been obtained by adding the following sentences after the first sentence of paragraph 1 of AU 530:

    Among other things, sufficient competent evidential matter includes evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that it has taken responsibility for them. This will ordinarily result in a report date that is close to the report release date.

We believe that this modification will promote consistency in dating of independent auditors' reports.

In addition, we recommend that paragraph 9 of AU 333, *Management Representations*, be revised, in part, as follows, "the [written] representations should be made as of the date of the auditor's report," to conform with the proposed amendment to AU 530.

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From: Matthew Leitch [m.leitch1@ntlworld.com]
Sent: Thursday, January 25, 2007 10:54 AM
To: Comments
Subject: Docket 21

Here are some observations and suggestions applying to both the draft guidance from the SEC and the draft AS2 from the PCAOB.

1) Quantitive vagueness

Despite the new guidance the amount of work needed by companies and their external auditors, and the assessment of controls reached, will continue to depend on negotiation rather than definition.

The guidance writes as if COSO's internal controls framework defines effective control, but it does not. It lists things to consider, but it does not quantify what should be in place in such a way as to provide a definition.

It is analogous to defining a "Long" piece of string without ever saying exactly how long a piece of string has to be to be considered "Long". Trying alterative phrases and referring to existing pseudo-definitions does not solve the problem.

This is consistent with the conventional approach of external auditors, but there are examples of regulatory regimes that have defined such things as billing accuracy using precise numbers, showing that it can be done using well known statistical techniques.

Progress should be made towards quantifying the requirements.

2) Technically narrow guidance

The guidance explicitly calls for assessing two things: (a) the design of the control system, and (b) the operating effectiveness of controls within it. Operating effectiveness is considered one control at a time and focuses one whether the control is being carried out as originally designed.

While these assessments are relevant and likely to form a part of any competent evaluation there are other approaches that can be used as well and are used by sophisticated companies and their auditors. The drafts as they stand leave sophisticated companies and their auditors with the impression that some of their most useful techniques are ignored or even contrary to the official requirements.

Other approaches that can be useful, and highly efficient in the right circumstances, include:

* Putting test transactions through a system and measuring the error rate.

* Collecting and analysing figures on discovered errors and backlogs.

* Testing the reliability of those figures using analytical tests.

* Gathering evidence to confirm initial views about inherent risk levels. (E.g. if inherent risk from

software changes is thought to be low this can be confirmed by looking at records of software changes or comparing files.)

In addition, the guidance describes an approach that is intended to be top down and risk focused, but only achieves that to a limited degree. Again, people who have already learned to employ more whole-heartedly risk focused, responsive methods could feel their skills are ignored or contrary to the requirements. For example, before 2002 PricewaterhouseCoopers adopted an audit approach globally called “Towards Performance Audit” that involved continuous planning throughout the audit as teams shared the results of every meeting and set of tests, as input to planning the next steps.

The methods of more sophisticated companies and auditors should at least be recognised and given approval in some way, even if detailed guidance is not feasible. This would allow and even encourage people to move towards more effective and efficient evaluations.

3) Attestation on management’s assessment

Before 2002 external audit firms assessed internal controls to the extent that they thought it a contribution towards more efficient auditing of financial statements. The major value of sections 404 and 302 was to focus on what *management* should be doing.

Removing the requirement for auditors to comment on management’s evaluation lessens the focus on management’s activities and cements the idea of an external audit of ICFR.

Now is the time to reconsider the case for an external audit of ICFR. Over the last two years it has become increasingly clear that management have access to information that external auditors do not have, and can therefore put in place an efficient, integrated evaluation as part of normal monitoring activities.

Just asking the external auditor to audit ICFR directly is asking the auditor to do something that has never seemed worthwhile in the past. However, asking the auditor to review management’s evaluation is quite different because of the special qualities of management’s evaluation and the importance of getting management to do things themselves.

Far from taking the focus off management’s evaluation we should be increasing the focus on it and removing the requirement for an external audit of ICFR.

Matthew Leitch
Independent consultant and researcher
United Kingdom

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February 2, 2007

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

Ref: PCAOB
Rulemaking Docket Matter No. 021

Dear Sir:

I have reviewed your latest auditing standard proposals. I currently work with two SEC registrants, mainly in an advisory capacity to assist them to set up internal management processes that will allow them to carry out an effective evaluation of their control processes. I also work with several Canadian public companies that are establishing management control evaluation processes to meet the latest Canadian regulations.

I use your standards as guidance in advising my clients on their internal processes. Many of your proposals will be effective in changing some of the difficulties that both external auditors and management teams are encountering with the existing standards. I do not act as an external auditor. Yet my comments refer to the part of your proposals that change the scope of the external auditors' report. I believe the latest proposals have missed the point of having an external auditor examine and report on these matters.

With respect to the auditors' role in evaluating and reporting on internal controls in a separate report, other than the financial audit report, I believe it was the intention of the Sarbanes Oxley Act to ensure that management's evaluation of controls was based on a process which could be substantiated and which provided appropriate evidence for management to make their conclusions.

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

I cannot agree with this, as I feel it is entirely the point to involve external auditors to evaluate management's process, and to report on whether the process was sufficiently valid to support management's conclusion. I do not think the auditors need to repeat management's work to be able to conclude on whether it is a sufficient and appropriate basis for management's conclusions or not. A certain amount of testing is required in order to evaluate effectiveness, but it should be a subset with the intention of evaluating the process, not for re-auditing controls as a second exercise. Yet the standard still requires the auditor to test controls and give an opinion, which is what the Act requires management to do already.

Furthermore, the audit report that is suggested in the standard still states "...We also have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X8, based on...". This statement definitely gives the impression that the audit was of management's assessment of an effective control environment, not a separate audit of controls.

The report then goes on to state, "Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits." This is contradictory to the first statement. Is the audit to express an opinion on management's assessment of an effective control environment, or is it an opinion on the company's internal control over financial reporting?

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

The direct answer to your question is yes, it is possible. Again, I do not believe the point was for the auditors to do an internal control audit. The point was to evaluate management's basis for evaluation of its own controls. In the same way that a financial auditor tests management's financial statements, based on testing and sampling, rather than reperforming all transactions. In order to add value to the reader of management's evaluation report, the auditor should attest on management's process of evaluation, and whether it supports the evaluation itself. The important point is – does management have sufficient basis and evidence to draw the conclusions it has reported, or is it likely that their process is flawed and would not have uncovered a material weakness?

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?

I have already stated under question #13, that I believe the proposed auditor's report is contradictory and unclear as to what opinion is being expressed. The scope and results are not clear, but I would like to take this further.

Presumably management is taking steps, above and beyond its daily management activities, in order to perform an evaluation of its control effectiveness and to meet its obligation under the Act. While there are no standards that management is obliged to follow, presumably most are attempting to perform a valid, professional exercise which will obtain sufficient evidence to support their conclusions. While it is not independent, management is generally trying to achieve an auditors' level of evidence. The SEC has given guidance to management, and many managers are also using the audit standards of the PCAOB and other professional standards to design their assessment programs.

In effect, under your proposal, what will happen is that both management and the external auditor will perform an audit of controls.

Both audits could in fact arrive at the conclusion that there are no material weaknesses in controls. In fact, we would expect that this will happen in the majority of cases. What is the benefit of having two such reports?

Consider the following possibility. The external auditor's conclusion, after testing controls according to professional auditing standards, is that there were no material weaknesses found and controls are effective. At the same time management has made the same conclusion, but without actually gathering any, or gathering much less, persuasive evidence to support its conclusions.

Since the auditor's conclusions are based on testing it is probable that their tests were appropriate and and supportable, and their conclusions were correct according to professional standards. Yet at the same time management's conclusions were not based on a rigorous process or evidence. Under the new standards what would the auditor have to say about this? It appears to me that nothing would be reported publicly, although the auditors may inform the audit committee.

Also consider the situation where the auditor has discovered a material weakness based on testing, but management had not identified this weakness. Consider also that management's failure was due to a poor evaluation process, rather than say a different test sample. The poor evaluation process may extend to other control areas where no weaknesses were found by the external auditor. The auditor will report publicly on the material weakness found, but not report on management's weak assessment process?

Wouldn't the reader of the certifications want to know whether management had any or sufficient evidence to support its conclusions? I propose that this is in fact the only useful information that the reader wants from the auditors. They do not want the auditors to repeat what they are expecting management to do correctly the first time.

Similarly, what role does the auditor play in evaluating and reporting on management's risk assessment? In order to perform its audit of controls, your standard requires the auditor to evaluate risk and test controls related to its risk assessment. It does not state what would happen if the auditor feels there is a major risk factor that management has not considered to be a major risk factor, or for which management has not tested related controls. The standard requires the auditor to determine whether controls exist to address this risk, and if so, to test those controls. If the auditor does audit these controls, and finds that the controls are effective for that period, does it not have any obligation to identify this difference it has with management's risk assessment?

Lastly, what would happen if management gives a clean assessment of its controls, and the auditor performs its own tests of controls, and also gives a clean opinion, yet a major weakness is uncovered later, possibly leading to a re-statement. If management has essentially performed a poor or minimalist evaluation process, and this was "vindicated" by a proper audit, then management's process has essentially been given a clean bill of health when it should not have been. What basis will the SEC or the courts have to find against management? The auditor will be able to protect itself by showing that its audit of controls was done according to professional audit standards. Management will claim that its processes resulted in the same conclusion as the auditors', and that while a different method was followed, they had no reason to believe their method was faulty or inappropriate at the time.

I view the auditor's role in this process as similar to a professional standards audit that the PCAOB might perform on an auditing firm. The PCAOB would check whether professional standards were followed and that there was sufficient evidence of the process followed by an audit firm in arriving at their audit report. You would not reperform the audit itself to any great extent. To my mind, it is the auditor's role to challenge, test and report on management's methods of performing its evaluation that is the important value-add for the readers.

In the case where management has performed a credible, evidence based evaluation of its controls, having a second report stating the same thing is a waste of time and money, and tells the reader nothing. But giving the reader an opinion that management's certification is based on a credible process is worthwhile, whether management issues a clean opinion or otherwise.

An Alternative Approach

There is an alternative to all of this but it would require changes to the Act as well as to the auditing standard. That alternative would be to remove the responsibility of management to audit and evaluate their own control systems. Then require auditors to perform tests of controls over high risk accounts as part of the financial statement audit. Remove the professional judgement possibility of auditors to rely on substantive testing alone, and require that control testing be performed in all financial statement audits. Auditors would then be required to define risk, in conjunction with management, and to conduct appropriate professional testing of controls related to those risks. Management would still certify that they are responsible for assessing risk and for designing and implementing appropriate controls. In this way audits and opinions are done by professional auditors, but the entire responsibility for all aspects of financial statements, including controls, clearly rests with management.

I believe that this approach would substantially reduce overall cost as well. The scope of a financial audit would be increased but not exceptionally. Costs of an audit would be higher than they would have been prior to Sarbanes Oxley, but less than the current approach. The evaluation efforts of management would be reduced, although control systems would still have monitoring systems in place that could be audited. A separate evaluation exercise by company staff would likely be avoided, and the emphasis would be on proper design and daily execution of controls, where it should be.

In this case your new standard could almost stand as is, except for removing the words "We also have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting". This would be replaced by "We have also audited W Company's effective internal control over financial reporting…"

I believe that many readers of financial statements are still unclear as to the possibility that an auditor could, in the past, give an audit opinion on financial statements without in fact testing internal controls. Your proposal of a new combined audit report makes it fairly clear that auditors can no longer do this, at least for large public companies. But we could make it more clear, if the Act itself didn't create confusion by having both management and auditors responsible for proving and certifying that controls are effective.

This suggestion might be complicated by any structure that has separate reporting standards for companies of various sizes. However I also believe that the extent of audits of controls can be different for companies of different sizes, and you have efforts underway to support this. So long as all public companies are required to have an external audit of their financial statements I don't see why audits of controls could not be included, given appropriate guidance for relative size and complexity.

Management of smaller companies have already been certifying their statements, short of a separate evaluation process. We could just stop the progression entirely, at the stage they are now at, and put the responsibility for auditing onto the auditors. Then do the same for larger companies.

I hope that these comments are helpful.

Sincerely,

Christopher Loucks, CA

From: Paige Easley [mailto:paige.easley@gmail.com]
Sent: Sunday, February 25, 2007 10:33 PM
To: Comments
Subject: Comments on proposed standard

Dear Sir or Madam:

After reading "PCAOB Release No. 2006-007, December 19, 2006", I would like to make a few comments.

Overall I agree with the changes that are suggested, specially the risk based approach for companies and the understanding that smaller companies may have different risks.

I have two areas of concern that were not mentioned in the release, they are:

- A base set of standards (for both IT and Finance) should be published by the PCAOB
- That the idea of point of time review should be reviewed to include those failures in controls though out the year should be counted as a deficiency even if it has been remediated.

Base set of standards - I realize that not all controls are key controls and not all key controls would be key controls for all companies. But, I would put forward that there are several key IT and Finance controls that would always be key for any organization and thus the PCAOB should outline them just as the OCC and OTS does for the banking industry. Examples of these type of key controls would be passwords on all in-scope IT applications and review of and balancing of financial information.

Point-in-time - In conversation with both the SEC and PCAOB representatives I have been told that the SOX audit is a point-in-time audit and even if a controlled had failed earlier, if it had been remediated and then tested successfully you would not note the earlier failures and there would be no deficiency. I disagree strongly with this presumption that the SOX audit should only be a point-in-time and these corrected deficiencies should not be part of the final report or used in determining control effectiveness. Thus, a company's key financial system could have had no passwords, logging, reviewing of infractions for the first half of the year, then be remediated and passed because passwords were turned on the second half of the year. The sample sizes used to determine operating effectiveness are not large enough to find any type of fraud, material mistakes when there is the ability to delete transactions without a trace, be the requester, approver and reviewer of a single transaction, to have anonymous abilities to enter, change or delete data without a trace can not be ignored. I propose that when deficiencies are found in a key control, it will be reported on and used in determining the overall risk at the end of the year, even if it has been remediated. I have found that second and third year companies are the ones most likely to completely ignore the control set for the first half of the year and then only in response to the internal audit review do they take any action to remediate the key control that was noted as deficient.

You ask in question number 6 "Would the performance of a walkthrough be sufficient to test the design and operation effectiveness of some lower risk controls". I would say no, since in my experience what I have been told in a walk through is often not what occurs. What I would suggest is that for low level risks that the sample size be made much smaller (in the 3 to 5 range).

Your comment about "Auditor's Attention Towards the Most Important Controls" is justified, but I would go farther in stating that the attestation auditor must provide a risk analysis showing why they have added key controls that the company being audited for compliance had not identified. The reason I believe this is important is that every single attestation firm as given me a list of controls and told me they were key without ever do any risk ranking to determine if the controls are truly key, important or even exist.

Thank you for your time.

Paige M. Easley
Partner
LP Risk Services, Inc.

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LUBRIZOL

Fluid technologies for a better world™

The Lubrizol Corporation
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February 21, 2007

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2893

Subject: PCAOB Rulemaking Docket Matter No. 21
Proposed Auditing Standard – *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements And Related Other Proposals*

Dear Board Members:

On December 19, 2006 the Public Company Accounting Oversight Board (PCAOB) issued Release 2006-007 proposing a new auditing standard entitled "An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements." The proposal would change the rules governing external auditor responsibilities under the Sarbanes-Oxley Act of 2002 Section 404 (SOX 404). At the same time, the Securities and Exchange Commission (SEC) proposed Release 33-8762 to clarify responsibilities for the related management assessment of internal control. These proposals have been exposed to public comment through February 26, 2007 after which they may be adopted by the PCAOB, approved by the SEC and supersede present requirements. The Lubrizol Corporation is pleased for this opportunity to share with you our feedback regarding these two proposals.

The Lubrizol Corporation is an innovative specialty chemical company that produces and supplies technologies that improve the quality and performance of our customers' products in the global transportation, industrial and consumer markets. We are headquartered in Cleveland, Ohio and are geographically diverse, with an extensive global manufacturing, supply chain, technical and commercial infrastructure. We operate facilities in 29 countries through the efforts of more than 6,700 employees. Our consolidated results for the year ended December 31, 2006 included total revenues of $4.0 billion.

The Lubrizol Corporation was defined as an "accelerated filer" to whom the provisions of SOX 404 and AS2 have been applied for the past three years. During this period, management has tested 828, 1,178, and 1,518 key controls in the fiscal years ended in 2006, 2005 and 2004, respectively. Additionally, our external auditors have reviewed and reported on management's assessment each year, including a review of all of these controls as required by SOX 404. The costs of SOX have been substantial to our company. External audit fees associated with SOX 404 work has resulted in increased audit fees of approximately 77%.

We continue to support the spirit and intent of the Sarbanes-Oxley Act. There have been several positive impacts with regard to our implementation of SOX 404 including the improvement of our documentation of policies and procedures and accountability across the organization relating to the financial reporting process. However, we continue to incur significant costs, both internal and external, to fulfill the requirements of SOX 404. As a result, we generally support the PCAOB and SEC recent proposals as they should help alleviate some of the burden and costs on registrants without compromising the intended benefits.

We believe the PCAOB proposed standard and the SEC proposed guidance provide a framework for implementing a top-down, risk-based approach. They have identified the approach including the focus on entity level controls, the identification of significant accounts and a risk-based selection of controls for testing. Additional emphasis has been given to entity-wide and company-level controls, especially those that can be linked directly to financial statement elements. The guidance would allow our company to place greater reliance on entity-wide and company-wide controls and reduce the number of key controls at the process level. This in turn would reduce the time and effort required to support management's assessment of internal controls. We agree there should be no requirement to identify every control in a process or to document every operating activity affecting internal control over financial reporting. We also believe this should result in reduced efforts and costs by our external auditors in evaluating internal control over financial reporting. We support the proposal to remove the requirement of the external auditor to evaluate management's process of evaluating internal controls over financial reporting.

Question 9 included in the PCAOB proposal asked "Should the guidance be issued as an interpretation or should it, or any part, be codified as a Commission rule?" As a result of this proposed standard, we believe we should be able to reduce the amount of documentation and testing that supports the internal control assessment for our company. We also believe that our external auditors should be able to increase their reliance upon management's work, assuming that the work is performed and documented to the level of detail required by the external auditor. However, we cannot control the interpretation of the recently issued guidance by the major public accounting firms and therefore will continue to perform and document our assessment to the level of detail required by our external auditor. For this reason, we request that any new internal control standard be issued as codified rules instead of interpretive guidance. The recently issued proposal is consistent with interpretive guidance issued by the SEC in May, 2006. Unfortunately, we believe the public accounting firms have hesitated to agree with the prior guidance and unnecessary time and effort continues to be spent documenting processes or testing controls that were unlikely to assist in detecting a material misstatement in a company's financial statements. We believe that the issuance of codified rules would help promote consistency and interpretation among public accounting firms.

Question 18 included in the PCAOB proposal asked "Will the proposed standard's approach for determining the scope of testing in a multi-location engagement result in more efficient multi-location audits? Both the PCAOB proposed standard and the SEC proposed guidance state that the multi-location testing requirements should be based upon risk rather than coverage. The provision requiring testing of controls over a large portion of the company would be eliminated. Previously entities were segregated into three categories: locations that are individually significant or involve specific risk, locations that are significant only when aggregated with others and locations that are insignificant individually and in the aggregate. We believe an insignificant entity automatically translates to a low risk of material financial misstatement to the company as a whole. We also believe that unless there are specific identifiable risks at a location, no additional controls or testing is deemed necessary. However, there could be additional qualitative or quantitative characteristics that should be used to determine the proper strategy for auditing multiple locations. The guidance is unclear as to how to apply this change and therefore we believe further guidance is needed.

The PCAOB proposal allows the consideration of knowledge obtained during previous audits, stating that after the first year's audit of internal control the auditor should be allowed to reduce the nature, timing and extent of testing based on his or her cumulative knowledge related to individual controls. However, the proposal specifically states that audit rotation of areas is not allowed. These statements appear to be in conflict. The approach outlined suggests three factors be considered including the nature, timing and extent of procedures performed in prior years; the results of that testing; and any changes in the control or its related process since the last audit. If an area is tested in year one and no deficiencies are identified from the testing, could the auditor continue to rely on this knowledge for one, two or even three years if no substantive changes to the process have occurred during the subsequent periods? Would the completion of an annual walkthrough be considered sufficient evidence of operating effectiveness? How long would an auditor be able to carry forward the prior knowledge obtained during an audit? Management would need to make some assumptions in these areas, which for all practical purposes would result in audit rotation. We believe the guidance is unclear as to how to apply this change and therefore we believe further guidance is needed.

In order for the external auditors to accept management's risk assessment, the risk assessment will need to be adequately documented along with the conclusions reached. There will need to be a well-developed, rational analysis of financial risks and documentation of assumptions. Although there is no official answer as to what this analysis should look like when completed, we believe both the PCAOB and SEC proposals give management adequate guidelines and room for interpretation in developing their risk assessment. Management will be able to design controls and conduct an evaluation that is tailored to their individual company circumstances. However, the results of the risk assessment will require ongoing discussions with the external auditor to ensure acceptance of management's conclusions.

The proposed guidance also allows for management and the external auditor to have different testing approaches. If management elects to use one testing approach and the external auditors select another and the results of testing produce differing conclusions, how is that difference to be reconciled and disclosed? Management might conclude that there is no deficiency while the auditors might conclude differently. Additional guidance on this situation would be appreciated.

The PCAOB also issued a proposed auditing standard on the external auditor's consideration and use of the relevant work performed by others. The large accounting firms still seem to be hesitant to rely on the work of others in certain areas, such as in the reviews of general controls and information technology. We request additional guidance be issued on how the work of others could specifically alter the nature, timing or extent of the external auditor's work. This could include how much retesting of the work of others would be required along with specific identification of areas where reliance would be acceptable.

In summary, we agree with the two overriding principles defined in the PCAOB and SEC proposals as summarized below:

1. Management should evaluate the design of the controls to determine whether they adequately address the risk that a *material* misstatement in the financial statements would not be prevented or detected.
2. Management's evaluation of the operation of its controls should be based on its assessment of the risk associated with those controls.

We believe the adoption of the proposed guidance would serve its intended purpose to tailor the audit of internal control to a company's individual circumstances, to focus the auditor's testing to the most important controls and to eliminate unnecessary auditing procedures. We request that any new rules or guidance by the PCAOB or the SEC be issued within sixty days after the end of the comment period to allow companies to realize the benefits of the changes in 2007. Thank you for the opportunity to offer our comments regarding the PCAOB and SEC proposals. We would be pleased to discuss our comments or answer any questions you may have.

Sincerely,

W. Scott Emerick

W. Scott Emerick
Corporate Controller and Chief Accounting Officer

MANAGED FUNDS ASSOCIATION

February 26, 2007

VIA ELECTRONIC MAIL:

rule-comments@sec.gov

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

comments@pcaobus.org

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

Re: SEC File No. S7-24-06;
PCOAB Rulemaking Docket Matter No. 021

Ladies and Gentlemen:

Managed Funds Association ("MFA") appreciates the opportunity to make this submission of comments to the: Securities and Exchange Commission's ("SEC") proposed interpretation and rule on "Management's Report on Internal Control Over Financial Reporting" ("Proposed Management's Guidance");[1] and the Public Company Accounting Oversight Board's ("PCAOB") proposed auditing statement, "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements," ("AS5") and related proposals "Considering and Using the Work of Others" and "Audit Committee Pre-Approval of Services Related to Internal Control" (together, referred to as "Proposed Auditing Guidance" and with Proposed Management's Guidance, referred to as "Proposed Guidance") that would supersede Auditing Standard No. 2 ("AS2").[2]

We commend the SEC and PCAOB's efforts to provide prospective guidance and rules under Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX 404") that takes a top-down, risk-based evaluation approach. We believe the Proposed Guidance provides a more pragmatic and cost-effective approach to compliance with SOX 404. Nevertheless, we believe further clarity and flexibility is necessary in the SEC and PCAOB's final interpretive guidance and rules under SOX 404 ("Final Guidance"). We respectfully request that Final Guidance provide further clarity and flexibility in certain areas, as discussed below, and take the unique position of public commodity pools ("Pools") into

[1] Securities Act Release No. 8762 (Dec. 20, 2006), 71 FR 76580.

[2] PCAOB Release No. 2006-007 (Dec. 19, 2006), Docket Matter No. 021.

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consideration. We believe such guidance will go a long way in building value for investors without hampering the long-term competitiveness of U.S. capital markets.

Introduction

MFA is the leading U.S.-based membership organization dedicated to serving the needs of professionals who advise, manage and operate commodity pools, as well as hedge funds, and funds of hedge funds. MFA has over 1,300 members, including professionals who manage a significant portion of the estimated $1.5 trillion invested in these alternative investment vehicles globally. Among the MFA membership are commodity pool operators and commodity trading advisors. As public commodity pools are subject to the requirements of SOX 404, our members have a keen interest in the development of prospective interpretations and rules under SOX 404.

Public commodity pools are regulated by the SEC, Commodity Futures Trading Commission ("CFTC"), National Futures Association ("NFA"), and the National Association of Securities Dealers ("NASD"), and are subject to both substantive and disclosure requirements under various state blue sky laws. MFA respectfully requests that the SEC and PCAOB, in issuing prospective interpretation and rules under SOX 404 consider the unique position that public commodity pools find themselves in as "net asset value"-based entities with multiple regulators and different corporate structures than most public companies.[3] In terms of staffing and resources, many Pools also face similar issues and concerns as smaller public companies.[4] Accordingly, we respectfully request that guidance extended to smaller public companies be extended, as applicable, to Pools.

Comments

We support and appreciate the SEC and PCAOB's efforts in providing a principles-based approach to compliance with SOX 404. We believe a top-down, risk

[3] While we believe that commodity pools, like investment companies, should be exempt from Section 404, as set forth in our September 18, 2006 letter to the Commission on the Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting (File No. S7-11-06), we restrict our comments in this letter to issues raised in the Release. For more information on commodity pools and their regulatory requirements, please see our September 18, 2006 letter.

[4] The Commission's Advisory Committee on Smaller Public Companies ("Advisory Committee") raised a number of concerns regarding the ability of smaller public companies to comply cost-effectively with SOX 404 in its Final Report to the Commission. Two of the characteristics the Advisory Committee focused on that create unique differences in how smaller companies achieve effective ICFR that may not be adequately accommodated in current SOX 404 implementation guidance, which we believe are applicable to many Pools include: (1) the limited number of personnel in smaller companies, which constrains the companies' ability to segregate conflicting duties; and (2) top management's wider span of control and more direct channels of communication, which increase the risk of management override.

Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (hereinafter "*Final Report of the Advisory Committee*") (April 23, 2006) at 35-36, available at: http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

based approach is an effective and practical way for management and outside auditors to fulfill their respective obligations regarding reports on internal controls over financial reporting ("ICFR"). Most importantly, we believe that by focusing management and auditors on the matters most important to internal control, the Proposed Guidance promotes a cost-effective method of compliance with SOX 404.

Still, we believe the Proposed Guidance needs to provide further guidance to entities with special characteristics and constraints, such as Pools and smaller public companies, as to how they may comply with SOX 404 within their structural frameworks. Pools and smaller public companies need more guidance as to how, in practice, the Proposed Guidance may be "scalable" and appropriately tailored to their businesses.

1. Guidance to Commodity Pools

Just as the Proposed Guidance takes a more flexible approach and recognizes the constraints of smaller public companies, we believe that a principles-based approach will also provide more flexibility to Pools when it comes to ICFR. Nevertheless, as "net asset value"-based entities, Pools have some inherent differences from public companies, which can make compliance with the Proposed Guidance disproportionately more difficult. We hope the SEC and PCAOB in promulgating, as well as implementing, rules and guidance under SOX 404, will take into consideration the unique differences, characteristics, and constraints of Pools. We are concerned that without this flexibility, the overly burdensome expense of SOX 404 compliance, will weaken the competitive stance of Pools' against alternative investment vehicles not subject to SOX 404, and diminish their overall contribution to the U.S. capital markets.

a) Pool Characteristics

The internal controls employed by Pools and their operators in connection with Pool financial reporting are rigorous, effective and wholly adequate to the business operations of Pools.[5] At the same time, they do not conform to the governance structure contemplated by SOX 404 and, more specifically, the internal control framework published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO Framework), which provides the fundamental model for SOX 404

[5] Pools trade highly liquid assets in a world of daily, marked-to-market settlements, the bulk of their assets are held at banks, futures commission merchants ("FCM"s) and securities dealers, i.e., entities subject to regulatory oversight, and their operations are fully summarized in daily brokerage and account statements. Pool operators tend to rely to a large degree on "tone at the top" and other high-level monitoring approaches to control, along with some segregation by function giving consideration to the size of the Pool operator's staff. Pool operators generally hire external administrators to perform functions, such as accounting.

Further, many Pools have SAS 70 exams conducted and provide such reports to their customers to demonstrate that the Pool has undergone an in-depth audit of their control activities by independent auditors. *See supra* note 12 and accompanying text.

compliance. Pools have no directors, officers or employees, let alone independent directors. In this respect, Pools differ from mutual funds and smaller public companies, which have boards and directors/officers. Pool operators, many of which are smaller privately held corporations or limited liability companies, serving as the Pool's general partner or equivalent, are generally managed by their ownership without independent directors. The SEC has already excluded asset-backed issuers from the rules implementing Section 404 in part due to the governance structures of those entities.[6]

In addition, the Pools' net asset value structure makes the burden of compliance more onerous than in the case of other public companies. If an operating company were to pay $1 million to achieve SOX 404 compliance, it is unclear how that expenditure will affect the value of such company's stock.[7] In the case of a Pool, that $1 million expenditure directly impacts the bottom line, reducing the net asset value of investors' holdings dollar for dollar.[8] We would also like to point out that while accurate Pool financial reporting is relevant to Pool investors for a variety of reasons, the integrity of Pool financial reporting controls is not relevant to any "market." Pools generally issue securities that do not trade in any market[9] and which, accordingly, cannot be the subject of manipulation. Accordingly, and not surprisingly, Pool investors and prospective investors do not typically analyze a Pool's financial statements to assess the appropriateness of the Pool's per unit value or the future prospects of the Pool. Pool investors are much more interested in monthly and annual rates of return, which the CFTC requires Pool operators to provide, together with a statement of income (loss) and a statement of changes in net asset value for the current period, to the investor on a monthly basis.[10]

b. Guidance Considering Pools

Internal controls are, of course, crucial regulatory compliance tools to the extent they are properly applied to an issuer. However, "[t]he primary objective of internal control over financial reporting requirements should be the prevention of materially

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[6] *See* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238, 68 FR 36,648 (June 18, 2003).

[7] *See* CRA International Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update, at 1.

[8] Section 2(b) of the Securities Act of 1933 mandates that whenever the SEC engages in rulemaking, it is required to consider whether the action will promote efficiency, competition and capital formation. *See* Peter J. Wallison, *Buried Treasure: A Court Rediscovers A Congressional Mandate the SEC Has Ignored,* AEI Online (Oct. 2005).

[9] Exchange traded Pools are index funds, the components of which are futures contracts the "trading" of which is completely driven by published rules. These ETFs report both the net asset value of the indices and the net asset value of the funds several times each minute.

[10] 17 CFR 4.22(a).

inaccurate financial statements; companies operate differently, depending on size, and internal control rules should reflect this fact; and the benefits of any regulatory burden—Section 404-related or otherwise—should outweigh the costs."[11] We believe the simplicity of the Pools' operations as "net asset value"-based entities engaged solely in trading activities, should likewise, translate into a more simplified assessment of ICFR.

The SEC and PCAOB have indicated that rules and guidance under SOX 404 are meant to be scalable. We believe, however, that the draft regulations do not go far enough in providing practical and scalable guidance for many Pools and smaller public companies.

(i) Proposed Auditing Standard: Considering and Using the Work of Others

The PCAOB's "Considering and Using the Work of Others" proposed auditing standard allows auditors to rely on the work of others, such as internal audits conducted by an independent audit committee or personnel. However, given their size, management is often more intimately involved in the day-to-day operations at many Pools and smaller public companies. We understand that in instances where management reports directly to those who sign the issuer's financial attestation, as is the case at many Pools and smaller public companies, the less outside auditors are able to rely on management's work product. For many Pools and smaller public companies, this translates directly into <u>greater</u> audit expenses since outside auditors will have to spend more time performing an independent review. The end result is that many Pools and smaller public companies would continue to be burdened with relatively greater audit expenses than larger public companies.

In addition, many Pools voluntarily have an annual "Statement of Auditing Standards No. 70" ("SAS 70") examination performed and provide the accompanying reports to customers/investors. Completing a SAS 70 exam shows that an entity has had an in-depth audit of its control activities conducted by an independent accounting and auditing firm.[12] In many instances, testing that is performed for a SAS 70 exam will be duplicative of testing performed to satisfy SOX 404 requirements. We respectfully request the PCAOB in its "Considering and Using the Work of Others" auditing standard, allow management and external auditors to consider SAS 70 reports in evaluating ICFR. We believe this would eliminate unnecessary, duplicative procedures and reduce costs, while maintaining the integrity of the process as SAS 70 exams are conducted by independent auditors.

[11] *Final Report of the Advisory Committee*, *supra* note 4 *at* 22.

[12] SAS 70 reports are provided in a uniform reporting format. As such, they enable investors to compare reports across different investment vehicles, many of which are not subject to SOX 404. Some Pool investors specifically request for SAS 70 reports.

(ii) Proposed rule 3525: Audit Committee Pre-approval of Services Related to Internal Control

We believe the PCAOB's "Audit Committee Pre-approval of Services Related to Internal Control" proposed independence rule is more appropriate than the direction regarding independence and internal control-related services provided in AS2. However, as Pools are not required and do not find it necessary as a "net asset value"-based entity to have an audit committee, many do not. In providing scalable guidance, we hope the PCAOB will consider the structural characteristics of Pools and provide applicable guidance.

(iii) Guidance through Illustrative Examples

We believe that one method, by which the SEC and PCAOB may provide further guidance while remaining principles-based in approach, is through the use of illustrative examples of how guidance under SOX 404 should be implemented. Illustrative examples would provide public companies with a clearer sense of what constitutes an acceptable level of internal controls and compliance with SOX 404. Further, we believe that illustrative examples would be especially helpful in providing Pools and smaller public companies, which have different characteristics and constraints from larger public companies, with a better understanding of how in practice the Proposed Guidance may be "scalable." Illustrative examples would also provide Pools and smaller public companies practical guidance and assurance that it's possible for them to comply with SOX 404 without radically changing their operations or business objectives.

The Proposed Management's Guidance indicates that management must maintain "reasonable support" for its assessment, but provides little guidance on the nature and extent of documentation to be maintained. An illustrative example might provide that documentation may be maintained in either hardcopy or electronic media, and that the extent of the documentation may be satisfied by narratives, flowcharts, and/or forms, among other methods. We believe illustrative examples would also be helpful in showing when a control weakness may constitute a "material weakness."

2. Duplicative Regulation by SEC and PCAOB

We share the view expressed by other public issuers that SOX 404(b) does not require outside auditors to perform an audit of internal control. From our experience, the external audit of internal control promulgated by the PCAOB in AS2, greatly increased compliance costs, is duplicative of, if not overshadowing of, management's role in assessing internal controls, and is not cost-efficient. For example, external auditors in conducting full-blown audits of internal control have performed limited control testing despite the fact that many balance sheet items may be cross-checked and validated against externally generated third party statements produced by FCMs and custodians. We applaud the SEC and PCAOB's efforts for providing more scalable, risk-based, and cost-efficient guidance.

However, we are concerned that the Proposed Guidance provides different, and not necessarily consistent, guidance on the issue of assessing ICFR. We believe the Proposed Management's Guidance provides more flexibility, while the Proposed Auditing Guidance is much more prescriptive. Some areas where the Proposed Guidance differs, for example, include discussion of: control environment evaluation, identifying significant accounts, and strong indicators of material weakness, as discussed in the Institute of Management Accountants February 13, 2007 letter to the SEC and PCAOB.[13]

a. Proposed Management's Guidance

While we appreciate the flexibility provided in the SEC's Proposed Management's Guidance, we are concerned that in practice the SEC guidance will be superseded by the PCAOB's more prescriptive Proposed Auditing Guidance. Since management relies on its outside auditor to approve its assessment of internal controls, we fear that the PCAOB's Proposed Auditing Guidance will become the de facto standard for management.

We believe the SEC should maintain its top-down, risk-based approach for ICFR, but provide management with greater confidence and certainty as to when, and how they may, fulfill such obligation. We believe that under SOX 404, management, rather than the auditor, is responsible for determining the appropriate controls, evaluation methods, procedures, and documentation of ICFR. Management is also in the best position to tailor the compliance procedures to fit the unique characteristics of its company. However, without more information on the minimum standard of internal control compliance, management will continue to live in uncertainty as to whether its internal controls will be overridden and redesigned by outside auditors. Further guidance will not only help improve management's efficiency in conducting an internal assessment, but will also provide management together with outside auditors, with a better understanding of what constitutes an acceptable internal review. Without such guidance, we are concerned the result will be that Proposed Auditing Guidance, like AS2, will continue to overshadow management's ICFR.

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[13] Institute of Management Accountants, Letter regarding SEC File No. S7-24-06 and PCAOB Rulemaking Docket No. 021 (Feb. 13, 2007), at 2, *available at*: http://www.sec.gov/comments/s7-24-06/lddevonish-mills5470.pdf. The letter provides:

Control Environment Evaluation – AS5 indicates that the auditor should assess the company's control environment and lists 5 specific areas for attestation. The SEC guide makes passing reference to the concept but does not provide specific evaluation criteria or any information on what would constitute a failing grade on control environment.

Identifying Significant Accounts – AS5 lists 9 specific factors that should be used to identify significant accounts. SEC guidance has no parallel guidance for management.

Strong Indicators of Material Weakness – AS5 lists almost 3 pages of specific factors that are relevant to determining if a material weakness is present. The SEC guidance starting on page 41 provides similar but different criteria to be used by management.

b. Proposed Auditing Guidance

We believe the Proposed Auditing Guidance represents a significant improvement from AS2 in terms of its responsiveness to the requirements of SOX 404, scalability, and cost-benefit. We believe removing the requirement to evaluate management's process and allowing auditors to consider and use the work of others, as directed by the Proposed Auditing Guidance, is key to reducing duplicative and redundant assessments of ICFR.

Nevertheless, we believe the Proposed Auditing Guidance does not go far enough in optimizing the cost/benefit equation, and could further reduce duplicative control evaluations. AS5 should focus on audit considerations and direct auditors to use the same SEC interpretive guidance used by management with respect to understanding how to complete an assessment of ICFR.

* * *

We believe the Proposed Guidance is a vast improvement from the status quo, but believe that continued and increased coordination between the SEC and PCAOB would further optimize the cost-benefit of SOX 404. We encourage the SEC and PCAOB to continue to work together in providing mutually reinforcing, cost-efficient guidance under SOX 404 that maximizes investor benefit while eliminating duplicative and redundant regulation.

3. Safeness of the SEC's Safe Harbor

We are in favor of the concept of a safe harbor under proposed Exchange Act Rule 13a-15(c) that would provide management that conducts an evaluation in accordance with Proposed Management's Guidance, certainty that it has satisfied its obligation to conduct an evaluation for purposes of Rule 13a-15(c). Nevertheless, for all of the reasons previously stated, we believe that the Proposed Guidance currently does not provide enough clarity and guidance for Pools to assess with an appropriate level of certainty that they have conducted an evaluation in accordance with the interpretive guidance.

We believe further guidance from the SEC and PCAOB, as discussed above, such as through illustrative examples, would greatly enhance SOX 404 compliance, increase investor value, improve cost-efficiency, as well as construct a "safer" safe harbor under Rule 13a-15(c).

4. Extension of Compliance Date for Non-Accelerated Filers

We respectfully request that the SEC delay implementation of the compliance date for management's report of internal controls and the auditor's attestation requirement for another year. Provided that Final Guidance is issued in May or June of 2007 at the earliest, issuers will have little time to comprehend how the Final Guidance translates into practice, let alone implement the necessary evaluation process, including testing and documentation, and/or remediation of any identified weaknesses. Without an extension, management of many Pools and smaller public companies will struggle to implement adequate internal controls while juggling their day-to-day responsibilities.

We believe an extension in the compliance date for management's report for ICFR and the auditor attestation requirement would provide non-accelerated filers with the necessary time to adequately focus on the internal assessment process; and to discuss with their auditors PCAOB's new auditing standards and implementation guidance. We believe this will translate into added-value and cost savings for investors.

Conclusion

MFA appreciates the opportunity to provide its views on the Proposed Guidance that the SEC and PCAOB have promulgated, and respectfully requests for the reasons stated herein that Final Guidance take into consideration the unique characteristics of Pools and provides more scalable guidance. We would welcome an opportunity to meet with Commissioners and Staff if that would provide assistance in your deliberations on these issues.

Respectfully submitted,

John G. Gaine

John G. Gaine
President

Cc: The Hon. Christopher Cox, Chairman, SEC
The Hon. Paul S. Atkins, Commissioner, SEC
The Hon. Roel C. Campos, Commissioner, SEC
The Hon. Annette L. Nazareth, Commissioner, SEC
The Hon. Kathleen L. Casey, Commissioner, SEC
John White, Director, Division of Corporation Finance, SEC
Conrad Hewitt, Chief Accountant, SEC
Chester Spatt, Chief Economist, SEC
Brian G. Cartwright, General Counsel, SEC
The Hon. Mark W. Olson, Chairman, PCAOB
The Hon. Kayla J. Gillan, Board Member, PCAOB
The Hon. Daniel L. Goelzer, Board Member, PCAOB
The Hon. Bill Gradison, Board Member, PCAOB
The Hon. Charles D. Niemeier, Board Member, PCAOB

MAZARS

London and Paris, February 26, 2007

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street, N.W.
Washington, D.C. 20006-2803
Attention: J. Gordon Seymour, Secretary, and Members of the Board

Re: PCAOB Rulemaking Docket Matter No. 021 – Release N° 2006-007 December 19, 2006 Proposed Auditing Standard – An audit of internal control over financial reporting that is integrated with an audit of financial statements and related other proposals

Dear Sirs,

Mazars, an international, integrated and independent organization, comprising in 2006 5,600 staff and partners working in 38 countries (and more than 7,000 employees in our worldwide integrated partnership in 40 countries as of January 1st, 2007), and with all its associated practices able to mobilize 13,000 professionals in 58 countries, hereby represented by Mazars LLP (United Kingdom firm in London) and Mazars & Guérard (French firm in Paris), is pleased to submit this letter in response to the request for comments from the Public Company Accounting Oversight Board (the "Board") on its Proposed Auditing Standard – An audit of internal control over financial reporting that is integrated with an audit of financial statements and related other proposals (together the "PCAOB AS No. 2"), in accordance with Section 404 and 103 of the Sarbanes-Oxley Act of 2002 (the "Act"). We appreciate the opportunity to comment on this PCAOB Release.

In North America, Mazars has a long standing presence via Mazars USA (created in 1988/1989, and registered with the PCAOB). As a natural extension of its development strategy, Mazars has formed several joint ventures with members of Moores Rowland International (MRI) since 2000 to assist its clients in various corners of the world. At the end of 2006, Mazars and the American members of MRI, decided to optimize their relationship. Mazars and Moores Rowland International have signed an agreement to launch a new international alliance between independent structures, named Praxity: its ambition is to allow each of these structures to offer national and international clients a service which conforms to the highest standards of professional excellence and ethics. Praxity, an international non-profit association registered in Belgium, will become operational in 2007.

We want to preface our specific comments with general consideration that we fully support implementation of rules strengthening the audit quality, and the contribution of these rules to restore the public confidence in financial reporting and in the world's capital markets. Mazars LLP and Mazars & Guérard are therefore fully committed to support PCAOB initiative, as well as those of IFAC, European Commission and other key European or national regulators that have been already doing good work and are implementing stronger controls in these areas of common concern.

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We welcome the opportunity to comment the Proposed Auditing Standard on a subject we consider improving the audit quality. Please find hereafter our comments.

General comments

Item 2: Release of 2006-007

- Proposed Auditing Standard No. 2 discussion paper – Key thoughts

  1. The importance of risk assessments is highlighted. This should reduce the problems of over-auditing both geographically and in the number of controls to be considered 'key'. This will be easier for accelerated filers as the information upon which to base risk assessments should now be available and more robust. For non-accelerated filers we are concerned that they will not be aware of the increased planning that is required to achieve the eventual reduction in work. The guidance in RIN 3235-AJ58 will be useful but is perhaps more theoretical than practical in application.
  2. A large number of problems associated with implementing AS 2 in the past have been caused by the 'fear factor'. This is what some people in management of the companies complying with SOX call the attitude of the external auditors. The concern from people we have spoken to is that the guidance does not materially reduce the 'fear factor' and that until external auditors publicly state how they will be treated, they will assume nothing has changed from the previous AS 2.
  3. The guidance does allow for some proportionality of controls depending on the size and complexity of the business, and this is to be welcomed. It is, however, difficult to place reliance on key controls that are not capable of demonstration, especially when this is combined with a reduction in the controls that are considered to be 'key'. We are concerned that this, though good in theory, will prove difficult in practice.
  4. The new definitions for deficiency, significant deficiency and material weakness are welcomed as this should help to reduce the scope, which is at least in part the intention of the amendments.
  5. The use of prior results in considering the extent of testing is interesting. It is a little unclear in the guidance what effect previous testing has on a control and for how long reliance can be placed on it. Would, for example, a walkthrough determining that the control had not changed be sufficient or would testing need to be undertaken with a reduced sample size etc…? Although the standard should not aim to be prescriptive in all respects, more guidance in this area would be useful as it is already being debated by companies and, in our experience, also external auditors.

- Proposed amendments to the Boards interim standard

  1. No specific comments to make

- Proposed interpretive guidance

  1. The proposed guidance is an useful information, but more a theoretical guide than a practical one. For example, little or no mention is made of consultation with external auditors when implementing a risk based approach. In practice, consultation with external auditors in all scoping matters has led to a better SOX experience.

Item 3: Release of 2006-007

- Extension of implementation deadline for non-accelerated filers etc…

Under the amendments, management would be required to issue their Management Report on Internal Control for years ending on or after 15th December 2007 and auditor attestation for years ending on or after 15th December 2008. The SEC has indicated that it may consider further delay based on the implementation of the revised AS 2.

The reasons given by the PCAOB for the delay are persuasive. Developments since the last delay was issued include the finalization of guidance for small companies from COSO, the GAO principles paper, the advisory report on smaller companies to the commission, changes to AS 2 and a consultation of commentators on proposed extension dates.

However, we would caution the following:

- Work expands to fill the time available to perform it. We have seen this with the previous delays as companies begin to comply, stop, and then begin again. In addition, this demonstrably weakens the ability of the company to introduce good remediation practices and achieve management buy in for the process;
- While the reasons for the delay are good and should provide relief for companies that apply all the new guidance in an effective manner, we believe that consideration should be given to a positive statement that this is intended to be the last delay – We are very concerned that companies are now wallowing in inertia in the hope that further delays and legislative challenges will reduce further their compliance burden. The result of this is that they will not be ready for the introduction of the Act as little/no work is currently being undertaken to comply. This appears to contradict one of the goals of the Act by allowing management to postpone their responsibility of ensure that they have implemented an effective system of internal controls over financial reporting.

We agree with the decision not to increase the relief to companies that currently are non-accelerated filers but become accelerated filers before December 15, 2008. We believe that an extension of this rule would cause confusion both within the companies concerned and within the investor community.

We approve of the additional disclosure requirement requiring non-accelerated filers to state that their controls will not have been subject to auditor attestation. We see no reason to exclude FPI's from this additional requirement as it will ease transparency and uniformity.

We approve of the proposed transition period for newly public companies, assuming that the appropriate disclosure of this is made.

Detailed comments, with answers to the questions

1. Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?
We consider that the description provided is helpful. However, it's not clear that once an account is identified as a significant account, if the auditor must then identify all assertions related to that account and test the related controls, or if they may test the control surrounding the assertion that is considered to present a reasonable possibility of material misstatements. Example, if accounts receivable net is identified as a significant account based on qualitative factors surrounding the allowance for doubtful accounts (the valuation assertion), must the auditor identify and test controls surrounding all assertions related to accounts receivable net or only those controls related to the provision for doubtful accounts?

2. Does the proposed standard place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud?
We consider that emphasis is appropriate. However, this element deserves more guidance in order to better link what should be done for an integrated audit compared to what is usually done when auditing financial statements. Otherwise, this could lead to an expectation gap between work performed by auditor and expectation from users. Guidance could be provided in order to require the auditor:
- to evaluate the design of system of detection or prevention of fraud set up by the management,
- to require the auditor to perform walkthrough on key controls designed to detect or prevent fraud.
Testing operating effectiveness of fraud controls is difficult, but back to some basics should be reminded. It could be for example controls regarding segregation of duties, cash authorization.

Moreover, we suggest a modification in the auditor's report, given the inherent risk in internal controls due to management override:
"[Inherent limitations paragraph]
Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements **<u>or fraud</u>**. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate."

3. Will the top-down approach better focus the auditor's attention on the most important controls?
Generally yes, however clarification is needed regarding whether controls related to all assertions for each significant account identified require testing, or only those assertions considered to contain a reasonable possibility of material misstatement.

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?
We believe that paragraphs 43 and 44 sufficiently address this issue. However, within these paragraphs, we believe that the references made to misstatements should be altered to made reference to "material" misstatements.
Regarding timing of testing in paragraph 17, it might be useful to note that a "test" of company level controls includes testing both the design and operation of the controls.

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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?
We believe it provide adequate guidance.

6. Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?
Yes; however in paragraph 52, one of the factors affecting the risk associated with a control is the nature and **materiality** of the misstatement that the control is intended to prevent or detect. If there is the presumption that a correctly executed top-down approach would lead the auditor to test "only those controls necessary to obtain reasonable assurance about whether material weaknesses exist", then this statement appears to contradict that presumption. Appropriate process documentation for significant process should allow for adequate description of these lower risk controls, and therefore the walkthrough of these processes would cover these controls.

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 new definitions for deficiency, significant deficiency and material weakness are welcomed as this should help to reduce the scope, which is at least in part the intention of the amendments.
Page A1- 45 regarding the definition of control deficiency, we suggest adding: "misstatements in the financial statements".

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?
Giving indicators of material weaknesses is an interesting improvement. However, providing more examples of potential material misstatements concerning controls relating to the control environment, segregation of duties, how internal control over information technology affects this assessment, the ability to commit the company and deficiencies related in management override would help auditors to better understand and identify potential material weaknesses.

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?
By including a broad statement such as antifraud programs and controls in the guidance of what "results in at least a significant deficiency" may cloud the definition of significant deficiency as many transaction based controls, such as a bank reconciliation, contain antifraud aspects. In large entities with multiple locations, a control deficiency in one location related to such an antifraud control, presumably, would not constitute a significant deficiency neither for that entity nor for the group.

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?
Due to the variety of possibilities and circumstance surrounding "strong indicators", we believe that the standard should allow the auditor to conclude that no "material weakness" exists when one of the strong indicators is present. Furthermore, the indicator relating to prior year restatements appears contradictory to the requirement to assess controls as of the balance sheet date. When the restatement is identified in the subsequent year, it appears that the control may be working properly in that year, and therefore the material weakness relates to the previous year's assessment.
One of the purposes of the new statement appears to be to allow for more auditor judgment, therefore, this would be consistent with the theme of the new standard.
We believe that the change would not lead to inconsistencies in the evaluations, rather inconsistencies in the outcome of the evaluations as the facts and circumstances surrounding each strong indicator are different, and cannot and should not be compared.

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

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?
Making reference to interim financial statements in the definitions suggests that the timing of control testing should cover these periods (e.g. certain controls may need to be tested at each reporting period). As management's and the auditor's reports on the effectiveness are as of the balance sheet date, this inconsistency may result in additional testing or lowering the materiality considerations during the final assessment of the impact of deficiencies when interim materiality differs from overall materiality for the annual audit.

13. Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?
No, since global evaluation of management's process contributes to the overall evaluation of control environment. We consider that the quality of the management's process is a good indicator of the quality of internal control.
In fact, in certain situations it may increase the level of audit work. For example, currently the company's management and the auditors come to an agreement on the scope of the significant accounts and process to be tested as part of this evaluation process. If this process were eliminated, the need for agreement would be diminished thereby allowing management's scope to differ, maybe significantly, from that of the auditors. If the process or accounts considered significant by the auditors are not documented and tested by management, the auditors would be required to perform additional procedures in order to understand and assess these processes.

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?
Possibly, however, the efficiency of the audit may suffer due to considerations noted in the response to question 13.

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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 the current opinion adequately communicates the current requirements as it is a function of the standard. It doesn't appear to us that the mere inclusion of the opinion renders the scope of results of the auditors work any more difficult for the reader to understand.

16. Does the proposed standard appropriately incorporate the value of cumulative knowledge?
Generally speaking, yes. The use of prior results in considering the extent of testing is interesting. It is a little unclear in the guidance what effect previous testing has on a control and for how long reliance can be placed on it. Would, for example, a walkthrough determining that the control had not changed be sufficient or would testing need to be undertaken with a reduced sample size etc…? Although the standard should not aim to be prescriptive in all respects, more guidance in this area would be useful as it is already being debated by companies and, in our experience, also external auditors.

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?
For routine controls within significant processes which are unchanged from prior years. A mere walkthrough would not provide sufficient evidence relating to the operating effectiveness of complex non-routine controls in which high levels of judgment are concerned.

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?
Although the guidance is consistent with the risk based model, in practice it may be somewhat harder to implement. For example, a particular business unit may be within the testing scope due to its size and impact on the consolidated financial statements, however, it may consist of several, sometimes hundreds, of relatively small entities that, individually could be excluded from the scope.

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?
We believe a single framework in appropriate.

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?
We believe it does.

21. Will requiring the auditor to understand whether relevant activities performed by others identified control deficiencies, fraud, or financial statement misstatements improve audit quality?
We believe that this is an essential component of relying on the work of others and is necessary to improve the quality of the audit.

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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 so. In fact, by being able to review and rely on the works of other provides the auditor with valuable insight into key components of the over control environment. In certain circumstances, we have found that using the work of others, especially internal audit, may strengthen the external auditors own tests as generally the internal auditors have a vast knowledge of the company, its risk and its operating environment.

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 framework appears appropriate.

24. Has the Board identified the right factors for assessing competence and objectivity? Are there other factors the auditor should consider?
Generally yes, however, in certain cases the factors relating to education may be somewhat restrictive. For example, if the person does not have a degree in accounting or even a college degree, but has been an accounting manager in the industry for a significant period of time, this should be considered with the factor affecting competence within the framework.

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?
It adds a certain level of complexity to the evaluation as the auditors are required to assess the hierarchy of the compensation systems in place, which to a certain extent can be subjective. It also may limit the company's ability to utilize potentially highly efficient and effective tester who work within certain specific business lines within the organization.

26. Will requiring a walkthrough only for all significant processes reduce the number and detail of the walkthroughs performed without impairing audit quality?
Generally, significant processes contain several sub-processes for which the auditor must perform a walkthrough. If one of the sub-processes is not relevant to the assertions being tested, the auditor should have the ability to remove it from the scope. This should be appropriately addressed within the standard.

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?
We believe that the standard appropriately limits the amount of assistance in performing the walkthroughs.

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?
The guidance does allow for some proportionality of controls depending on the size and complexity of the business, and this is to be welcomed. It is, however, difficult to place reliance on key controls that are not capable of demonstration, especially when this is combined with a reduction in the controls that are considered to be 'key'. Also, generally, as noted in the standard, smaller business rely on

significant management input in their day-to-day operations which significantly increase the risk of management override, limiting the auditor ability to place reliance on the controls. We are concerned that this, though good in theory, will prove difficult in practice.

29. through 33.
No specific comments.

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?
The Board should consider allowing for immediate adoption of the new standard. Although not all aspects of the new standard would be able to be fully utilized in the first year, the new definitions of significant deficiencies and material weakness along with the standards for assessment could be utilized in the first year.

Other comments

- Page A2-5 – Using the Work of Others - 10:
  we suggest to add in a) the nature **and timing**

Kim Hurst
Mazars LLP
Risk Management & Audit Quality

Jean-Luc Barlet
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February 23, 2007

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

RE: Rulemaking Docket 021 -- *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

Dear Mr. Secretary:

McGladrey & Pullen, LLP is pleased to submit written comments on the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, the proposed auditing standard, *Considering and Using the Work of Others in an Audit* and other related proposals. McGladrey & Pullen, LLP is a registered public accounting firm serving middle-market issuers.

McGladrey & Pullen, LLP supports the PCAOB's proposed auditing standard on internal control over financial reporting and the related proposals. Overall, we believe that these proposals will facilitate continued progress in upholding the investor protections that are so fundamental to the success of the Sarbanes-Oxley Act (the Act) and the market vitality that has been the result of its passage. These changes also will serve to improve the effectiveness and efficiency of the process related to the internal control assessment and attestation provisions of the Act. Overall, we believe that the proposed changes strike the right balance between cutting compliance efforts and costs and maintaining the significant benefits of Section 404 of the Act and the audit of internal control over financial reporting.

We expect the proposed changes, along with the proposals (File No. S7-24-06) by the Securities and Exchange Commission (SEC), will result in a reduction of total efforts and costs related to Section 404. We also believe that total cost reductions will likely vary based on facts and circumstances for each particular issuer, the state of its evaluation process of internal control over financial reporting, and the extent to which management already has effective internal control over financial reporting in place.

We also believe that the benefits from the SEC and PCAOB proposals will be greatest to issuers that have not yet initially implemented the requirements of Section 404. Although the effects of the new guidance will vary from issuer to issuer, the maximum opportunities for efficiencies and cost-effectiveness related to Section 404 are optimized when management and auditors work together to conduct the assessment and attestation in a complementary manner, and when the auditor can make effective use of management's work. We also believe that the cost of complying with Section 404 can be reduced as issuers and auditors become more experienced with the application of Section 404.

We support the PCAOB's increased emphasis and flexibility on the auditor's use of professional judgment, and its decision to apply a single model of auditor reporting on internal control over financial reporting applicable to all public companies that is scalable to companies of varying size and complexity. We also support the PCAOB's position requiring auditors to obtain evidence regarding the operating effectiveness of controls to determine whether the controls in place actually work as intended. We also believe that requiring auditors to apply a risk-based approach to testing controls supports the reliability of the audit.

We also express our strong support of the PCAOB's project to develop guidance and education for auditors of smaller public companies. The project will facilitate scalability of the proposed standard in an effective and efficient manner for audits of these smaller issuers. The effective and efficient application of the proposed standard will depend heavily on the success of this project.

We appreciate the PCAOB's emphasis on more flexibility in determining the extent to which the work of others may be used by the auditor and believe that the changes in the proposed standard on internal control over financial reporting in this area, coupled with the existing interim standard "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322), can achieve the Board's objective of efficient and effective implementation of audits of internal control over financial reporting. We do not believe that the Board's proposed standard, *Considering and Using the Work of Others in an Audit*, that would supersede the existing interim standard is necessary, as it contributes little to the achievement of the Board's objectives in this area, and could actually weaken audit effectiveness through inappropriate use of the work of others. If however, the Board determines that it is necessary to have a new standard for considering and using the work of others in an audit, we believe the Board should incorporate certain concepts identified later in this letter, which are missing from the proposed standard, to ensure both effective and efficient implementation of integrated audits of the financial statements and internal control over financial reporting.

We recognize that there were various requests for comments within the PCAOB's Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements and Related Other Proposals*, however, we have limited our comments to the significant matters noted below.

While we are supportive of the direction of the proposed standards, particularly their increased emphasis on appropriate exercise of auditor judgment, we offer the following specific comments as suggestions to improve the proposed standards to meet the overall goal of making implementation of audits of internal control over financial reporting more effective and efficient.

Auditor's Use of Professional Judgment

As indicated previously, we support the PCAOB's increased emphasis and flexibility on the auditor's use of professional judgment. However, we note that by allowing the auditor to exercise a greater degree of professional judgment, there may be more inconsistency in applying the proposed standard in practice. As such, effective monitoring by the PCAOB inspections staff will be critical to promoting an appropriate degree of consistency by, and among, auditors.

Presumptively Mandatory Performance Requirements

While we support the objective of performing both an efficient and effective integrated audit of ICFR and of the financial statements, we note that the proposed standard includes presumptively mandatory performance requirements relating to engagement efficiency. We are concerned that the inclusion of these presumptively mandatory performance requirements may actually detract from the well-established objective of auditing standards which is to provide guidance for the conduct of a high quality audit.

Considering and Using the Work of Others

We believe that the changes in the proposed standard on internal control over financial reporting (ICFR) coupled with the current interim standard, *"The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"* (AU sec. 322) achieve the Board's objective of efficient and effective implementation of an integrated audit of the financial statements and ICFR. Accordingly, we do not believe that the Board's proposed standard, *Considering and Using the Work of Others in an Audit*, which would supersede AU sec. 322, is necessary as it will result in little additional efficiency. More importantly, we believe that the effectiveness of the audit of the financial statements could potentially be diminished by inappropriate use of the work of others.

On the other hand, if the Board decides that a new standard on using the work of others is necessary, one very important principle in AU sec. 322 that has not been included in the proposed standard relates to the auditor's ability to use the work of others, where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, and in particular the concept that in these circumstances, the auditor's evidence should not consist solely of the work of others. We recommend that the Board consider including paragraphs 21 and 22 of AU sec. 322 in the proposed standard to reinforce this important concept.

In addition, even though the "principal evidence" concept previously included in PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements* has been eliminated, the auditor must still be in a position to state in the opinion that he or she has audited the financial statements and management's assessment of ICFR. As noted in paragraph 9 of the proposed standard, *Considering and Using the Work of Others in an Audit*, judgments about the sufficiency of evidence obtained, assessments of risk, the materiality of misstatements, and evaluations of test results, must be those of the auditor. We believe that replacing AU sec. 322 with the proposed standard will likely lead to confusion regarding the auditor's implied obligation to obtain principal evidence to support the auditor's opinion.

Paragraphs 3 through 6 of the proposed standard, *Considering and Using the Work of Others in an Audit*, describe the auditor's responsibility to determine whether there are activities performed by others that can be used in connection with the audit. We believe that these paragraphs will likely lead to unnecessary effort being expended to look for activities significantly removed from those of internal auditors and similar groups described in AU sec. 322, which upon consideration, will not be useable because of issues related to competence and objectivity or are not tests that provide audit evidence as described in the proposed standard. Accordingly, we see no benefit to adding these paragraphs. If the Board decides to adopt the proposed standard, then we recommend that the discussion of competence and objectivity, as discussed in paragraphs 13 through 17 of the proposed standard, precede the consideration of relevant activities in order to more appropriately reflect the thought process of the auditor in considering the work of others. In addition, the Board should describe the extent of documentation considered appropriate to demonstrate compliance with paragraphs 3 through 6 of the proposed standard.

Scaling the Audit

We appreciate the guidance and requirements placed upon the auditor found in paragraphs 9 through 12 of the proposed standard on the audit of ICFR, and as indicated previously, we fully support the PCAOB's project to develop guidance and education for auditors of smaller public companies. While we agree that the size and complexity of the issuer should be evaluated when planning and performing the integrated audit, we note that the guidance and requirements in paragraphs 9 through 12 apply to integrated audits of all issuers, not just "smaller companies" as defined in the proposed standard. As such, we recommend that the "heading" preceding paragraphs 9 through 12 be changed from "Scaling the Audit for Smaller Companies" to "Scaling the Audit." This change would help mitigate the possibility that these important paragraphs of the proposed standard were omitted from consideration by auditors of issuers who do not meet the definition of a "smaller company." Lastly, we note that in paragraphs 9 through 12 of the proposed standard, the attributes of "size" and "complexity" receive approximately equal emphasis. We believe that paragraphs 9 through 12 should be revised to place more emphasis on the importance of considering the complexity of the issuer when scaling the audit as a "smaller" company may not be indicative of a "less complex" entity.

Company-Level Controls

We agree that the evaluation of company-level controls is an important part of a top-down, risk-based approach to the audit. However, while paragraph 43 of the proposed standard indicates that "some company-level controls are designed to operate at the process, transaction, or application level and might adequately prevent or detect on a timely basis misstatements to one or more relevant assertions," there is no indication as to how frequently company-level controls can be linked directly to a relevant assertion. We do not disagree with the conceptual underpinning of the guidance provided in paragraph 43 of the proposed standard, however we do believe that the lack of guidance regarding the frequency with which these types of company-level controls may be expected to be encountered in practice potentially may lead auditors to search for non-existent controls of this nature. We believe that it would be a fairly infrequent situation where testing solely company-level controls without testing at least some lower-level controls would be sufficient because effective functioning of company-level controls is often dependent on the use of accurate and reliable data subject to lower-level controls. We recommend that examples be added to the guidance to illustrate the linkage and the benefit that might be derived from such controls in determining the nature, timing and extent of testing lower-level controls.

Consideration of Fraud and Company-Level Controls

We believe it is important that when an auditor assesses risk when planning the audit, that the interaction between the identified risks of fraud for certain assertions be addressed when scoping the audit of ICFR. We recommend that this notion be clearly articulated in the proposed standard. For example, we believe the Board should better articulate this notion in the interaction between the risk that the control might not be effective as described in paragraph 51 and whether the control is intended to address significant fraud risks. We also recommend that fraud be added to the list of factors that affect the risk associated with a control as articulated in paragraph 52 of the proposed standards.

Additional clarity with regard to the consideration of the precision of company-level controls as it relates to the risk of fraud would be helpful. In other words, we believe that the concept regarding company-level controls cited in paragraph 43 of the proposed standard should be reiterated earlier in the standard – around paragraph 17 – the section on Identifying Company-Level Controls – to better address the auditors' consideration of fraud and to better integrate fraud considerations consistent with the concepts in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

Removal of "Large Portion" and "Principal Evidence"

We are supportive of the Board's guidance related to multi-location testing requirements which now focus on risk rather than coverage and also are supportive of the deletion of terms "large portion" and "principal evidence" from the proposed standard on ICFR. However we believe that the simple removal of this terminology from the proposed standard on ICFR does not change the auditor's requirement to obtain sufficient audit evidence to support the auditor's opinion. Accordingly, we recommend that the Board add guidance to the introductory section of the proposed standard on ICFR as well as the sections dealing with scoping of the integrated audit clearly articulating this very important requirement of the auditor. We believe that adding this wording will serve to bridge any "expectation gap" between management and the auditor that might result from the deletion of "large portion" and "principal evidence" from the proposed standard.

Roll-Forward Procedures

Paragraph 63 of the proposed standard on audits of ICFR, indicates that "When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what, if any, additional evidence concerning the operation of the controls for the remaining period is necessary." We note that included in this sentence are the words "if any," which appear to indicate that there are situations in which the auditor could conclude that no additional evidence or procedures are required to be obtained or performed to test the effectiveness of such controls over the remaining period. That is, in accordance with paragraph 63 of the proposed standard, there are situations where the auditor would not obtain any evidence regarding the operating effectiveness of controls as of the specific date being reported on (not even inquiry about changes in the design of controls since the date of interim testing). We believe that this guidance is in conflict with both interim auditing standard AU 313.08 (substantive tests) and interim auditing standard AU 319.99 (tests of controls in a financial statement audit). Both AU 313.08 and AU 319.99 indicate that at least some procedures (inquiry at a minimum) would need to be performed in order to extend conclusions reached at an interim date to the balance sheet date. As such, we believe that either the words "if any" should be removed from the guidance in paragraph 63 of the proposed standard or that more specific guidance and/or examples be added to the proposed standard illustrating under what circumstances no additional audit evidence would need to be obtained.

Strong Indicators of Material Weaknesses

We note that the description of strong indicators of material weaknesses differ between the Board's proposed standard on ICFR and the SEC's proposed management guidance. As we indicate in our letter to the SEC on its proposed management guidance, we believe that the SEC should conform its description to the PCAOB's description of such factors. Conforming the two documents will help to reduce potential confusion, inconsistencies, and possible inefficiencies that may occur as a result of these differences.

Definition of Material Weakness and Associated Reporting

We note that the definition of a material weakness has been changed from the definition provided under PCAOB Auditing Standard No. 2. We believe that when a material weakness exists, the definition of material weakness required to be included in the auditor's report on ICFR may cause confusion on the part of users of the auditor's report.

The sample "Scope paragraph" of the auditor's report on ICFR found in paragraph 96 of the proposed standard states in part –

> "Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances."

While the above sentence from the sample auditor's report on ICFR clearly states that the auditor only assesses the risk that "a material weakness" exists, when a material weakness is deemed to exist, the definition of material weakness required to be included in the auditor's report on ICFR as required by paragraph 100 of the proposed standard leads to confusion because the definition of a material weakness states in part that "A material weakness is a control deficiency, or combination of control deficiencies …" When reading the scope paragraph of the auditor's report on ICFR combined with the definition of a material weakness, a user could easily be led to believe that the auditor scoped the engagement to detect control deficiencies (not just material weaknesses) because a material weakness could be the result of the aggregation of more than one control deficiency and the auditor is charged with finding all material weaknesses.

While we acknowledge that paragraph 70 of the proposed standard clearly articulates that "the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness," we recommend that the scope paragraph of the auditor's report on ICFR be modified to clearly articulate that the auditor is charged with only detecting individual material weaknesses, but must evaluate whether less severe control deficiencies, if any, detected as a result of performing procedures to detect a material weakness aggregate to a material weakness.

Documentation

We are concerned that there may be possible unintended consequences relative to the interaction between the requirements of the proposed standard on ICFR and the Board's Auditing Standard No. 3, *Audit Documentation* as a result of the use of the words "should" and "must" throughout the proposed standard. For example, paragraph 51 of the proposed standard under the *Relationship of Risk to the Evidence to be Obtained,* includes a requirement that "[f]or each control selected for testing, the auditor should [emphasis added] assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result." Compliance with this requirement could generate a level of documentation relating to the auditor's assessment of risk that may not necessarily add to the level of effectiveness of the audit. Because each use of "should" or "must" potentially drives a documentation requirement, we recommend that the Board broadly reconsider the use of the word "should" and "must" throughout the standard to ensure that disproportionate auditor effort is not unnecessarily devoted to documenting consideration of items that would ordinarily be incorporated into the auditor's overall methodology. If the word "should" is used as a statement of fact, we recommend that alternatives to the word "should" be used by the Board so as to decrease any confusion regarding documentation requirements.

Effective Date

We believe that an effective date for the proposed standard(s) that would be least disruptive in practice would be to make the proposed standard(s) effective for audits of periods ending or after December 15, 2007. However, unless the proposed standard(s) are issued by the Board and approved by the Commission within 90 days, it may not be possible for our firm to work the changes through our methodology and tools and to sufficiently train our personnel to meet that objective.

Thank you for the opportunity to comment on these proposed standards. Questions concerning our comments should be directed to Bruce Webb, National Director of Auditing (515.281.9240) or Leroy Dennis, Executive Partner – Audit & Accounting (952.921.7627).

Very truly yours,

McGladrey & Pullen, LLP

From: kcarey@metlife.com
Sent: Tuesday, January 16, 2007 9:26 AM
To: Comments
Subject: Comment Letter
Attachments: Prochaska to Olson 121106.pdf

Public Company Accounting Oversight Board
1666 "K" Street NW
Washington, D.C. 20006

Re: Comment Letter

To Whom It May Concern:

Please include the attached letter, dated December 11, 2006 in the comment file as a comment on the Board's internal control rulemaking process. It is our understanding that the comment period formally began shortly after December 11 and we would like MetLife's submission to be included in that process.

If there are any questions or need for further information, please don't hesitate to contact me.

Thank you.

Kate Carey

Kate Carey
Vice President
MetLife
1620 "L" St., NW, Suite 800
Washington, D.C. 20036
(202)296-2361

(See attached file: Prochaska to Olson 121106.pdf)

The information contained in this message may be CONFIDENTIAL and is for the intende

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Joseph J. Prochaska, Jr
Executive Vice President
Finance Operations and
Chief Accounting Officer

Mark W. Olson
Chairman
Public Company Accounting Oversight Board
1666 K Street N.W.
Washington, D.C. 20006

Dear Mark,

It was a pleasure to meet you at the FEI Luncheon in New York City on November 17, 2006 and I appreciate the opportunity to communicate MetLife's views on the Sarbanes-Oxley Act of 2002 ("SOX"). These views are derived from our experience in connection with the requirements of Section 404 and 302 of SOX and subsequent guidance released by the Securities and Exchange Commission ("SEC") and the Public Company Accounting Oversight Board ("PCAOB"). Without question, SOX re-emphasized the importance of financial controls for public companies and established new demands for corporate accountability. Overall, we support SOX's positive impact on MetLife's culture as it has elevated the awareness of accounting and control issues and enhanced accountability throughout the organization.

Since the passage of SOX, MetLife has monitored the development and proactively participated in the application and adoption, and as such, we recognize that there are several areas where additional guidance may enhance the effectiveness and efficiency of the underlying process without compromising the benefits of the legislation.

MetLife has always valued strong internal control over financial reporting, and have been obtaining internal control letters under the old audit standard prior to the issuance of AS2 since the mid-eighties. Starting in 2003, we aligned our control evaluations with the quarterly certifications that the Chief Executive and Chief Financial Officers were required to complete for Section 302. In fact, we were the only client our external auditor to receive an opinion letter on our internal controls over financial reporting in 2003.

Further, MetLife was one of the first companies to execute a significant acquisition subsequent to the adoption of SOX. The completion of the Travelers acquisition on July 1, 2005 required significant effort to achieve SOX compliance. In keeping with our leadership position, we decided to incorporate Travelers in our annual assessment of internal controls over financial reporting for the year ended December 31, 2005, rather than to use the scope exception available at the time.

While we are pleased with the benefits derived from the SOX process, we appreciate this opportunity to provide some observations resulting from our experiences for your consideration.

1. Emphasize a Top-Down, Risk-Based Approach

The Board should consider incorporating all aspects of the May 16, 2006 guidance into the revised AS2 standard. A top-down risk-based approach is the most effective and efficient approach to assess internal controls over financial reporting. Further the new standard should emphasize the importance of a company's internal control environment, and how it can impact the risk of the risk financial reporting fraud or other material failure, in order to focus auditors on what really matters, which is identifying material weaknesses in a company's system of internal control before such weaknesses result in material misstatements in the company's published financial statements.

2. Service Organizations

The Board should allow management to place reliance on SAS 70's performed on its own processes by external auditors engaged by management. In providing services, many of our business partners rely on our internal control structure. Accordingly, we provide them with SAS 70 reports covering the processes and controls upon which they rely. SAS 70 reports are issued by independent auditors using a prescribed format established by the AICPA to conclude as to the design and effectiveness of specific processes and controls within an organization. In accordance with the revised SEC October 6, 2004 FAQ, when management engages auditors to prepare SAS 70 reports, management is not allowed to rely on these reports yet business partners and external auditors are able to for SOX 404 testing purposes. As such, management must duplicate previously completed efforts and incur unnecessary costs, to arrive at an already known and certified conclusion. To maximize efficiencies, there needs to be close coordination between the SEC and the PCAOB to ensure both parties are in harmony to maximize the potential benefits associated with this revision.

3. Auditor's Role in Assessing Management

The Board should consider eliminating the auditor's opinion on management's assessment. We believe that the issuance of an independent audit report on the effectiveness of internal control over financial reporting provides substantial value to both the investing public as well as audit committees. However, the current requirement for separate opinions on both the financial statements, and on management's assessment of the internal controls over financial reporting (the "dual opinion system") is unnecessarily complex. We recommend that the auditor express an opinion only on the effectiveness of the internal controls as it relates to the audit of the financial statements. We believe this change retains the benefit of management's focus on internal controls but does not require the cost of a full blown audit of the management assessment process.

4. Work of Others

The Board should consider allowing the work of others to be relied on at a higher level by its external auditors in "low" and "medium" risk areas after the initial audit of internal controls has been completed. Auditing Statement No. 2, *An Audit of Internal Controls Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements* ("AS 2") states that the independent auditor must obtain the "principle evidence" for their opinion. After the initial audit, auditors should be allowed to rely on management walkthroughs when completed by competent and objective personnel in "medium" and "low" risk areas. Changes of this nature would align the amount of auditing effort with the perceived risk of a potential financial misstatement and would enable significant cost savings for both management and its auditors.

5. Improved Term Definitions

The Board should consider rewording the assessment of the likelihood of a material weakness to be at least "reasonably possible" as opposed to "more than remote." While we believe these terms are synonymous, there appears to be a perceived difference in the marketplace. For example, current implementation guidance does not require that a material weakness in internal control over financial reporting be found in every case of a restatement; however, current practice would lead to a different conclusion. If an error is detected, it should be evaluated like any other deficiency based on all facts and circumstances available. This has been an area of concern for many registrants and additional guidance on this topic would help eliminate any inconsistencies among audit firms.

6. Auditor Independence

The Board should consider creating a "diminimus" rule on monitoring auditor independence. We support the pre-approval concept and believe that it enhances transparency and communication between the Audit Committee and the auditors. However, the current guidelines are too restrictive and require both management and its auditors to focus their attention on trivial details that can be construed as violations of independence instead of focusing their judgments on meaningful company issues.

As stated earlier, to ensure that companies optimize any revised guidance from the SEC and PCAOB, both regulatory bodies should issue such guidance simultaneously. Compliance with SOX at MetLife is an extensive, ongoing effort, which involves significant personnel and financial resources. We are proud of our efforts to-date and feel that we are on the forefront of the thought leadership in this endeavor. We thank you for allowing us to communicate some of our experiences and recommended enhancements that we feel would be of benefit to MetLife, and to many organizations facing the same issues.

Should you have any questions or would like to discuss this topic further, please don't hesitate to contact me.

Best regards,

December 11, 2006

Microsoft Corporation
One Microsoft Way
Redmond, WA 98052-6399

Tel 425 882 8080
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Microsoft®

February 26, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 021

Microsoft appreciates the opportunity to comment 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").

Microsoft recognizes and appreciates the time and effort that the PCAOB has dedicated to developing standards that are responsive to concerns that have been raised, particularly about the effectiveness and efficiency of the process of auditing internal controls over financial reporting (ICFR). We support the direction of the proposed standards in improving the balance between quality and efficiency of the audits by supporting a top-down, risk-based approach, encouraging broader auditor flexibility and judgment, and supporting the use of prior knowledge and assessment results. We have strong concerns about maintaining consistency between the external audit and management assessment approaches and about the support the auditors will receive from the PCAOB in implementing the proposed standards. We also have comments on a few other topics.

Improvement in quality and efficiency

We believe that the proposed standards set the stage for meaningful improvements in effectiveness and efficiency of audits of ICFR. The top-down, risk-based approach that is the foundation of the proposed standards should enable auditors to focus attention on the critical controls that would detect a material misstatement, which should also result in a reduction in the key controls tested.

The proposed standards allow for broader auditor flexibility and judgment. The requirements to perform walkthroughs are being focused on significant processes. The auditor is given greater freedom in choosing how to test controls, with an acknowledgement that documentary evidence may not exist for all controls, which could then be tested with a combination of inquiry and observation.

The proposed standards also encourage the use of prior knowledge and audit results to guide the risk assessment and testing approach, reducing the required evidence in subsequent years based upon the type and results of prior years' testing and the stability of the controls. Also, the proposed standards explicitly provide for benchmarking of automated controls.

The second proposed standard expands the potential for auditor reliance on the work of others, which should better align the audit and the management assessment and leverage management's more in-depth knowledge of the controls. It removes the "principal evidence" requirement and also removes the requirement for original work in testing of controls in the control environment. We support these changes and believe that they will result in increased efficiencies.

Consistency with management assessment approach

We expect to make meaningful changes in our management assessment of ICFR based upon the current exposure draft of the U.S. Securities and Exchange Commission's ("SEC") proposed interpretive guidance ("proposed guidance"). In light of these anticipated changes, we are concerned with maintaining good coordination and consistency between management's assessment and the external auditors' standards and practices, including PCAOB Audit Standards, PCAOB inspection practices, and external audit firms' policies, practices and proposed standards. To optimize reliance and achieve quality and efficiency objectives, management's assessment approach will need to be consistent with and acceptable to the external auditors' standards. Furthermore, even though the requirement for an opinion on management's assessment process has been recommended for elimination, a management assessment approach that varies too greatly from the auditor's viewpoint could be of concern.

With all of the positive changes in the proposed standards, we believe that good potential exists for meaningful improvements in audit effectiveness and efficiency and alignment with management assessment changes. As clients, companies have a vested interest in these improvements. We also have strong concerns about the auditors' ability to realize these efficiencies.

As a general statement, we believe that external auditors may not move as quickly as their clients might expect in implementing the changes noted above. It seems likely that auditors will be concerned about whether the PCAOB inspection practices will mirror the proposed standards.

To alleviate these concerns, auditors will need to be assured that the PCAOB inspections will be aligned with the proposed standards. Because of the time lag between audits and inspections, the PCAOB will need to clearly communicate that the inspections will be aligned with the proposed standards for audit years starting with the effective date. This communication can take a variety of forms, including workshops or educational forums. We also suggest that the PCAOB monitor the external audit firms' guidance for implementing the proposed standards and be involved in any efforts to develop additional interpretations or practice aids that elaborate on the concepts in the proposed standards.

Other comments

Consideration of interim financial statements

For purposes of deficiency evaluation, the proposed standard includes a misstatement of the company's "annual or interim financial statements" in the definition of "material weakness" and "significant deficiency." We believe that the reference to interim financial statements could result in companies' having to use an inappropriately low quantitative threshold to evaluate control deficiencies. In our view, deficiencies should be evaluated and classified based upon their potential future impact on annual financial statements, since the management assessment addresses whether controls are operating effectively as of the end of the year. The impact of control deficiencies that are identified during the year should be extrapolated and compared to an annual quantitative threshold (in addition to considering qualitative factors, of course). Therefore, we believe that the words “or interim” should be removed from the definitions of a material weakness and a significant deficiency.

Company-level controls

The proposed standard refers to company-level controls in paragraphs 16 and 17 stating that these controls should be tested and considered in determining the scope of other testing. Also in paragraph 43 the proposed standard indicates that company-level controls could be relied upon to prevent or detect misstatements to one or more relevant assertions.

At Microsoft we have documented and tested company-level controls in lower risk areas to allow us to focus on the most important and pervasive controls, with the additional benefit of reducing or eliminating testing of process level controls. We expect to expand this practice next year in implementing the SEC proposed guidance. Controls that we have relied on in this manner include variance analyses, management reviews, and monitoring activities, which have a direct relationship to financial statement assertions. From our discussions with other companies, we believe that these are fairly common types of direct company-level controls. If needed, we are willing to provide examples of company level controls that we rely upon and/or participate in efforts to develop supplemental information about company-level controls.

IT general controls

The proposed standard touches very lightly on the subject of information technology and refers the auditor to AU sec. 319 for a discussion of IT risks to consider**.** General IT controls are a difficult area for many companies in that they are often over-scoped and over-tested. We believe that the proposed standard should emphasize that auditors can be quite selective in limiting IT controls in scope to only those that are necessary to adequately address material financial reporting risks. In our response to the SEC proposed guidance, we are suggesting examples of such controls. While the examples may not need to be as extensive in the proposed standards, some level of detail could be included to elaborate on the point that the audits of IT controls can be more limited than they are today. The suggestions for examples that we provided to the SEC are as follows:

1. Access to programs and data - Limiting user access testing to the few, high risk accesses that create potential for material misstatements. These accesses should be directly tied to identified financial statement risks. Any guidance that could be developed about types or expected numbers of accesses that might be relevant for a typical large-sized, complex company would be helpful.

2. Program development and changes – Examples of adequate controls to prevent material misstatements. We expect these examples might include a small number of key controls, such as final user acceptance testing and move-to-production final sign-offs.

3. Operations – Examples of typical critical key controls, such as backup of key financial data tied to material risks.

Deficiency evaluation

For many companies, deficiency evaluations have been structured using a framework that was developed by several of the larger audit firms. This framework has been useful in driving consistency of thought and communication but has also been restrictive. The factors laid out in the proposed standard to consider in evaluating control deficiencies or combinations of deficiencies are helpful and provide more room for judgment. We suggest that the proposed standard include a statement that the deficiency evaluation factors in the standard can be used instead of the more prescriptive framework.

In addition to the comments above, we have included responses to several of the specific questions posed in the proposed standards in the Appendix to this letter.

In conclusion, we want to reiterate our appreciation for the thoughtful consideration of input and the development of proposed standards that we believe will allow for meaningful improvements in audits of ICFR. If you have any questions or would like to discuss any of our comments, please contact Marilee Byers at (425) 706-2122 or marileeb@microsoft.com.

Sincerely,

Frank H Brod

Frank H. Brod
CVP Finance and Administration

Robert W. Weede
Assistant Corporate Controller

Marilee Byers

Marilee Byers
Director, Financial Compliance Group

APPENDIX

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

We believe that the proposed standard does clearly describe a top-down approach. The top-down, risk-based approach that is the foundation of the proposed standards should enable auditors to focus attention on the critical controls that would detect a material misstatement, which in many cases could also result in a reduction in the key controls tested. The change in the wording of the likelihood component of the material weakness definition from "more than remote" to "reasonable possibility" and the change in the magnitude component of the significant deficiency definition from "more than inconsequential" to "significant" should allow for increased judgment and better focus in determining significant deficiencies.

In the structure of the proposed standard, risk assessments focus audit effort on the most important areas. Identification of significant accounts to include in scope, selection of relevant assertions, controls and the nature and extent of testing evidence to be obtained are all independently determined based on relevant risks. For companies with multiple locations, the proposed changes in the multi-location guidance shift the focus from an emphasis on coverage to an emphasis on identifying and including high-risk locations. At each decision point, the application of thoughtful risk assessments should focus the audit effort.

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

Fraud is discussed in paragraph 45 as a factor that should be considered along with relevant assertions. Including fraud as a consideration for each significant account, similar to how assertions are considered, gives it an appropriate level of importance.

We have a concern about paragraph 79, which indicates that fraud "of any magnitude" on the part of a senior management should be treated as a strong indicator of a material weakness. While senior management fraud must certainly be taken very seriously, we suggest that it would not necessarily rise to the level of a material weakness. This is particularly true given the broad definition of "senior management" that is included in paragraph 79.

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

Yes, in our opinion the top-down approach does accomplish that purpose. We believe that a positive result of the top-down approach will be to highlight and focus on substantial and pervasive controls, such as self-audits or other types of monitoring controls that provide better coverage and assurance than testing a small sample of a given population. We can envision that companies will strengthen or develop those types of monitoring controls in some areas where they do not exist today, which would improve the companies' control structures. A side benefit is that there will likely be fewer key controls to test.

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?

The proposed standard refers to company-level controls in paragraphs 16 and 17 stating that these controls should be tested and considered in determining the scope of other testing. In paragraph 43 the proposed standard indicates that company-level controls could be relied upon to prevent or detect misstatements to one or more relevant assertions.

At Microsoft we have documented and tested company-level controls in lower risk areas to allow us to focus on the most important and pervasive controls, with the additional benefit of reducing or eliminating testing of process level controls. We expect to expand this practice next year in implementing the SEC proposed guidance. Controls that we have relied on in this manner include variance analyses, management reviews, and monitoring activities, which have a direct relationship to financial statement assertions. From our discussions with other companies, we believe that these are fairly common types of direct company-level controls. If needed, we are willing to provide examples of company level controls that we rely upon and/or participate in efforts to develop supplemental information about company-level controls.

The SEC proposed guidance makes a distinction between entity-level controls that are directly or indirectly related to a financial reporting element. Directly related controls can be designed to adequately prevent or detect misstatements, whereas indirectly related controls typically would not adequately address a specific risk for a financial reporting element. This is a helpful distinction in discussing company-level controls, and we suggest that the proposed standard be revised to include this idea.

Finally, it would be helpful for the SEC and the PCAOB to use the same terminology in discussing these controls, adopting either “company-level” or “entity-level” as a common descriptor.

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?

In the structure of the proposed standard, risk assessments focus audit effort on the most important areas. Identification of significant accounts to include in scope, selection of relevant assertions and controls and the nature and extent of testing evidence to be obtained are all independently determined based on relevant risks. For companies with multiple locations, the proposed changes in the multi-location guidance shift the focus from an emphasis on coverage to an emphasis on identifying and including high-risk locations. At each decision point, the application of thoughtful risk assessments should focus the audit effort.

The proposed standard also contains a useful description of risk factors to use in determining significant account risk and control operating effectiveness risk. Because the proposed standard discusses these two risk assessments separately, it makes it clear that they are not interdependent. A key control over a high risk significant account or process could be assessed to be low risk in terms of its operating effectiveness, which would affect the type and extent of testing. We believe that this flexibility to apply judgment to the testing process will be beneficial.

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

For lower risk controls, we believe it is possible that the performance of a walkthrough could be sufficient. As mentioned in the response to question 5, these lower risk controls could include controls over high risk accounts or transactions, if the control environment was strong, the control had a history of operating effectiveness, the control design had not been changed, and prior years' test results were favorable. A walkthrough might also be sufficient for controls that do not lend themselves to examination of evidence, such as some of the indirect company-level controls.

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 although somewhat vague. Because the significant deficiency definition is primarily relevant in determining which deficiencies should be reported to the Audit Committee, the interpretation of the definition will likely be in the context of what would be significant to the Audit Committee and members of senior management who exercise similar financial statement oversight. The proposed definition is more reasonable and allows for companies to focus on more important financial reporting matters than under the prior definition which included the phrase "more than inconsequential."

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 direct experience with this issue but are not aware that auditors are not appropriately identifying material weaknesses. The proposed standard states quite clearly, particularly in paragraph 72, that a deficiency should be evaluated by determining whether there is a reasonable possibility that the controls **will** fail to prevent or detect a misstatement, not whether they **did** fail to prevent or detect a misstatement.

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 proposed changes will probably reduce the amount of effort devoted to identifying and analyzing deficiencies. The current definitional terms "more than remote" and "more than inconsequential," although subject to judgment, seem to imply a broader spectrum of possible outcomes than "reasonable possibility" and "important enough to merit attention by those responsible for oversight of…financial reporting." We believe that fewer issues will appear to be on the margin between "deficiency" and "significant deficiency" under the new definition and therefore less effort will be devoted to the analysis.

For many companies, deficiency evaluations have been structured using a framework that was developed by several of the larger audit firms. This framework has been useful in driving consistency of thought and communication but has also been restrictive. The factors laid out in the proposed standard to consider in evaluating control deficiencies or combinations of deficiencies are helpful and provide more room for judgment. We suggest that the proposed standard include a statement that the deficiency evaluation factors in the standard can be used instead of the more prescriptive framework.

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?

We believe that the proposed standard should allow an auditor to exercise judgment over whether a deficiency exists. In the presence of a strong indicator of a material weakness, the auditor is not likely to conclude that there is not a deficiency, but it is possible, especially if the magnitude of the indicator were quite small. The auditor would need to defend his/her judgment and document it appropriately, particularly for one or more of the strong indicators stated in the proposed standard.

Any time judgment is involved, there is the potential for inconsistency and this is certainly true in the evaluation of deficiencies. Whether there will be more inconsistency with this change is difficult to predict.

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

We believe that additional guidance regarding IT general controls would be very helpful. Specific suggestions are included in the body of the letter.

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?

We believe that the reference to interim financial statements could result in companies' having to use an inappropriately low quantitative threshold to evaluate control deficiencies. In our view, deficiencies should be evaluated and classified based upon their potential future impact on annual financial statements, since the management assessment addresses whether controls are operating effectively as of the end of the year. The impact of control deficiencies that are identified during the year should be extrapolated and compared to an annual quantitative threshold (in addition to considering qualitative factors, of course). Therefore, we believe that the words "or interim" should be removed from the definitions of a material weakness and a significant deficiency.

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

Removing the requirement for an evaluation of management's process will not have a significant impact on the audit work, in our opinion. Based on discussions with our auditors and observations of their process, it seems clear that they are not spending a significant amount of time specifically auditing management's process.

The other reason that removing the requirement will not have a large impact is that we will want to continue to align our management assessment process with the external audit process to optimize auditor reliance on the work of others. The auditors' reliance on our work will undoubtedly continue to require some retesting of management's assessments.

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

The auditor can perform an effective audit without performing an direct evaluation of the quality of management's process. To the extent that management's assessment process is intertwined with the operation of the controls (e.g., monitoring processes) or the auditor is relying upon management testing, then the auditors will have to continue to perform some type of indirect assessment of management's 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?

The introductory paragraph of the sample opinion in paragraph 96 of the proposed standard still states that the auditor has "audited management's assessment…that W Company maintained effective internal control over financial reporting…" The Opinion paragraph clearly concludes on the effectiveness of ICFR, but the inconsistency is potentially confusing. The important judgment and opinion is that the controls are operating effectively and that is described in the Scope and Opinion paragraphs.

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

The proposed standard does provide for using cumulative knowledge in determining the extent of testing, as described in paragraphs 65 through 69. However, except for specifically mentioning benchmarking of automated controls, the proposed standard does not allow for rotation or benchmarking of control tests. We believe that rotational testing can be appropriate in areas other than automated controls and would like to see the standards allow for that possibility based on the judgment of the auditors.

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?

For lower risk controls, we believe it is possible that the performance of a walkthrough could be sufficient. As mentioned in the response to question 5, these lower risk controls could include controls over high risk accounts or transactions, if the control environment was strong, the control had a history of operating effectiveness, the control design had not been changed, and prior years' test results were favorable. A walkthrough might also be sufficient for controls that do not lend themselves to examination of evidence, such as some of the indirect company-level controls.

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?

We believe that the approach for determining multi-location testing scope will result in more efficient audits. With the current requirement to include a large portion of the company in scope, the auditor may not have been able to fully consider qualitative risks. The risk-based approach will probably remove from testing locations that have been included simply to reach a quantitative limit or could bring locations into scope that have been excluded purely on quantitative grounds. Also auditors may have more flexibility to consider centralized, company-level and/or monitoring controls that may provide equivalent or greater coverage. Whatever the specific outcome, the focus on risk and judgment is an improvement over the current requirements.

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?

The same principles should apply for relying on the work of others, whether for an integrated audit or a financial statement audit. The requirements for competence and objectivity should be equally important in either scenario. The particular required competencies of the people performing the work may vary, but the framework should be the same.

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?

The proposed definition of relevant activities as “tests performed by others that provide evidence about the design and operational effectiveness” seems to be too restrictive. Monitoring activities would not typically be thought of as “tests performed” but are likely to be quite reliable in certain circumstances. The definition should be modified to be more inclusive, using terms such as “activities” or “monitoring processes” or “assessments”, instead of, or in addition to, the more restrictive “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, we believe that the auditor should have a full understanding of any control deficiencies, fraud or misstatements identified by others performing relevant activities.

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

In our opinion it is not necessary. If the auditor has decided that he/she can rely on the work of others based on the competence and objectivity standards, then the other parties should be able to provide sufficient evidence.

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?

We believe that the criteria may be too restrictive and onerous. We favor giving the auditors more judgment in how they determine competence and objectivity. This could be accomplished by changing the first sentence of paragraph 14 to read, “Factors relevant to the assessment of the competence of the individuals performing tests **could** include, **for example – ”.**

We are interested in the auditor having the flexibility to rely on management testers in addition to Internal Audit. In many companies the Sarbanes-Oxley program management individuals are equally competent and also objective in terms of field locations, although they may not report organizationally to the Audit Committee. The “organizational status” section in paragraph 15.b. could be interpreted to limit reliance to Internal Audit. A suggested change is to remove the first two bullet points of paragraph 15.b. Alternatively, the language could be changed to add that the responsible persons could report to a person of sufficient status and objectivity to serve an oversight function similar to an Audit Committee function.

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

Other factors that could be considered for assessing competence are the person’s knowledge of the processes, controls and accounting in the areas where the person is performing relevant activities, and also participation in the company’s program for training on Sarbanes-Oxley compliance requirements in general and specific to the company.

As mentioned above, the “organizational status” section seems to lean heavily in favor of the use of Internal Audit personnel, even though we believe one of the intents of the proposed standards was to expand the population of others who can be relied upon. See response to question 23 for suggested changes.

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?

As a practical matter, individuals performing the testing are probably not often in a position to influence their own compensation by how they perform the testing or report the results. Adding compensation policies as a factor of objectivity does not seem necessary.

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

Requiring a walkthrough only for significant processes should reduce the number of walkthroughs which are currently performed for all transactions. We support this change that allows for auditor judgment to determine when walkthroughs are necessary to maintain audit quality.

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?

We believe that the proposed standard should allow the auditor to more broadly use the work of others in performing walkthroughs, including complete reliance on the work of others if the auditor determines that the quality or rigor of the walkthrough would not be compromised. If performed by competent and objective testers and if properly documented in a manner that can be appropriately reviewed and evaluated by the auditors to meet their reliance standards, walkthroughs should be no different than other testing in terms of reliance.

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 principles of the proposed standard apply very appropriately to large and small companies. The top-down, risk-based approach provides a good degree of flexibility that can be applied to tailor the audit approach to fit the company's circumstances, large or small. The additional language included in the proposed standard to address differences between small and large companies is helpful and is appropriate to all companies. We do not believe that additional language or guidance is needed.

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?

In our opinion, the effective date should be as early as possible in calendar year 2007. An early effective date will make it possible for auditors and management of calendar year companies to work together to incorporate proposed standard changes in scope and plans for 2007 audits and assessments.

From: Wendy Huang [mailto:Wendy.Huang@MolinaHealthCare.Com]
Sent: Monday, February 26, 2007 4:59 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 021

- PCAOB Question: Does the proposed standard clearly describe how to use a top-down

approach to auditing internal control?

My Comment: Is the top-down approach of using the risk assessment to be performed from scratch each year? Once it is done the first year to determine the linked significant processes and accounts, and assuming little or no changes in subsequent years, the risk assessment should not have to be reperformed annually, correct?

- PCAOB Question: 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?

My Comment: An auditor should NOT be allowed to conclude that no deficiency exists if one of the strong indicators is present (unless the restatement of financial statements is not due to an error, such as the acquisition or disposal of a business segment). It may not necessarily lead to a material weakness, but a control or significant deficiency should at least be concluded if one of the strong indicators is present (with the exception stated above). If one of the strong indicators has been identified, there has to have been a deficiency/breakdown somewhere in the process—it's just a matter of finding where it occurred. Otherwise, it would lead to inconsistencies in the evaluation of deficiencies, as some auditors would conclude that a deficiency exists and some would not. That leads to more consistency problems than inconsistencies in the level of deficiency concluded.

- PCAOB Question: Does the proposed standard appropriately incorporate the value of

cumulative knowledge?

My Comment: It is still not entirely clear. My interpretation of the proposed revision to the standard is that the only affect of obtaining and using cumulative knowledge is just doing a walkthrough instead of full testing, that the only way that testing can be reduced is by doing a walkthrough. Is that correct? Rotational testing is still not allowed? Could we not rotate testing of "secondary" controls? For example, if one risk is mitigated by several, say 5, "secondary" controls, could the auditor not rotate the controls and test maybe 2 of those secondary controls each year?

- PCAOB Question: Will the proposed standard's approach for determining the scope of testing

in a multi-location engagement result in more efficient multi-location audits?

My Comment: Yes, it will be more efficient, but the proposed standard's approach is still not too clear on exactly how to apply the risk-based methodology, as auditors tend to interpret risk based on materiality, which in turn leads to the amount of coverage.

- PCAOB Question: Does the proposed standard on auditing internal control appropriately

describe how auditors should scale the audit for the size and complexity of the company?

My Comment: No, still not clear on how to scale down the audit.

Wendy Huang, CPA

Director of Internal Audit
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Jeffrey M. Monohan
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February 26, 2007

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street, N.W.
Washington, DC 2006-2803
comments@pcaobus.org

Securities and Exchange Commission
Office of the Secretary
100 F Street, NE
Washington, DC 20549-1090
rule-comments@sec.gov

Re: 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*

SEC File No. S7-24-06
Proposed Interpretation - *Management's Report on Internal Control Over Financial Reporting*

Dear Sir or Madam:

I appreciate the opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (PCAOB) with respect to its Proposed Auditing Standards – *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; PCAOB Rulemaking Docket Matter No. 021] and from the Securities and Exchange Commission (SEC) with respect to its Proposed Interpretation – *Management's Report on Internal Control Over Financial Reporting* [SEC Release Nos. 33-8762; 34-54976; File No. S7-24-06]. My comments provided are based on my insights and experiences in performing integrated audits at a Big Four public accounting firm and participating in management's assessment of internal controls over financial reporting (ICFR) within a Fortune 100 company when serving as a Director of Financial Compliance.

I support the PCAOB's efforts to clarify Auditing Standard No. 2 and align this standard with the interpretive guidance proposed by the SEC. Overall, I strongly agree with a principles-based approach to the internal control assessment and employing a top-down risk-based approach that requires testing of operating effectiveness of only ICFR necessary to prevent or detect *material* misstatements in the financial statements. However, I believe additional consideration, emphasis, and clarification is required with respect to some areas. To that end, I offer the following comments and observations for your consideration.

Thank you for the opportunity to comment on these proposed standards and interpretation. If you have any questions, please do not hesitate to call me at (626) 378-1923.

Respectfully Submitted,

Jeffrey M. Monohan

Comments

PCAOB Proposed Auditing Standard – *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals*

Questions

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

Removing the requirement for an evaluation of management's process will eliminate some unnecessary audit work. However, the extent of this elimination will be minimal. To obtain any efficiencies from leveraging efforts of management's assessment with the independent auditor's assessment over ICFR, management's process will have to operate at a level of quality (considering nature, timing, and extent of work performed by management and the competence and objectivity of those performing the operating effectiveness of ICFR) that would be acceptable to the independent auditor to allow the auditor to rely on as much of management's work as possible over processes considered having low to moderate risk. If the auditor decides to utilize management's work in these areas, the auditor will require reperformance of portions of management's work. The aforementioned is not much different from what is being performed today.

Eliminating the independent auditor's evaluation of management's process will more than likely encourage the auditor not to use management's work. There is little benefit for the independent auditor to use management's work. Managing one's risk and liability associated with an audit is an integral part of an independent auditor's business model. Why would an auditor place greater exposure on himself or herself and reperform portions of *management's work* when applying the principles of "considering and using the work of others in an audit" in an effort to reduce his or her own work? Unless an independent auditor reperforms a substantial portion of management's work, how can an auditor obtain reasonable assurance that the work performed in a particular area is adequate and can be relied upon for the independent auditor's opinion of ICFR? It is more practical that an independent auditor would gain greater assurance over his or her own work over testing the necessary audit sample to determine operating effectiveness of ICFR than reperforming portions of management's work (even considering that the auditor reperforms portions of management's work and appropriately applies the principles of the proposed auditing standard over considering and using the work of others in an audit). In addition to the obvious monetary benefit generated through audit fees for performing the necessary work associated with the assessment of ICFR by himself or herself, the independent auditor can reduce audit risk by performing all necessary work to substantiate his or her audit opinion over ICFR.

Although the requirement for an independent auditor's opinion on management's assessment process is being proposed for elimination, the duplication of work and associated costs (management process owners effectively still will get tested twice—as a result of procedures related management assessment of ICFR and the independent auditor's assessment of ICFR) will remain. The independent auditor will continue to employ a conservative approach and cause similar inefficiencies as in past years. Management could encourage the independent auditor to employ the necessary principles and procedures to have the auditor consider and use the work of others, but the auditor always has the option to decide not to for various reasons. Through the PCAOB inspections of the audits performed by the independent registered public accounting firms, PCAOB inspectors are focused on the quality of the audit performed. The PCAOB inspectors cannot detect that the auditor has not appropriately leveraged management's work when management's work meets all the principles stated in its proposed auditing standing of "Considering and Using the Work of Others in an Audit." This would be beyond the scope of the PCAOB's inspection. Therefore, there is little that can be done to stop these inefficiencies. Management will continue to be plaque by the duplication of efforts created by its and the independent auditors assessment of ICFR.

Question 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 proposed standard's approach needs additional clarification. A combined coverage (similar to AS2 Appendix B4. – "a large portion of a company's operations and financial position") in conjunction with the degree of risk associated with a location or business unit will allow for greater flexibility and efficiencies for management and its independent auditors. The inclusion of AS2 Appendix B4. language in combination with assessing risk of material misstatement would provide greater clarification.

Question 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?

Although many concepts of the proposed standards can be implemented currently, the proposed standards would need to be approved by May 31, 2007 in an effort to obtain maximum benefit to audits for years ending on or after November 30, 2007. This timing would provide management and its independent auditor sufficient time to plan and effectively implement the proposed changes.

<u>Observation</u>

Management's need to report all control deficiencies to the independent auditor

Within paragraph 84 (e) of the proposed standard, it states that management should disclose to the auditor *all deficiencies* in the design or operation of ICFR identified as part of management's assessment. This would include deficiencies, significant deficiencies, and material weaknesses. However, according to the SEC Proposed Interpretation the purpose of management's assessment is to assess whether there is a reasonable possibility of a *material* misstatement in the financial statements not being prevented or detected on a timely basis. As such, management would only be able to disclose with reasonable assurance to the auditor significant deficiencies or material weaknesses over ICFR if management employed an assessment process to achieve compliance with the SEC Proposed Interpretation. I would recommend that references to management's disclosure of deficiencies be restricted to significant deficiencies and material weaknesses to avoid any unintended inefficiencies.

Subject: Comment on Rulemaking Docket No. 021, PCAOB Release 2006-007
From: icfr@financeintegrity.com
Date: Tue, Feb 06, 2007 8:32 am
To: comments@pcaobus.org
Cc: phillipsl@pcaobus.org, viragS@pcaobus.org

This comment letter concerns Rulemaking Docket Matter No. 021, PCAOB Release 2006-007.

The views expressed in this letter are my personal beliefs and opinions. These views have not been considered or endorsed by any company or organization.

Throughout my career, I have been an advocate of strong internal control, particularly with regard to the processing, accounting, and reconciliation of financial transactions.

As chairman of the audit committee of an eleven thousand member professional association, I convinced the Board of Directors that the annual financial statement audit did not provide assurance on internal control and therefore a separate audit of internal control would be beneficial. Within six months, the association received an attestation report that validated management's assertion that the association had effective internal control. All of this occurred at least five (5) years before Section 404 was even conceived.

I believe the Sarbanes-Oxley Act of 2002 is great legislation that has and will continue to discourage unethical behavior. In my view, the mandated CEO/CFO certifications, severe penalties, and the government's more aggressive pursuit of white collar criminals are particularly effective at discouraging fraudulent financial reporting.

The wording of Section 404 is reasonable and appropriately focuses attention on financial reporting. In turn, the Commission's initial definition of ICFR was correct for what was included and excluded from the definition. Extremely noteworthy, the Commission recognized that ICFR *"does not encompass the elements of the COSO Report definition that relate to effectiveness and efficiency of a company's operations and a company's compliance with laws and regulations ..."* I believe the fatal flaw in AS2 is the Board did not clearly synchronize its guidance with the Commission's definition of ICFR and did not clearly emphasize what was excluded from ICFR.

Concerning the proposed release, I strongly urge the Board to delete paragraph number five (5). If this paragraph survives, self-serving auditors will be given the power to control which framework is used by management. From a practical standpoint, it is likely most registrants and their accounting firms will use the same control framework; however, the Board should not mandate this be the case. It is important to note the Commission expressed an important view on control frameworks in Footnote # 50 of its proposed guidance to management:

- ***"... we are not requiring that companies use the guidance in the auditing literature to conduct their evaluation approach. The Commission encourages the development of methodologies and tools that meet the objectives of the ICFR evaluation."***

If paragraph five is not deleted or altered in a significant way, the PCAOB will seriously undermine the Commission's stated preference that new control methodologies and tools be developed. Again, please consider deleting paragraph number five (5).

I am cautiously optimistic new control methodologies and tools will be developed in the near future. With any luck, perhaps these will be clearly and unequivocally focused on financial reporting.

Patrick Montgomery, CPA, CFE, CTP
icfr@financeintegrity.com
icfr@executiveintegrity.com

Cc: Laura Phillips, Deputy Chief Auditor
Sharon Virag, Associate Chief Auditor

Moody's Investors Service

99 Church Street
New York, New York 10007

Gregory J. Jonas
Managing Director
Tel: 212.553.1449

February 26, 2007

Mr. J. Gordon Seymour
Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

RE: Rulemaking Docket Matter No. 021 – An Audit of Internal Control Over Financial Reporting

Dear Mr. Secretary:

Moody's appreciates this opportunity to comment on the PCAOB's proposed auditing standard on an audit of internal control over financial reporting.

We are writing from our perspective as users of company financial statements and internal control reports in the course of rating the credit risk of debt instruments.

We believe that reporting on internal control has helped restore confidence in U.S. financial reporting which was badly shaken after massive instances of fraudulent reporting. Our discussions with companies suggest that control reporting has promoted investment in the people, policies, processes, and systems necessary to support quality reporting. Further, Moody's has benefited from new information about control problems which has helped us assess the risk of misleading financial reporting, which is one of many elements we consider when assessing credit risk. These benefits have been significant.

By any measure, the costs of implementing reporting on internal control by management and auditors have been high, indeed a multiple of what was projected during the debate over the Sarbanes/Oxley Act. Most commentators have argued that some portion of the cost is unnecessary. Although we have no special insight into costs, we have seen nothing to suggest that concerns about costs are invalid. Accordingly, we support policies that promote efficient control reviews by management and auditors, provided, of course, that this can be done without reducing the benefits of reporting on control.

While much of the commentary about control reporting has been concerned with compliance costs, evidence suggests that important goals of reporting on controls are not being fully achieved:

a) There appears to be insufficient emphasis on controls that prevent senior management from fraudulently manipulating financial reporting (cooking controls).
b) Material weaknesses too often lag rather than precede material errors in financial reporting.

We have discussed these issues with the staff and Board in the past, and appreciate the provisions you have included in the proposed standard to address these issues. In particular:

- To focus on management fraud related controls, the provision that would always require the auditor to evaluate the control environment and controls over the period end financial statement close process and test controls to address the risk of management override.
- To encourage proactive identification of control weaknesses before they result in financial reporting errors, the provision noting that whether a control deficiency is a material weakness does not depend on whether a misstatement has already occurred.

Controls that Prevent Senior Management from Fraudulent Reporting

The requirement to report on internal control resulted from one particular type of internal control breakdown: senior management of some major public companies overrode their control systems and intentionally issued misleading financial statements. History has shown that senior management cooking the books has been the most costly of control failures. It has caused billions in investor losses, undermined confidence in reporting affecting the liquidity and cost of capital for many companies, and triggered significant new regulation and requirements, including reporting on controls. Other forms of fraudulent reporting, such as misleading reporting by lower-level employees, have not had the same impact. Neither has control failures resulting in honest errors in financial reporting, regardless of whether they relate to insufficient accounting skills, complex reporting requirements, difficult estimates or judgments or system failures.

Because of its dominant importance, ensuring adequate controls that prevent senior management from cooking the books must be a focus of control assessment. Although other controls are important, companies, auditors and regulators should give first priority to cooking controls.

Yet, despite many hard lessons, control-related literature does not give priority to cooking controls. Control frameworks, auditor guidance on controls, and the SEC's guidance to management each seem to treat fraud-related controls as no more important than a myriad of other control issues.

Internal control reports to date also suggest that audit committees, management and auditors are not giving priority to controls related to senior management fraud. For example, in the latest year of internal control reporting, of the thousands of companies that Moody's rates, only four referred to fraud-related control weaknesses, including tone at the top, and in each case the companies had discovered instances of fraudulent reporting prior to reporting fraud-related control problems.

Why haven't management, auditors, standard setters and regulators given priority to controls related to cooking the books? We speculate reasons possibly include:

- Its difficult for senior management to objectively assess its own tone
- Assessing controls that prevent senior management from cooking the books are often judgmental and its hard to obtain objective compelling evidence absent an instance of senior management fraud
- Controls over senior management are sensitive and uncomfortable for audit committees, management and auditors to address
- Control frameworks don't provide much guidance on cooking controls
- Control-related literature doesn't give priority to cooking controls; risk assessment is left to judgment.

We are pleased that the Board recognizes that a top-down, risk-oriented approach alone is unlikely to ensure adequate focus on fraud-related controls. We suspect that those in senior management who are inclined to cook the books will deem book cooking to be of low risk and direct subordinates to spend time on other controls management deems more important. Similarly, auditors, who decide to accept and retain clients in part based on their assessment of the integrity of senior management, are likely to deem book cooking by management they trust to be of low risk, absent an audit standard that mandates a focus on controls over senior management fraud.

Because senior management fraud has been so costly for investors and difficult to prevent and detect, we suspect there is a lot more to learn about controlling senior management fraud. We suggest that the PCAOB promote research into instances of senior management fraudulent reporting specifically to identify controls that would have prevented the fraud and reasons why auditors failed to identify the material weakness in controls. The insight from this research could help improve controls, improve audit quality and inform future auditing standards.

Material Weaknesses as Leading Indicators of Reporting Risk

Few would question that strong controls are essential to quality financial reporting. As users of control reports, we had hoped that material weaknesses flagged would provide insight into the risk of future errors in financial reporting, and provide management time to address control weaknesses before they resulted in reporting failures.

Unfortunately, reports citing material weaknesses appear to be lagging rather than leading indicators of financial reporting problems. Of the companies Moody's rates, during the last year of internal control reporting, 74 companies reported material weaknesses in internal control, but only 4 did not experience prior reporting errors (restatement or material audit adjustment) in the area related to the material weakness.

The data suggest management and auditors require evidence of error or fraud before they are willing to conclude that a control concern is a material weakness. Why are management and auditors so reluctant to cite a material weakness absent evidence of a past error? Concluding that a control issue is a material weakness involves considerable judgment, which is sure to be questioned when it involves controversial and unhappy news. We suspect that management, audit committees and auditors are asking for hard evidence to support a view that control problems are material weaknesses. We also suspect that the hardest evidence is when control breakdowns result in reporting errors.

Yet, the lagging nature of reported control weaknesses undermines their usefulness to users of financial statements. Further, failing to identify a material weakness may reduce the chance that management will take corrective action in time. Reporting control weaknesses after financial reporting problems have occurred is analogous to a medical doctor reporting high blood pressure only after the patient has suffered a heart attack.

The Board may wish to turn up the noise level on this important problem. It seems that practice is entrenched in the notion that reporting problems must be present to justify a material weakness. A few ideas to do so are:

- Identify in the standard itself the problem of the lagging nature of many control weaknesses to date and call for improvement
- Be clear in the standard that a key goal of reporting on internal control is to identify material weaknesses before related reporting problems occur
- Explain in the standard why the Board concluded that the absence of a reporting problem is irrelevant when judging whether a control deficiency is a material control weakness.

We thank you for considering our comments. Of course, we would be pleased to discuss them with the Board or staff should they desire further information.

Sincerely,

Gregory J. Jonas **(s)**
Managing Director

From: Matthew.Moog@ey.com
Sent: Wednesday, December 20, 2006 5:22 PM
To: Comments
Subject: Docket 21

1) On page A2-4, #7 reads "The auditor should evaluate the extent to which he or she will use the work of others. Areas in which the auditor might use the work performed by others to reduce the procedures the auditor otherwise would have performed include –
• Procedures the auditor performs when obtaining an understanding of the company's internal control over financial reporting;
• Procedures the auditor performs when assessing risk;
• Procedures the auditor performs when testing the effectiveness of controls; and
• Substantive procedures the auditor performs when testing account balances and disclosures."

Should this be interpreted the auditor may rely on the work of others for walkthroughs and identifying key controls as long as a percentage of the work of others is re-tested? If so, should the auditor's evaluation of the related risk be formally assessed and documented to support the decision?

Regards,

Matthew W. Moog

Ernst and Young LLP | Technology & Security Risk Services
NY - Financial Services Office
(212) 773-2096 – office | (866) 833-4790 – fax
Matthew.Moog@ey.com

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From: Matthew.Moog@ey.com
Sent: Saturday, January 13, 2007 12:47 PM
To: Comments
Subject: Revision to my comment submission information

January 13, 2007

Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

On December 20th, 2006 I submitted a comment to your comments@pcaob.org mailbox re: Docket #21 with respect to section A2-4, #7. Please note that the submission was made on my personal behalf and as such reflects my personal views and not the views of my employer. Please update my submission record and comment to reflect this.

Sincerely,

Matthew Moog

Copy to: Mr. J. Gordon Seymour, Secretary and Deputy General Counsel

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February 23, 2007

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

Reference: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

Thank you for this opportunity to provide comments on the PCAOB's proposed standard An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements (the proposed audit standard). The respective efforts by the SEC, PCAOB, external audit firms, and filers to enhance the effectiveness and efficiency of the audit of Internal Control over Financial Reporting (ICFR) is commendable.

It is now apparent that the initial implementations of SOX 404 were indeed inefficient (and of questionable effectiveness). Too much of the wrong work was completed, while possibly not adequately addressing the significant risks to ICFR. This has continued to be carried forward, at many companies, in the years subsequent to the initial implementation.

Further, initial implementations did not place the proper priority on the types of risks that led to the enactment of the Sarbanes Oxley Act in 2002 (including issues with the control environment, fraud at the senior level, and management override). The reason for this was that Auditing Standard No. 2 – An Audit of Internal Control over Financial Reporting Performed in Conjunction with An Audit of Financial Statements (AS2) focused the audit of ICFR at too detailed a level and did not provide for the proper reliance on a risk assessment of ICFR. Auditors felt justifiably compelled to audit to the most conservative clause within AS2. Thus, although AS2 contained the appropriate principles, there was lack of sufficient clarity or directive for the auditor. What were interpreted as the rules of AS2 directed the auditor on a significantly different path (i.e. auditing to the most conservative clause or trying to audit everything) rather than focusing on risk. When risk was introduced to the auditors' approach, it generally manifested solely in determining the nature, timing and extent of testing of controls (controls that probably should not have been in scope in the first place).

The direction provided by the SEC and the PCAOB, in May 2005, seemed to present the opportunity for auditors to rethink their approach. It has been stated that management also should embrace the new approach. However, the practical reality is that any filer that did try to embrace a top-down, risk-based approach did so at its own peril. There would be no recourse for filers in the situation where management chose to embrace the top-down, risk-based approach and the auditor disagreed philosophically. Filers would then be stuck in a situation that would lead to significantly greater external audit fees, or worse, deficiencies in its process of evaluating ICFR.

The current proposals from the SEC and the PCAOB offer meaningful direction and the opportunity for filers to implement Section 404 in a more meaningful top-down and risk-based approach. The proposals also alleviate some of the pressures placed on the external auditors who had interpreted the prior standard to create an audit to the most conservative clause.

The only significant barrier that I see to successful implementation of this new audit standard is clarification of the definition of reasonable possibility as exists throughout the standard and in the definition of Relevant Assertion ("…a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated.")

Without clear guidance from the PCAOB (other than deferring to SFAS5 and other authoritative literature that defines "reasonably possible.") on the intended order of magnitude of this one phrase, the audit profession could elect to interpret (reinterpret) its definition, reducing the bar to such a low level that risk assessment will not be a meaningful exercise. If that occurs, the efforts of the SEC and PCAOB to clarify and improve the standards may have been in vain. There will be limited improvements in the effectiveness and efficiency of the audit of ICFR.

AS2, section 9 defined more than remote to be "…either reasonably possible or probable" per the meaning of evaluating the likelihood of a loss contingency in SFAS5. The auditing profession, perhaps because this was a new term, perceived more than remote to be the boundary **between** remote and reasonably possible. In quantitative terms, one Big 4 firm stated that this represented more than a 5-10% probability of occurance in its interpretation of how to implement AS2.

Comments from more than one of the major audit firms have indicated that their belief is that the proposed audit standard does not change this conceptual threshold. Further, one Big 4 firm has stated that in replacing the term "'more than remote likelihood' with the term 'reasonably possible' within the definition of material weakness and significant deficiency…the PCAOB acknowledges that while this represents a change to the language, no change has been made to the conceptual threshold."

If this is indeed the PCAOB's position, that reasonably possible and probable are theoretically just above the 5-10% range of probability, then there is no need for risk assessment and this should not be considered a top-down or a risk based approach. It would be more appropriately termed a top-down and risk-based **testing** approach. The majority of same, lower relevance controls will continue to remain in scope. The difference will be that the auditors will feel more compelled to alter the nature, timing and extent **of the testing of controls that should not be tested in the first place**. A focus on the risks of material misstatement in the financial statements will remain elusive.

It is recognized that the PCAOB does not desire to define reasonably possible with a quantitative range in the evaluation of control deficiencies (proposed audit standard, section 73). Based on historical interpretation and current commentary from the Big 4 related to this one particular definition, we request much greater clarity in establishing the order of magnitude of what makes the likelihood of material misstatement reasonably possible. Without this clarification, the inevitable result is that it will not be possible to implement a risk assessment strategy, and there will be neither a top-down nor a risk-based approach.

Respectfully,

Todd W. Moore, CPA
Superior, CO

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February 26, 2007

Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
rule-comments@sec.gov

Laura Phillips
Deputy Chief Auditor
PCAOB
1666 K Street, N.W.
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comments@pcaobus.org

Re: SEC Proposed Rule Concerning Management's Report on Internal Control over Financial Reporting – Release Nos. 33-8762; 34-54976 (File No. S7-24-06); and

PCAOB Proposed Audit Standard – An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals -- Release No. 2006-007 (Rulemaking Docket No. 021).

Dear Ms. Morris and Ms. Phillips:

The Nasdaq Stock Market, Inc. ("NASDAQ") appreciates the opportunity to respond to the Securities and Exchange Commission's (the "Commission" or "SEC") Proposed Rule Concerning Management's Report on Internal Control over Financial Reporting and the Public Company Accounting Oversight Board's ("PCAOB") Proposed Auditing Standard Regarding an Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements. NASDAQ's perspective on these issues is informed by its status both as the operator of a venue for companies to raise capital in the public markets and as an accelerated filer that has been subject to the internal control reporting provisions of the Sarbanes-Oxley Act ("SOX") for the past three years.

SOX's central purpose of restoring confidence in the public markets has been a resounding success. SOX has brought heightened attention to the quality of financial reporting on the part of management and their outside auditors. At the same time, however, the excessively high costs of implementing Section 404 have placed the U.S. capital markets at a competitive disadvantage. These costs are associated with the level of documentation that has been required by outside auditors, the due diligence underlying the required auditor attestation, and the overly broad scope of internal controls subject to the legislation's reporting requirements.

Accordingly, our suggestions are directed at better leveraging the beneficial elements and making changes to lessen the cost of elements of SOX that generate fewer benefits.

It is our opinion that the current and proposed guidance, while beneficial in many respects, still does not address some of the more costly aspects of SOX compliance. Specifically, we are concerned about: (i) the inconsistency and apparent conflict between guidance issued by the SEC to management and guidance issued by the PCAOB to the auditors; (ii) the redundancy between management and independent auditor activities; (iii) the lack of clarity about the scope of evidentiary proof requirements; and, (iv) the lack of clarity about the evaluation of general technology controls. We believe that these are the four major drivers of excessive costs.

The corporate control landscape has changed dramatically over the last three years as public auditors have focused on audit services as their core product, management has accepted through their attestations that good control is good business and the PCAOB has provided oversight of public auditors. Given these profound structural changes it is our opinion that elimination of unnecessary costs is long overdue. Our recommendations to minimize these unnecessary costs follow.

The proposals need to resolve inconsistent guidance between the SEC and PCAOB. Neither the SEC nor the PCAOB guidance 'sets the bar' as to an expected level of review by auditors. In the absence of explicit direction to the contrary, this lack of clarity will certainly lead auditors to take too expansive a scope in their reviews and provides no incentive for auditors to adopt a scalable approach and rely on an integrated audit to reduce costs. In addition, the PCAOB proposal introduces a concept of a "small but complex" company that is not found in the SEC guidance. The subjective determination about complexity could lead an auditor not to appropriately scale its reviews.

Another area where the guidance is in conflict relates to the use of a risk-based approach. The SEC guidance promotes a risk based approach and the use of evidence obtained from on-going monitoring and self-assessment for evaluation of controls in lower risk areas. The PCAOB guidance encourages reliance on the work of others but identifies objectivity as a requirement for this reliance. The SEC and PCAOB guidance seem to be in conflict in this regard. We believe the best method of achieving the intent of the proposals is not only to describe the principles of an acceptable control program but also to provide instructions to the auditor with specific guidance on how to assess the effectiveness of these principles. Without further clarity in the guidance to independent auditors, a proactive self-assessment program instituted by management might result in increased auditor's fees due to the auditor's perceived inability to rely on the work performed by management.

The focus of the independent auditor's opinion should be on evaluating the effectiveness of management's program rather than the effectiveness of individual internal controls. Management should continue to be held accountable for the accuracy of their financial statements and the effectiveness of their associated internal controls. The current proposal, however, removes the need for an independent auditor opinion on the execution of management's program rather than removing the opinion on internal controls. This provides minimal relief, as we believe the primary driver of auditor fees is the opinion on internal controls. The auditor needs to be refocused toward seeing the forest (management's program effectiveness) rather than the trees (individual controls). A successful model in how to achieve this is the FDIC Improvement Act program that applies to FDIC insured banks. This legislation achieved improved controls at banks in a more cost effective fashion, because the FDIC deployed a program effectiveness assessment, in contrast to the current extensive process control testing strategy imposed on public companies.

The proposals should clarify requirements for evidentiary documentation of controls and proof that they are working effectively. The amount, form and medium of documentation should be consistent, reasonable and clear. For example, the proposed requirement for walkthroughs has been modified to apply to significant processes only, but the guidance continues to require the auditor to prescribe the sufficiency of staff performing the walkthrough and to have oversight of the activities. This allows the auditor to dictate the level of detail to be performed and may add a layer of redundancy with regards to testing after the walkthrough. Other areas of ambiguity include the recommendation that higher risk areas require more evidence and lower risk areas less evidence; the recommendation does not, however, clarify what "less evidence" entails. Describing case studies that serve to set the bar for companies and independent accountants would be helpful in resolving discrepancies in documentation between the companies and the independent auditors.

The proposals should clarify the evaluation of general technology controls. The breadth and depth of general technology controls appropriate to address the risk of a material misstatement has not been sufficiently articulated. Subjectivity and lack of clarity has led to increasing levels of annual testing to prove that the general technology controls are adequate. Although both the SEC and PCAOB are advocates of automated controls, lack of clarity is negating the efficiency of choosing automated rather than manual controls, and inhibiting progress in relying on these controls.

Finally, we believe that it is also important for the PCAOB to discipline auditors when they fail to take advantage of appropriate opportunities to reduce testing and other redundant activities, thereby minimizing the costs involved with their review, and for the PCAOB to provide transparency to these actions. This would send a clear message that over-auditing of internal controls is inconsistent with the concepts discussed above, and would make the revised standards meaningful.

We appreciate the opportunity to contribute to the proposed recommendations. Please contact me at (212) 401-8744 if you have any questions.

Very truly yours,

Brian O'Malley

Brian G. O'Malley
Senior Vice President
Internal Audit

BGO/as

National Association of Manufacturers

Jay Timmons

Senior Vice President
for Policy and Government Relations

February 26, 2007

[Via E-mail]

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, D.C. 20006

Re: PCAOB Rulemaking Docket Matter No. 21

To whom it may concern:

The National Association of Manufacturers (NAM)—the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states—appreciates the opportunity to comment on the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting that is Integrated with the Audit of Financial Statements and Considering and Using the Work of Others.* A significant number of our members are public companies and are affected by changes to auditing standards over internal controls.

We appreciate that the PCAOB (the Board) has been responsive to the concerns of companies in the past and we appreciate that the Board has issued the most recent guidance to help businesses more efficiently comply with standards covering the audit of management's assessment over internal controls. Many of our members have reported that Section 404 of the Sarbanes-Oxley Act of 2002 has led to better internal controls and that they have seen the value in the enhanced controls over financial reporting. At the same time we feel that preparation and compliance for the initial audit performed by the external auditors has become a massive and costly effort. It is our hope that the proposed changes will reduce the overall cost and complexity of the audit of internal controls over financial reporting.

We see the proposed changes as a positive step towards more cost effective Sarbanes-Oxley compliance. In particular, we believe the proposal to combine the audit of internal control over financial reporting with the audit of financial statements will significantly address some of our concerns in this area. By combining these audits, companies will be able to more efficiently comply with the law while maintaining the integrity of the internal controls audit.

Additionally, we appreciate that the proposed standard would shift emphasis in the audit to a principles-based model, leveraging risk-based assessments that allow companies to better focus their resources on the areas of greatest risk to the financial statements while reducing the cost of compliance. Current regulations, which require detailed testing in low-risk areas,

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distracts attention from entity level controls that far better address the risk of material misstatements in the financial statements.

The proposal to allow auditors to use information gathered in previous audits will also help mitigate the cost of compliance and maintain the integrity of the audit. Previous guidance led to repeated audit procedures on the same controls year over year that had no real value unless there was a significant change in the control. We hope that the proposed guidance will lead auditors to focus on low-risk areas only when new processes have been put into place or if significant departmental changes occur that warrant increased scrutiny.

We are however, concerned about the timing of the draft proposal and the corresponding comment period timeline. For year end filers, the timeline will not allow a full implementation in 2007. An earlier release would have allowed calendar filers to incorporate final guidance into the 2007 planning process and capture potential gains this year. While, external audit work is often heavier in the second half of the year, this is not the case with management's assessment. Thus, the timing does not allow management the required time to assess and adopt the changes to the standard.

Overall, we are pleased with the Board's proposed standard and commend you for your efforts to streamline the audit of internal control over financial reporting. We are anxious to see how quickly the auditing community will adopt the new proposals and the resulting changes in the cost and complexity of the audit.

Thank you for the opportunity to comment.

Sincerely,

JTimmons

Jay Timmons

Cc: The U.S. Securities and Exchange Commission

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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

February 26, 2007

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

RE: Rulemaking Docket 021: Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements

Dear Members of the Board:

The National Association of Real Estate Investment Trusts® (NAREIT) welcomes this opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (PCAOB) on the concepts and questions contained in Rulemaking Docket 021: Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements (proposed standard or AS5).

NAREIT is the representative voice for U.S. real estate investment trusts (REITs) and publicly traded real estate companies worldwide. Members are REITs and other businesses that develop, own, operate and finance income-producing real estate, as well as those firms and individuals who advise study and service those businesses. We are proud to report that the real estate/REIT industry has been consistently ranked in the top three of 24 industry groups for corporate governance according to the Corporate Governance Quotient rankings published by Institutional Shareholder Services.

This letter offers certain general and specific comments in response to the proposed standard. NAREIT has previously participated in and been very supportive of efforts to provide additional guidance to reduce the burden of compliance while maintaining effective controls over financial reporting.

Summary Comments

NAREIT and its members strongly support the need for effective internal controls over financial reporting. We believe that, on balance, the proposed

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standard would continue to improve the effectiveness and efficiency of public company financial reporting.

We believe it is appropriate and more efficient for the auditor to integrate its audit procedures and opine on a company's internal controls over financial reporting and financial statements without issuing a separate opinion on management's annual internal control evaluation process. We are hopeful that this will lead to more efficiency and reduced audit expenses.

It should be noted, however, that our members expressed concern regarding alignment of management's process with their auditors. Due to the highly subjective nature of the Sarbanes-Oxley compliance process, it is possible that both parties could approach this effort differently with equally valid positions. For example, a company may use a sampling methodology that is different from that used by its audit firm. In these cases, it would be helpful if AS5 stated specifically that each party can individually determine the effectiveness of the internal control framework as long as the conclusions reached are in fact the same.

In cases where a company and its audit firm have different views on implementation and/or conclusions with respect to Sarbanes-Oxley, it would be particularly helpful for PCAOB guidance to be more specific. Although AS5 goes a long way in this regard, many topics still need additional clarification. Examples include the following:

- *Scoping methodologies.* Based on paragraphs 24 - 29, auditors have given member companies guidance that they must redo their risk assessments and not only map each of the entity level controls into the individual business cycles, but additionally 'risk rate' every control within each cycle. This would require them to essentially recreate the Sarbanes-Oxley process and spend a significant amount of time and money to completely overhaul documentation as well as incur additional audit fees with no real benefit.

- *Materiality methodologies.* We suggest that some conservative "safe harbor" thresholds be incorporated into the guidance to serve as examples in providing guidance to assist management in determining whether certain controls could have a material impact on the financial statements. For example, if a breakdown in a specific control, taking into consideration potential skews in performance measures from one-time events, is estimated to have an impact of less than:

  - 2.5% of Revenues,
  - 2.0% of Operating Income,
  - 1.5% of Income before Income Taxes, or
  - 1.0% of Total Assets
  - 1 cent of EPS

  and would not:

- Change net earnings to net loss or vice versa,
- Affect the company's compliance with regulatory requirements, or
- Affect the company's compliance with debt covenants or other contractual arrangements,

then such control would be deemed to be immaterial.

- *Sample size determinations.* Many of NAREIT's member companies use a standard testing methodology that incorporates risk as well as volume when determining sample size. It would be helpful if the PCAOB would provide an illustration of a sample size methodology similar to the example below.

Annual Sample Sizes for Manual Controls

	Low Risk	Medium Risk	High Risk
Annual control	1	1	1
Quarterly control	1	2	3
Monthly control	4	5	6
Weekly control	10	15	20
Once daily control	20	30	40
Multiple times daily control	30	45	60

We support the PCAOB's position that the auditor should consider the size and complexity of a company, and consider ways of streamlining and eliminating unnecessary procedures while planning and performing the audit of internal controls. We applaud the PCAOB for acknowledging that smaller, less-complex companies should have smaller, simpler audits, and that the auditors should expect and accept that a smaller company's control activities may be different and documentation of those controls less formal than found in some larger companies.

While we believe that AS5 is a significant step in the right direction, as with Accounting Standard No. 2, the accounting firms must apply the rules and interpret the guidelines. We believe that the anticipated increase in audit efficiencies and reductions in work effort and cost from adopting AS5 will only be achieved if the PCAOB's evaluation of audit firms discontinues the detailed compliance-based approach to enforcing the standards that it has taken thus far. The audit firms will implement AS5 based on how they are evaluated by the PCAOB.

In this regard, we encourage the PCAOB to take the lead and adopt the spirit and philosophy of the proposed standard while conducting its inspections of audit firms. To this end, we recommend that the PCAOB issue a statement to the auditing profession describing the steps it will take to ensure its evaluation of audit performance will be consistent with the top-down, risk based approach discussed in AS5. Only with this change to the PCAOB's inspections can we hope to see any increase in efficiencies and reduction in audit fees.

Specific Comments

- Auditing standards consider inquiry, observation, inspection of documentation, and appropriate reperformance of tests of controls. However, most of our members found that while completing their Section 404 procedures, their auditors focused largely on the inspection of documentation. Essentially, many auditors had taken the position that in the absence of documentary evidence, controls must be presumed to be ineffective. This is a significant Section 404 compliance issue for most companies and will continue to increase costs if reasonable guidance is not adopted. For example, the absence of supervisory sign-off on an account reconciliation may be deemed a deficiency, even though the supervisory review had, in fact, been performed and could have been verified by inquiry and observation. In addition, our members have noted that the current system for auditing internal controls has no tolerance for the type of human error that could reasonably be expected to occur in situations involving the compilation of large amounts of data.

- The PCAOB standards establish reporting requirements for material weaknesses and significant deficiencies. While we believe the PCOAB's proposal to replace the reference to "more than remote likelihood" with "reasonable possibility" within the definitions of material weakness and significant deficiency would be an improvement, we suggest that the reporting and remediation requirements be modified based on an even higher threshold level, *i.e.* only control deficiencies that would "likely" result in material misstatements would be required to be reported externally.

- It would be helpful if the PCAOB would provide additional explanation on the role and importance of information technology (IT) general controls as they relate to internal controls over financial reporting. Additional guidance also would be helpful that explains the relationships or dependencies between IT general controls and application controls, particularly in smaller companies, including examples of situations when an IT general control deficiency could result in an application control breakdown, in turn leading to a material misstatement. Some guidance or examples of the relationships between application controls in prepackaged software and IT general controls necessary to support them would also be helpful.

- Paragraph 15 indicates that "the auditor must consider the possibility of misstatement to both annual and interim financial statements" but paragraph 14 states that materiality should be based on annual financial statements. Some additional guidance would be helpful in understanding considerations of interim financial statements misstatements while using the annual financial statements as a basis for judging materiality.

- Paragraph 22 indicates that the auditor *should* assess specific activities as part of a company's period end reporting process. However, this list of activities may not be all inclusive and there may be other controls that are more important and on which management places greater reliance, such as period-to-period comparisons, actual-to-budget comparisons, trend analysis, performance metrics, etc. Accordingly, we recommend that the PCAOB indicate that the auditor should *consider* assessing (rather than "should assess") the specific activities shown in paragraph 22 and also should consider whether there are other controls that should be included in the auditor's assessment of a company's period end reporting process.

- Paragraphs 45 and 78 refer to antifraud "programs and controls." Many companies' antifraud provisions include a governance policy and a mix of fraud prevention and detection controls that are embedded into various operational processes, but don't have a separate and discrete antifraud program. We encourage the PCAOB to explain its expectations for an antifraud program if indeed companies are expected to have a specifically defined antifraud program. The current wording may cause the auditor to seek an undefined yet specific antifraud "program" above and beyond the company's controls to prevent and detect fraud.

- Appendix 2, paragraph 4 indicates that tests performed by others that provide evidence that controls are working "typically are similar in nature, timing, and extent to the procedures that the auditor would have performed himself or herself." The guidance, however, does not explain that the auditor should also consider that tests performed by others may include other effective procedures to determine if controls are operating effectively, and even though the test may include different test procedures than the auditor would have designed, the results of these other tests may still be considered relevant activities to support the auditor's reliance and conclusions.

  Without additional clarification, the guidance for using the work of others may result in the external auditors directing the work of others, such as the company's internal auditors, to perform the tests precisely as the auditor would design and execute them. This would be inefficient and costly, and moving in the opposite direction of the stated goals of enhancing the effectiveness and efficiency of control evaluations.

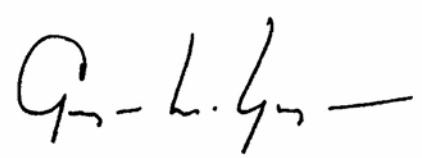
- Many companies, including the early adopters, have already completed their assessments of internal controls over financial reporting and their assessments have been successfully audited as part complying with the Section 404 requirements. While some interpret the SEC's Proposed Rule – Management's Report on Internal Control Over Financial Reporting as requiring a complete re-work of their risk assessment and control mapping exercises, others may see it as a "relaxing of the rules." We request that the PCOAB explicitly state that changes a company makes as part of adopting the SEC's Proposed Rule should not be interpreted as a derogation or weakening of controls that could jeopardize management's or the auditor's assessment of internal controls over financial reporting.

- Some companies have been reluctant to consult with their auditors and other advisors about internal controls due to fear that such a conversation might be construed as evidence that a material weakness exists. We encourage the PCAOB to further clarify that it is acceptable for management to consult with auditors and others without fear of retribution and to encourage management and their auditors to be able to have an open dialogue on all matters including seeking advice that will assist in maintaining sound internal controls.

Conclusion

NAREIT strongly supports the need for effective internal controls over financial reporting. We believe that, on balance, the proposed new rules would continue to improve the effectiveness and efficiency of public company financial reporting. We look forward to further guidance from the PCOAB, and will continue to participate in the positive evolution of corporate practices that promote ethical and effective financial reporting.

Respectfully submitted,



George L. Yungmann
Senior Vice President, Financial Standards

National Retail Federation
The Voice of Retail Worldwide

February 26, 2007

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

RE: PCAOB Rulemaking Docket Matter No. 021

Dear Board Members,

The National Retail Federation (NRF) welcomes the opportunity to comment on the PCAOB's proposed audit 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; PCAOB Rulemaking Docket Matter No. 021). NRF is the world's largest retail trade association, with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalog, Internet, independent stores, chain restaurants, drug stores and grocery stores as well as the industry's key trading partners of retail goods and services.

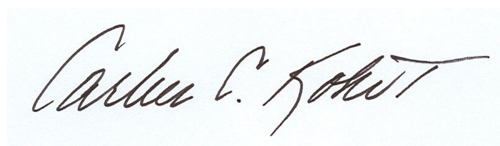
We are pleased to note that the proposed standard addresses the concerns we raised in our May 1, 2006 letter on behalf of our members in that it: endorses a top-down approach to auditing internal controls; stresses the importance of risk assessment; clarifies the definition of a material weakness; allows increased reliance on the work of others; and removes the requirement to evaluate management's process. We believe that the proposed changes will not only preserve the intended benefits of the audit of internal controls, but will improve the quality of the audit by focusing energies on the areas of greatest risk. It will also result in greater efficiency and cost savings in the audit of internal control. NRF encourages the Board to adopt the proposed auditing standard as a final rule.

We also encourage the Board to work closely with its inspectors to ensure that they embrace the spirit and intentions of the proposed rulemaking. We raise this issue because we are hearing from our members—who are hearing from their auditors—that earlier changes espoused by the Board have not been consistently put in practice by the inspectors. We believe this inconsistency drives the auditors to "over-audit" due to the fear that the inspector's judgment of what is "risk-based" will differ from the auditor's judgment. This environment results in duplicative and costly testing with little added value. We suggest the following actions as a way to ensure the proposed guidelines are adopted throughout the audit cycle. Specifically we ask the Board to:

- Encourage the inspection teams to work directly with the audit firms in the coming months to discuss how the changes in the standard will be incorporated into the inspection process.
- Provide further guidance permitting consideration of knowledge obtained during previous audits and using the work of others, especially in the audit of information technology.

The National Retail Federation thanks the Board for its consideration of our suggestions. We welcome any further discussion on this topic. With the collective efforts of the PCAOB, issuers, and auditors, a sustainable solution to the audit of internal control is sure to be found.

Sincerely,



Carleen C. Kohut
SVP and Chief Financial Officer
National Retail Federation

National Venture Capital Association

February 23, 2007

VIA Email

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Re: SEC Proposed Rule Concerning Management's Report on Internal Control over Financial Reporting – Release Nos. 33-8762; 34-54976 (File No. S7-24-06); and

PCAOB Proposed Audit Standard – An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals -- Release No. 2006-007 (Rulemaking Docket No. 021).

The National Venture Capital Association (NVCA) represents the vast majority of American venture capital under management.[1] NVCA member firms and the funds they manage provide start-up and development funding for innovative entrepreneurial businesses.

VC firms form and manage the funds that invest in start-up and early-stage businesses, which they commonly call "portfolio companies." Venture capital investing relies on the ability

[1] The National Venture Capital Association (NVCA) represents more than 450 venture capital and private equity firms. NVCA's mission is to foster greater understanding of the importance of venture capital to the U.S. economy and support entrepreneurial activity and innovation. The NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provides reliable industry data, sponsors professional development, and facilitates interaction among its members. For more information about the NVCA, please visit www.nvca.org.

of venture capital funds ("VCFs") to exit those investments through a liquidity event, with the proceeds being distributed to their investors.

Although venture firms' focus is on private companies, both the state of the regulatory environment for public companies and the state of the overall US environment for capital formation are critically important to venture capitalists and the companies they fund. For the types of small, high-growth technology companies that are the focus of many venture funds, investment dollars must be devoted to key business goals if those companies are to survive and hopefully grow. Money spent on unproductive regulatory compliance can quickly undermine the ability of small start-ups to disrupt the market share of entrenched incumbents or break through skepticism to create entirely new industries. This is especially true in the ever-growing number of technologies and products where the competition is truly global.

Because venture capital investing relies on the ability of VCFs to exit those investments through one of two liquidity events – IPO or acquisition – the impact of the Sarbanes-Oxley Act ("SOX" or "the Act") on both exit strategies has rippled through the entire venture capital community.

Section 404 of the Act ("SOX 404") is clearly one contributing cause in the general slowdown of the U.S. IPO market.[2] NVCA members see SOX 404 as disadvantaging U.S. companies seeking access to public capital markets, diverting resources away from more productive activities and adding significant new deadweight expenses. This affects the going-public process directly. Companies with net income below a certain threshold cannot attract a critical mass of IPO investors. SOX 404 compliance costs reduce the net incomes of companies, which disguises their value to potential purchasers of a public stock offering. This is true despite new rules allowing for deferral of full SOX 404 compliance for IPOs because venture capital investors prudently insist that full SOX compliance must be assured before the company goes to the public markets. Therefore, the progress of venture-backed companies toward an IPO is

[2] McKinsey & Co., *Sustaining New York's and the US's Global Financial Services Leadership*, (2007), p. 97. This study, commissioned by the City of New York found that SOX 404 compliance "can be overwhelming for smaller companies that lack the infrastructure necessary to comply efficiently."

artificially delayed both by diversion of resources and the lower net earnings that come from the unproductive expenses of SOX 404.

Similarly, venture capital-backed companies pursuing an acquisition strategy are affected by the Act's implementation cost burden. Acquirers are now prudently insisting that companies of interest be SOX-compliant before any deal is finalized. However, this prudence often forces young, thinly capitalized start-ups to become compliant at a time when, in the current environment, the costs of doing so are most excessive.

Equally important to the current considerations of the cost-benefit balance of SOX 404 compliance is the absence of the often-cited lower cost of capital that was supposed to offset the high cost of SOX 404 for issuers and investors. Our members do not see it and there is certainly no proof that investors will pay a "cost of capital premium" for SOX 404 compliance.[3] Therefore, the fact that IPO investors are increasingly drawn to foreign stock markets and non-U.S. IPO companies is not surprising.

I. BACKGROUND ON NVCA'S COMMENTS

We are encouraged that there seems to be widespread understanding and concern regarding the problems that have come from the implementation of SOX 404. We have hoped that the efforts of the SEC and the PCAOB would result in a substantial change in the Section 404 cost-benefit balance.

Unfortunately, much of the behavior at the root of the problem is now entrenched and we are skeptical that well-intentioned efforts that emphasize better implementation will be sufficient. Having read both the SEC Release on Proposed Rules Concerning Management's Report on Internal Control over Financial Reporting ("SEC Release") and the PCAOB's Proposed Audit Standard and Related Other Proposals ("PCAOB Release"), we conclude that a significant

[3] Interim Report of the Committee on Capital Markets Regulation, Section V: Sarbanes-Oxley Section 404, pp. 124-125 (November 30, 2006).

change in the way the Commission and the Board interpret the Congressional intent of SOX 404 is needed.

Given the many external pressures that have driven auditor behavior in response to the regulatory mandates under SOX 404, [4] we believe that the following actions are necessary to achieve a significant correction in the SOX 404 cost-benefit balance.

- <u>Eliminate the external audit of the effectiveness of internal control over financial reporting ("ICFR").</u>

While the statutory language of 404(b) requires auditors to attest to management's assessment of internal controls it does not require a separate audit of the effectiveness of the controls.[5] The SEC's rules and the PCAOB's auditing standards should be revised to eliminate the requirement for the auditor to attest to the effectiveness of an audited company's ICFR.

- <u>Use an economically sound method of cost-benefit analysis in evaluating the success of SOX 404 implementation.</u>

The problem with excessive SOX 404 cost is well known. However, the benefits are incremental and difficult to measure. The SEC should develop a cost-benefit analysis of any new standards based on an actual review of market behavior and reaction to the new rules. Neither the SEC nor the PCAOB has sufficiently defined the metrics that will be used to

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[4] As we noted in our comment letter on the Draft *Report of the Advisory Committee on Smaller Public Companies*: "Accounting firms' fear of liability from civil sanctions and criminal sanctions by the SEC, the PCAOB and prosecutors, not to mention civil securities class action suits, drives conservative judgments and excessive work. Furthermore, it is also widely understood that accounting firms have economic incentives to expand the scope of their internal controls audits." Available at: http://www.sec.gov/rules/other/265-23/26523-378.pdf, p. 11.

[5] Sarbanes-Oxley Act Section 404(b) reads, in its entirety: "INTERNAL CONTROLS EVALUATION AND REPORTING. – With respect to the internal control assessment required by subsection (a) each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement." While the Board cites ambiguous language in SOX Section 103 as statutory justification for the audit of ICFR effectiveness, (PCAOB Release at 16), nowhere does either Section 404 or Section 103 say or clearly imply that the auditor is to replicate management's required assessment of the effectiveness of ICFR.

determine a successful reform outcome. Commissioner Kathleen Casey's recent statements are instructive here. At the PLI's *SEC Speaks* Conference this month in Washington, she said that recent judicial rebukes of the SEC's cost-benefit analysis

> "offer an opportunity to more fully incorporate economic analysis into our decision making, rather than simply viewing it as a purely mathematical exercise or a postscript to a predetermined policy outcome. Investors and our markets deserve a more rigorous analysis than merely following gut instincts or embracing the 'it feels good, so it must be right' approach. In our rulemaking, this requires a process that ensures a full appreciation of the economic implications of various policy choices and fully estimates the costs and benefits associated with our actions."[6]

- <u>Defer compliance with SOX 404(b) for smaller companies until the results and analysis of a sound cost-benefit study are complete.</u>

Deferral of the costly auditor attestation of ICFR for smaller companies (including smaller accelerated filers) is appropriate "unless and until" the cost-benefit imbalance of SOX 404 compliance is clearly corrected.

The task of developing new rules and standards that will bring about more efficient implementation and are scalable in their application to all sizes and ages of companies must be accomplished in the face of pressures that may be beyond the scope of the proposed new standards to fix. Still these pressures must be considered and new rules need to work despite them. Therefore, the SEC and the PCAOB must ensure that the new SOX 404 auditing standard <u>eliminates</u> the regulatory basis and neutralizes the effect of the other pressures that drive auditors' excessive cautious and costly implementation.

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[6] Commissioner Kathleen L. Casey Remarks Before SEC Speaks, Washington, D.C.
February 9, 2007. Available at: http://www.sec.gov/news/speech/2007/spch020907klc.htm

II. GENERAL COMMENTS ON POLICY ISSUES THE COMMISSION SHOULD ADDRESS

The need for SOX 404 reform was the specific topic of remarks made by Commissioner Casey in her SEC Speaks address.[7] We concur with her remarks as to a number of important matters.

First, the Rules that both the Commission and the Board approved created the problem. They need to "own" the problem and find a solution. Second, the test of success is not whether these current rulemaking processes arrive at theoretically sound rules. Instead, the test is whether the new rules "alter the behavior [SEC] policies have driven."[8] Finally, Commissioner Casey seems to acknowledge that digging out of the SOX 404 hole may take as long as it took to get into it. Ongoing evaluation of the costs and benefits of new rules is part of the Commission's and the Board's regulatory responsibility. Therefore, new rules should be implemented cautiously in recognition of the failures to anticipate the great cost that came from these sweeping audit and attestation requirements.

A. Impact on Smaller Public Companies

We support the direction of these proposals for limiting unnecessary auditor-driven requirements. We also applaud the SEC's recently-approved deferral of compliance for IPO companies. While this addresses one compliance hurdle in the going-public process, it does not address the root problem – excessive cost for a limited benefit.

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[7] "We need to fix 404. No other issue in recent times has come to symbolize regulation gone awry than this relatively modest-looking provision of the Sarbanes-Oxley Act. While the spirit and letter of the law never contemplated the costly and burdensome result that this provision has generated, *the law's implementation undoubtedly facilitated such a result*. The Commission and the PCAOB are now faced with attempting to undo *the regulatory framework and consequent market behavior that has driven this costly compliance regime.…* I look forward to considering the comments that I hope we will receive on these proposals. I am committed to fine tuning these proposals to ensure that we achieve the results we all hope for. In the end, however, I believe we will only be able to measure our success by whether our reforms are sufficient to *alter the behavior our policies have driven.* And that will require an *ongoing assessment and determination by the Commission* of whether we have achieved our goals." *Id.* [emphasis supplied].

[8] *Id.*

As SEC Chief Accountant Conrad Hewitt has observed, ICFR audit costs tend to be "very regressive" in terms of their impact on smaller companies[9] – the companies upon which venture capital is focused. While the smallest 4500 publicly traded companies have been able to defer much of the compliance burdens of Section 404, the typical venture-backed IPO company is larger than $75 million market capitalization. As noted in the Report of the SEC Advisory Committee on Smaller Public Companies ("ACSPC"), there are an additional three thousand companies with market capitalizations of less than $700 million.[10] Together with the non-accelerated filers these companies make up less than seven percent of total equity market capitalization.[11] These smaller accelerated filers in particular have born the brunt of the grossly expensive implementation of SOX 404 under PCAOB Auditing Standard No. 2 ("AS-2"). They should not be required to continue to waste resources on the AS-2 driven process when the cost-benefit balance for these companies is indisputably skewed toward cost.

We are aware that the Commission is sensitive to the timing of the current requirements for non-accelerated filers. We believe that further deferral is appropriate for non-accelerated filers as well as an expansion of the deferral of SOX 404(b) auditor attestation requirements to smaller accelerated filers. This is the case for two important reasons. First, the proposed revision of the SEC rules and PCAOB standards, while possibly a significant step forward for larger companies, are not "scalable" for smaller companies to the extent that SOX 404 compliance cost would be justified by the benefits. It will almost certainly take much more time, effort and debate to make them so. Second, even if the ultimate revisions of rules and standards are sufficiently sweeping to correct the cost-benefit imbalance, it will take some period of implementation before the results are known. SOX 404 compliance is such a complex mix of rules and guidelines, diverse participants and external pressures that the impact of any change will not be known until it has been implemented and, with the passage of sufficient time, evaluated.

[9] Conrad W, Hewitt, SEC Chief Accountant, Unpublished Remarks before SEC Speaks, February 9, 2007.
[10] *Final Report of the Advisory Committee on Smaller Public Companies* (April 23, 2006), Appendix E, Table 1.
[11] *Id*., Table 2.

Making smaller accelerated filers or non-accelerated filers part of this test would almost certainly bring about substantial waste. Therefore, now that the Commission is aware of the disproportionate impact of SOX 404 on smaller accelerated filers, serious reconsideration should be given to the ACSPC's Recommendation III.P.2 which would exempt companies with less than $250 million in annual revenues[12] (or some similar metric) from the auditor attestation requirements of SOX 404 until the new rules have been implemented and fully evaluated. When it is widely acknowledged that SOX 404 compliance has placed small cap companies in a deep and expensive hole, the Commission should acknowledge the "First Law of Holes" and allow a moratorium on digging.

B. <u>The External Audit of the Effectiveness of ICFR</u>

The PCAOB's proposed new audit standard represents a serious effort to right the cost-benefit balance in the external ICFR audit. However, in the proposed form, the new Auditing Standard on Audits of ICFR -- so-call Auditing Standard No. 5 ("AS-5") -- will not reduce auditor work to the point where SOX 404 is cost effective.

SOX 404 cost excesses are driven primarily by the requirement that the auditor attest to the effectiveness of ICFR. Regulations, not the language of the Act, are the basis for this expansive auditor role in the SOX 404 scheme.[13] Sound policy arguments support the total elimination of the audit of ICFR effectiveness.

- Without question, improvements in the quality of financial reporting began well before SOX 404 was implemented. New management responsibilities and board practices will continue to have a significant impact on the quality of financial reporting with or without the external audit of ICFR effectiveness.
- The primary value of SOX 404 is the requirement that management report on the effectiveness of internal controls.

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[12] *Id*., p. 48.
[13] See *supra*, note 5.

- The outside audit of ICFR effectiveness provides some additional assurance, but the benefit is only incremental and the cost is unacceptable.
- Were the external audit of effectiveness eliminated, audit firms would still review ICFR as part of the financial statement audit and the PCAOB would still review financial statement audits.

C. Auditor Liability

We have consistently promoted ACSPC Recommendation V.P.1, which proposes a protocol for accounting that would protect the good faith preparer from regulatory action or legal liability as a means of reducing the liability driven portion of excessive audit costs. In fact, NVCA has a history of working with the accounting profession to restore common sense to the private securities class action system, which adds enormous costs and drives dysfunctional behavior in both issuers and auditors.

A safe harbor for reasonable auditor judgments would be a small step toward both the larger reform goal and the immediate challenge of restoring the use of judgment and common sense in SOX 404 auditing practices. It is beyond dispute that auditors' liability concerns drive costly auditing and conservative decisions. The safe harbor approach is a sound means for addressing this problem.

D. PCAOB Audit Standards on ICFR

The SEC has the obligation to ensure that AS-5 balances the benefit to investors against the cost to the economy and capital formation, in particular. The SEC's oversight must reflect a broader view of investor protection than the PCAOB has exhibited. It is important to keep in mind that the issuers are the auditors' clients and that the auditors are not government examiners. The SEC should ensure that AS-5 provides the intended benefits of SOX 404(b) and no more.

IV. COMMENTS ON SEC RULES AND GUIDANCE PROPOSALS

A. The Commission should seriously consider elimination, or substantial limitations on the auditor attestation for the effectiveness of ICFR.

The SEC's rule revision proposals, in conjunction with its Proposed Guidance, reflect a significant effort toward limiting costs that result from unnecessary auditor involvement in SOX 404(a) management assessments of ICFR. However, as noted above, there are serious impediments to a cost-effective SOX 404 process so long as auditors are required to attest to the actual design and operational effectiveness of ICFR. No matter what SEC rules require and no matter what the Auditing Standards say, the depth and breadth of the auditor's review will be driven by liability and economic pressures on audit firms. The liability threats on the Big Four accounting firms and the absence of significant competition in public company auditing services will continue to drive costs that exceed the incremental benefits of the auditor attestation.

As noted already, NVCA's principal focus is on smaller companies. Therefore, we say with great certainty that the cost-benefit imbalance is insurmountable so long as the SEC requires an audit of the effectiveness of ICFR for smaller companies. For larger companies, however, there may be cost-effective alternatives to the elimination of SOX 404(b) requirements.

The language of SOX 404(b) requires the auditor to attest to management's assessment of ICFR. Were the Commission to change its rules to eliminate the audit of effectiveness and retained the requirement for an audit of management's review, it might make a substantial impact on SOX 404 costs for all companies. Of course, the audit standards would need to be conformed as well. However, an elimination of auditor liability arising from an attest to the company's ICFR's effectiveness, along with clear SEC guidance as to what management is required to do in its assessment, could substantially reduce auditor test work and auditor fees.

On the other hand, if an audit of effectiveness must be retained, the "design-only" approach to this audit could substantially improve the cost-benefit balance. A design-only audit of ICFR would bring external oversight to management ICFR systems and provide incremental assurance that management had designed its ICFR effectively. Furthermore, a design-only audit would entail some review of operational effectiveness as the auditor spot-checked the implementation of the design.

B. <u>The revised SEC rules and proposed guidance for management on reporting under SOX 404(a) provide an important step toward limiting excessive costs in completion of the management's 404(a) obligations.</u>

The SEC's proposed "safe harbor" for management reporting under SEC Rules evinces the Commission's commitment to a very important goal – replacing the PCAOB auditing standard as the default standard for management's compliance with its SOX 404 assessment and reporting obligations. The Proposed Guidance on the Management Assessment of ICFR ("Proposed Guidance") appears to be based on appropriate standards of reasonable risk assessment and flexibility to make it possible for management to conduct its assessment in a risk-based manner.

There is one very important statement regarding smaller companies in the guidance that we believe deserves further emphasis. At the end of the section on *Identifying Financial Reporting Risks*, (Section A.I.a. of the Proposed Guidance), it says: "[I]n a small company with less complex business processes that operate on a centralized basis with little change in the risks or processes, *management's daily involvement with the business* may provide it with adequate knowledge to appropriately identify reporting risks."[14] The key phrase, "management's daily involvement with the business" describes an important part of the control environment in many venture-backed companies. Indeed, even when processes change as the company grows, a manager's daily involvement provides the opportunity to assess ICFR risks and to provide important mitigating controls on an ongoing basis. We believe the Proposed Guidance would be improved by more emphasis on these important factors in smaller companies.

Of course, so long as the auditor must attest to either the effectiveness of ICFR or to the management review, audit standards will drive the extent of the external auditor's work. There

[14] SEC Release, p. 24 [emphasis supplied.]

are a number of aspects of the PCAOB's proposed standards and rules that could still require management to meet the audit standard for its assessment rather than the Proposed Guidance. Therefore, we note some specific recommendations for revisions to the PCAOB's proposals in our comment below. In addition, as a general oversight matter, the SEC should ensure that the audit standard is harmonized with its management guidance to a very fine degree. Only then will the SEC guidance become the *de facto* standard to replace the auditing standard's current status.

IV. OVERARCHING COMMENTS ON PCAOB PROPOSALS

The proposed new Audit Standard on ICFR outlines a framework that is a definite improvement over AS-2. The proposed standard focuses on making improvements in many of the major areas that have led to excessive cost in the past. If the new standard's top priority was making the SOX 404 audit as cost-effective as possible, it could result in greater efficiency and lower cost. However, the new framework will probably not significantly reduce SOX 404 audit costs for the following reasons.

- The depth and breadth of ICFR audit work remains the subject of auditor judgment and they retain significant leverage in deciding how much audit work is required to address risks that they define.
- Auditors' financial incentives are to exercise their professional judgment with a bias toward the need to do more work, not less.
- Auditors will expand their work in order to avoid liability. As long as auditors are required to attest to the effectiveness of ICFR, the liability risk associated with this work will be as much a driver of this work as the risk of a material weakness in ICFR.
- Auditors have already developed procedures and trained their staff on how to perform audits of ICFR, which means that significant changes to those procedures will result in additional costs for them.
- Recent experience indicates that even with pressure from issuers, the SEC and the PCAOB, the auditors are still performing excessive work and are able to demand commensurately high fees.

The only ways the PCAOB can correct the failings of AS-2 and address the cost-benefit imbalance in SOX 404(b) compliance, is to modify the auditor requirement in one of two ways:

- Eliminate the requirement for the auditor to attest to the effectiveness of ICFR; or
- Eliminate the requirement to audit the *operational* effectiveness of ICFR.

As we have noted above, most of the improvements to ICFR and most of the investor benefit of SOX come from management's work. The incremental additional assurance that the auditor can provide cannot be cost-justified. If the SEC and the PCAOB deem an auditor's role to be essential, a significant percentage of the potential incremental assurance can be obtained through an audit of the design of the issuer's ICFR. However, a design-only audit may not limit auditor work substantially unless it resulted in less auditor liability.

If the new standard is not modified in significant ways, it should be implemented with a two-year sunset provision during which time the SEC should exempt smaller companies from the requirements of SOX 404(b). An expiration date will ensure that the PCAOB and the SEC evaluate the cost-effectiveness of its implementation and do so in a timely manner.

V. GENERAL COMMENTS ON THE PCAOB PROPOSALS

The PCAOB's primary goal appears to be maintaining an audit framework that achieves the PCAOB's own definition of "investor protection." As investors in start-up companies, venture capitalist believe their voices should be heard as clearly as those of investor advocates, many of whom represent groups that do not invest in smaller public companies. For most investors, an imbalance as severe as exists in SOX 404 compliance is not merely an excessive cost, it is a waste. While AS-5 reflects much effort to "enhance audit efficiency" of external audits of ICFR, the "cost" side of the cost-benefit balance does not receive sufficient emphasis in its Release or in its Proposed Standards.

While the Board seeks input on how many fewer hours will be required for auditors to conduct an audit under AS-5, the standard continues to give the auditor wide discretion in determining the amount of work required for each audit. Therefore, only the audit firms can answer the question about hours.

On the other hand, how much money can be saved under AS-5 is a number upon which the auditors' issuer-clients can at least opine. We believe the cost impact will be minimal because the Big Four accounting firms have the final say. We have already noted the reasons – liability, economic incentives and lack of competition. Unfortunately, the PCAOB's Release fails to indicate that significant cost reduction is a goal of AS-5. Continued waste is the likely outcome.

While AS-5 emphasizes a risk-based approach to auditing, it fails to state that a cost effective audit requires the auditor to assume an acceptable level of risk that there will be material weaknesses in ICFR that neither management nor the auditor will be able to identify through a review process that provides "reasonable assurance" and no more.[15]

In the same vein, AS-5 does not seem to take into account the fact that management has many incentives to maintain effective ICFR under SOX 404(a). The auditing approach reflected in AS-5 seems to be based on a belief that management cannot be trusted to fully comply with SOX 404(a). It also seems to ignore the myriad other changes that were undertaken by issuers -- whether SOX-driven or voluntarily – that have improved the quality of internal controls over financial reporting. As long as the tone of the PCAOB standards suggests that auditors should not trust management to make sound judgments regarding the effectiveness of ICFR, the audit framework will never be cost effective for shareholders.

AS-5 is a continuation of the "better implementation" approach to improving the SOX 404 situation. It is a triumph of hope over experience. The PCAOB has issued extensive guidance under AS-2 aimed at improving the cost-benefit balance. With all this effort, the costs still outweigh the benefits. The only way to limit audit waste in ICFR work is for the

[15] The SEC Release contains a better formulation of an appropriate reasonableness standard. The definition of reasonable assurance outlined at pages 14-15 of the SEC Release, for example, should be incorporated into AS-5.

implementation guidance to be crystal clear and unambiguous. This is difficult in the context of a risk based, top-down approach because the auditor is the one who determines what is "enough work" and what controls need to be evaluated and tested.

VI. SPECIFIC RECOMMENDATIONS FOR IMPROVING THE PCAOB PROPOSALS

On the assumption that neither the SEC nor the PCAOB will recognize the need to make more far-reaching proposals for change, we offer the following recommendations for changes to the PCAOB's proposed new standards and rules.

A. Improving AS-5 as a Standard for the Full Audit of the Effectiveness of ICFR

1. Guidance on scoping should be more explicit:

AS-5 guidance for planning the audit should explicitly say that the auditor should begin the audit by reviewing the ICFR assessment performed by management. AS-5 says that one of the many things the auditor should consider when planning their ICFR audit is the "type and extent of available evidence related to the effectiveness of the company's ICFR." Once management has completed its assessment of ICFR in accordance with the proposed SEC guidance, there will likely be significant evidence that the auditor can use. The auditor should be required to use this evidence in planning and scoping their audit in order to limit unnecessary work. The auditor should then be required to report to the audit committee if the auditor determines that it needs to test significant accounts or significant processes that were excluded from management's assessment.

2. A risk based process should allow for rotational testing of significant processes:

Audits of financial statements include the concept of "rotational" testing and an audit of ICFR should also embrace the same concept. Unfortunately, AS-5 explicitly excludes an important type of rotational testing. For example, if certain key processes have not changed from the prior year, there were no material weaknesses or significant deficiencies in those processes in the prior year, and management's assessments of the significant processes did not uncover any problems, the auditor should be allowed (if not required) to use their professional judgment to test those processes on a rotational basis.

Walkthroughs should be done on a rotational basis as determined in the risk assessment. AS-5 requires walkthroughs of each significant process – an improvement over AS-2 which required walkthroughs of each major *class of transactions within each significant process.* The requirement to perform walkthroughs even if the auditor is satisfied that there have been no changes to controls tested in the previous audit is inconsistent with a risk based approach. Auditors should be strongly encouraged to use their prior knowledge in assessing risks and designing the level of audit testing, including which processes are appropriate for walkthroughs on a rotational basis. Walkthroughs are one of the testing methods that drive excessive costs. AS-5 requires the auditor to test both the design effectiveness and operational effectiveness, which are both linked to walkthrough testing. The cost of walkthroughs can be reduced by performing them on a rotational basis.

3. The standard should include a relevant definition of materiality:

The definition of materiality and the materiality thresholds that the auditor must use in planning their audits of ICFR have been refined in AS-5. These changes are an improvement over AS-2. However we are still concerned that the auditor will use materiality thresholds that are too granular. This is due in part to the underlying definitions of materiality in accounting and auditing literature and in SEC guidance. These definitions are so all-inclusive that there are still only vague limits as to what an auditor can determine to be material. Since these determinations drive the scope of testing and the demands for documentation, AS-5 would likely again drive audit work that is far in excess of any reasonable cost-benefit balance. In order to reduce waste, the standard should include a quantitative materiality rule appropriate for the ICFR audit rather than relying on vague qualitative standards developed for disclosure purposes like SEC's Staff Accounting Bulletin No. 99.

4. Reasonable unpredictability should be the goal:

AS-5 paragraph 69 says that the auditor should "introduce unpredictability into the testing and respond to changes in circumstances." Such guidance can be read to mean that the auditor/issuer relationship is adversarial in nature. While introducing unpredictability into audits is appropriate, care should be taken to avoid a suggestion that the audit of ICFR is a cat-and-mouse game of "Gotcha." This will only increase audit waste. An appropriate caution should be included in paragraph 69 and the audit committee should have oversight of this aspect of the plan.

5. The Standard should emphasize "reasonableness" in auditing ICFR:

AS-5 should prominently incorporate the language of the SEC Release regarding the overarching application of "reasonableness" in each aspect of SOX 404 compliance. As a minimum, the auditor should not apply a more stringent standard of reasonableness than management is required to use in its assessment under SEC rules and guidance. In particular, the PCAOB's proposed revision of Interim Standard AU sec. 230 defines "reasonable assurance" as "a high level of assurance."[16] On the other hand, the SEC Release notes that the SEC's definition of the key term "reasonable assurance" is "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."[17] AS-5 should clearly state that its standard of reasonable assurance in ICFR audits is the same as the Commission's. Furthermore, every definition that bears upon "the level of detail and degree of assurance" in the PCAOB's standards that relate to ICFR audits should be closely reviewed to eliminate any potential disharmony with the standard management is required to use in assessing the effectiveness of ICFR.

B. Improving the Proposed Standard on the Use of the Work of Others

The proposed new PCAOB Standard on the Use of Work of Others is a definite improvement over the previous guidance. However, it should be more directive in order to be effective. For example, the guidance should explicitly say that the auditor should rely on the

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[16] PCAOB Release, p. A4-2.
[17] See SEC Release, p. 14-15.

work of management, internal auditors or outsourced auditors for other than high risk audit areas so long as the other auditor meets the standards of competence and objectivity in AS-5.

C. PCAOB Inspections Should Randomly Obtain Issuer-Client Input on Questions of Audit Efficiency.

We appreciate the PCAOB's plan to apply pressure for more efficient audits through its inspections of audit firms. However, efficiency will be difficult to determine if the PCAOB inspector relies solely on the work papers and explanations of the auditor. Therefore, as part of the PCAOB's audit inspection, its inspectors should communicate with issuers on a random and confidential basis to obtain objective input on the efficiency of audit. Such contact can be managed to avoid a diminution of auditor independence and ensure candor on the issuers' parts. A PCAOB inspection that seeks such input would send a necessary message to auditors that there is at least some risk in doing excessive or redundant work.

CONCLUSION

The prolonged difficulty and substantial waste that has resulted from SOX 404 implementation is a very serious matter for the American economy in general and for venture capital's ability to make a positive contribution to the economy. We strongly encourage the SEC and the PCAOB to assume responsibility for the problem that their rules have created. The facts supporting substantial change as well as the case for using a cost-based measure of success are overwhelming. Therefore, NVCA stands ready to assist the Commission and the Board as they move to the next step in solving this serious problem.

Sincerely yours,

Mark G. Heesen
President

NEENAH PAPER INC

W. Alan Barnes, CPA, CIA
Director of Internal Audit

PCAOB Rlemaking Docket Matter No. 021

February 26, 2007

I want to thank you for the opportunity to comment on the PCAOB proposed changes to the auditing standard associated with the internal controls over financial reporting and the proposed standard on using the work of others. I have included responses below for all the suggested questions (see "NP Response:" following each question) as well as some general comments.

The Board has done a good job in addressing many of the concerns voiced by companies in the proposed audit standard and to focus the audit on matters most important and eliminate unnecessary procedures. The attempt to reduce the details and specificity although substantial still falls short in some cases as noted in many of my responses to published questions. I also believe the attempt to provide guidance to scale the audit for smaller companies should rather address scale of audits for all companies based on many factors with a company being classified as a smaller company only being one factor.

As it relates to sections A (1) "Directing the Auditor's Attention Towards the Most Important Controls" and A (2) "Emphasizing the Importance or Risk Assessment" these I believe were first addressed back in May 2005 in the guidance for using a Top Down and Risk Base approach. This guidance although beneficial for my company's 2006 compliance efforts was late in its communication and thus not adopted early by external auditors and management timely enough to have the greatest efficiency and cost savings impact. Now that it will be incorporated officially in the audit standard it will be utilized more fully by the entire SOX compliance community.

As it relates to section B (1) "Removing the Requirement to Evaluate Management's Process" this should be included in the final auditing standard version as it will provide management of companies of all sizes more flexibility in the structure of the SOX compliance process. With SEC guidance provided to management from the SEC and the removal of this requirement companies will be able to move from a relationship with their auditor's as a governor of management's process to instead one of being an economic influencer to allow more judgment on how to balance the level of work needed to support management's assessment along with final guidance on the auditor's being able to use more of the work of others.

As it relates to section B (4) "Removing Barriers to Using the Work of Others" the second part of # 8 references the report on management's assessment which is to be removed as noted in section B (1) and the reference here should be removed. As the head of small internal audit department my limited resources, and has been the case with most internal audit departments, has been too involved with the project management, documentation and testing for the SOX compliance process. As a service to management and the Board of Directors, Internal Audit acts as an independent appraisal function by examining and evaluating the adequacy and effectiveness of the company's system of internal control and quality of performance. This service has been limited in recent years to mostly or only those internal controls over financial reporting due to the resource requirement for SOX compliance. This proposed standard on allowing the auditor to rely on the work of others which are deemed competent and objective is a key component to rebalance the value Internal Audit can provide and the final standard should not be too restrictive.

Below are responses to each of the published questions.

A. Focusing the Audit on the Matters Most Important to Internal Control

1. Directing the Auditor's Attention Towards the Most Important Controls

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

NP Response: No, there is one statement which reads in paragraph 16 “finally, the auditor selects for testing controls that sufficiently address the assessed risk of misstatement to each relevant assertion” which should have the word “material” before the word “misstatement” to more clearly maintain focus on only material misstatements.

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

NP Response: No, there is one statement in identifying significant accounts which reads in paragraph 26 “susceptibility of misstatement due to errors or fraud” should rather read “susceptibility to fraud or errors considered a material misstatement.

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

NP Response: No not by itself but in conjunction with the use of a focus on only areas considered high risk for a potential material misstatement it should. The top-down approach rather focuses an audit on more efficient methods.

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?

NP Response: No, in paragraph 17 the statement “The auditor's evaluation of company-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on controls at the process, transaction, or application levels” states testing can be reduced but does not mention elimination of any testing. This should be added to provide guidance in considering areas of testing which could be eliminated as well as reduced.

2. Emphasizing the Importance of Risk Assessment

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?

NP Response: No, in paragraph 8 the statement “A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention the auditor should devote to that area” does appear adequate in addressing the level of work the auditor should perform but does not address “evidence” as listed in the question but this should be inferred in the statement as listed and no changes are recommended.

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

NP Response: Yes, and in some instances performance of a walkthrough along with auditor documented observation should be sufficient to test the design and operating effectiveness of some medium risk controls as well to allow greater use of resources on the high risk controls.

3. Revising the Definitions of Significant Deficiency and Material Weakness

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?

NP Response: No, the listing of specific items in paragraph 78 and the wording “ordinarily result in at least significant deficiencies” is too narrow and limits the use of judgment when deficiencies even though they may fall within these listed areas may be of a quantitatively small or one-time occurrence nature and one a prudent official would conclude as not being 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?

NP Response: I would think this would be addressed in the evaluation of identified deficiencies, specifically those which involved actual misstatements and the evaluation process of the deficiency by itself or in conjunction with other deficiencies looks at the “potential” misstatement amount that could have been reasonably possibly to occur.

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?

NP Response: No as I would still expect that deficiencies of any level identified would be communicated to management and the same level of documentation and tracking effort expended as in previous years unless the standard provided specific guidance on exclusion of communication and tracking of deficiencies of insignificant amounts or remote possibilities of potential misstatements.

4. Revising the Strong Indicators of a Material Weakness

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?

NP Response: Yes the standard should allow an auditor to conclude that no deficiency exists when one of the strong indicators listed in paragraph 79 is present as the items listed themselves involve judgment in determining if they are truly deficient.

6. Clarifying the Role of Interim Materiality in the Audit

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

NP Response: No as the top-down risk base approach and other included topics when finalized along with auditor judgment should provide adequate guidance for auditors to determine an adequate scope for the audit of internal control.

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?

NP Response: Yes the reference to interim financial statements should be removed from the definitions of significant deficiency and material weakness and be replaced with reference to external reporting of financial statements instead. Once an annual materiality has been determined it should be used for the financial statement audit and audit of internal control throughout the year regardless of the period covered. This should have little impact on the scope of the audit as judgment should be used in determining the level of work required and when based on the particular circumstances involved.

B. Eliminating Unnecessary Procedures

1. Removing the Requirement to Evaluate Management's Process

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

NP Response: Yes, removing the Requirement to Evaluate Management's Process should be included in the final auditing standard version as it will provide management of companies of all sizes more flexibility in the structure of the SOX compliance process. Along with the SEC guidance provided to management from the SEC companies will be able move from a relationship with their external auditor's as a governor over management's process to instead one of being an economic influencer only and allow management more flexible judgment on how to balance the level of work needed to support management's assessment.

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

NP Response: Yes, because the risk base guidance that drives the level of work performed by the auditor independent of the level of work performed by management to support their own assessment of the internal controls which I believe the investor places more reliance.

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?

NP Response: Yes, as any reference to the level of work performed by management has no reflection on the auditor’s own effort or results and if retained only confuses the average investor as to the meaning or importance of that separate opinion.

2. Permitting Consideration of Knowledge Obtained During Previous Audits

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

NP Response: Yes.

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?

NP Response: For areas of low and possibly some medium risk areas or processes the auditor’s observation and collaborative inquiry in conjunction with the walkthrough procedures should be sufficient evidence of operating effectiveness.

3. Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage

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?

NP Response: No, there is a conflict in the appendix paragraph B16 which states “Special Situations. The scope of the audit should include entities that are acquired on or before the date of management's assessment. . .” which is in conflict with the SEC June 2004 statement that they would not object to management electing to exclude entities from the scope of their assessment in the year of acquisition which has also meant being excluded by the auditors. The location scope focus should be based on risk as the main consideration. There may be instances that while a location may impact one or more of the identified significant accounts on a qualitative basis it may be determined through experience that the risk of a material misstatement attributed to a particular location is low.

4. Removing Barriers to Using the Work of Others

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?

NP Response: No, There are multiple references which restrict the auditor relying on the work of others or is in conflict with other parts of the audit standard. As it relates to section B (4) “Removing Barriers to Using the Work of Others” the second part of # 8 references the report on management’s assessment which is proposed in the revised audit standard to be removed as noted in section B (1) and the reference should be removed. Also in paragraph 15 (b) as it relates to consideration as to whether the board of directors or the audit committee oversees employment decisions related to the responsible persons and whether the responsible persons have direct access and report regularly to the board of directors or the audit committee is too restrictive and should be removed. For many public companies the only one which may report directly to the board of directors is the CEO and the only ones which may report directly to the audit committee usually is the internal auditors. This then would greatly reduce the selection of any others within an organization which could be objective and independent of a process from being considered for reliance on their work by the external auditors.

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?

NP Response: No, not as it relates to scope because the second sentence in paragraph 4 of the Considering and Using the Work of Others in an Audit standard should incorporate a reference to risk to ensure focus is maintained on only the higher risk areas. “Tests performed by others that provide such evidence typically are similar in nature, timing, and extent to the procedures that the auditor would have performed himself or herself *according to the level of risk* as part of obtaining sufficient competent evidence to support the auditor's opinion.”

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

NP Response: Yes, it drives the level of work of others the auditor may rely on and should have an impact on the audit quality and the efficiency of the audit.

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

NP Response: No, the level of audit evidence should be based on auditor judgment according to the control type, frequency, risk and other factors and not included in the current standard.

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?

NP Response: No, There are multiple references which restrict the auditor relying on the work of others such as in paragraph 15 (b) as it relates to consideration as to whether the board of directors or the audit committee oversees employment decisions related to the responsible persons and whether the responsible persons have direct access and report regularly to the board of directors or the audit committee is too restrictive and should be removed. For many public companies the only one which may report directly to the board of directors is the CEO and the only ones which may report directly to the audit committee usually is the internal auditors. This then would greatly reduce the selection of any others within an organization which could be objective and independent of a process from being considered for reliance on their work by the external auditors. The wording should be simplified to take into consideration the competency and objectivity of the person(s) performing the relevant activities and the auditor judgment then as to what level of reliance and re-performance by be required or if they can rely on their work at all.

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

NP Response: No, as mentioned previously those listed in the first bullet of paragraph 15 (b) are too restrictive and should be removed. Also in paragraph 15 (a) it references policies in place which prohibit individuals from testing areas in which they are assigned or relatives are employed but official policies may not be drafted that address testing as many companies will just be implementing these testing procedures once the final audit standard is published and the level of work of others is determined that the auditor can rely upon. Instead of referring to policies this section should refer to company policies or practices so not to exclude practices in place but which are not formally documented as policies.

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?

NP Response: I am afraid the practical effect will be that any compensation arrangement for individuals performing the testing will be viewed by auditors as eliminating them from consideration of reliance on any testing they perform. Even with a compensation arrangement in place the determination that a strong control environment is in place could compensate to a level and allow at least some reliance on the testing performed by these individuals.

5. Recalibrating the Walkthrough Requirements

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

NP Response: Yes.

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?

NP Response: Yes the proposed standard should allow the auditor to more broadly use the work of others in performing walkthroughs as long as it is verified by auditor observation or evidential matter obtained.

C. Scaling the Audit for Smaller Companies

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?

NP Response: No, in paragraph 9 the note makes reference to a smaller company being one with a market cap of approximately $7 00M or less and revenues of approximately $250M or less. The heading should rather reference scaling the audit as appropriate for company size and not reference smaller companies only. This note is good information but a statement should be added that it is not absolute and many of the references for scaling the audit could also be appropriate for companies with amounts which exceed those listed in this note. As an example the first bullet in paragraph 12 describing how testing via inquiry combined with observation or other procedures can in many cases provide sufficient evidence about whether the control is effective could be appropriate in some cases for companies of all sizes.

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

NP Response: Yes, some other attributes of smaller, less-complex companies that the auditor should consider when planning or performing the audit could be reliance on controls performed by outside parties, competency of the financial expert identified on the audit committee, and reporting structure for those with financial reporting responsibilities.

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?

NP Response: No other than those mentioned in response to question 29 and the fact noted in the response to question 28 that differences associated with any size company should be taken into consideration when determining the scale of the audit.

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

NP Response: No because it is only one of many factors that should be taken into consideration but again this scaling of the audit should be for all size companies and not just directed to those meeting the requirements to be classified as a smaller company.

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?

NP Response: No, as mentioned above in response to question 28 the heading should rather reference scaling the audit as appropriate for company size and not reference smaller companies only. This thresholds note is good information but a statement should be added that it is not absolute and many of the references for scaling the audit could also be appropriate for companies with amounts other than those listed in the note. As an example the first bullet in paragraph 12 describing how testing via inquiry combined with observation or other procedures can in many cases provide sufficient evidence about whether the control is effective could be appropriate in some cases for companies of all sizes.

D. Simplifying the Requirements

III. Proposed Rule 3525 – Audit Committee Pre-approval of Services Related to Internal control

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?

NP Response: No.

VI. Effective Date

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?

NP Response: The board should structure the effective date to be as early as possible during the current calendar year but provide a statement that for inspection purposes the current year's audit procedures completed prior to the effective date would be considered as being judged as performed under the preceding audit standard and other guidance published up to the effective date. The reason the effective date should be as early as possible is many companies and their auditors are already having planning discussions especially the impact of the removal of the opinion by the auditor on management's assessment.

NEW YORK
CITY BAR

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PCAOB RELEASE NO. 2006-007; 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 Financial Reporting Committee of the Association of the Bar of the City of New York (the "*Committee*")[1] in response to Release No. 2006-007, December 19, 2006 (the "*Proposing Release*"), in which the Public Company Accounting Oversight Board (the "*PCAOB*") proposed a new 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 (such other proposals, collectively with the Proposed Standard, being referred to herein as the "*Proposal*"). The Proposed Standard would supersede the PCAOB's Auditing Standard No. 2 ("*AS No. 2*").

Our Committee is composed of lawyers with diverse perspectives on financial reporting matters, including members of law firms and counsel to major corporations, investment banks, public accounting firms and institutional investors. A list of members of the Committee is attached as Annex A to this letter.

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[1] Please note that this letter does not necessarily reflect the individual views of each member of the Committee, nor does it necessarily reflect the views of the institutions with which Committee members are affiliated.

Introduction

The Committee supports the goal of improving the effectiveness and efficiency of audits of internal control over financial reporting by public accounting firms as part of the performance of an integrated audit of financial statements and applauds the efforts of the PCAOB in developing the Proposal. We believe that the Proposed Standard, if properly implemented, will advance the goal of producing internal control audits to which both management and external auditors apply reasoned judgment and a top-down, risk-based approach.[2] We agree with the PCAOB that to achieve this result it is desirable to promulgate a new standard on auditing internal control rather than revise AS No. 2.

We strongly support the PCAOB's proposal to eliminate unnecessary procedures and commend the PCAOB's efforts in developing the Proposal. By refocusing multi-location testing requirements on risk rather than on coverage, permitting consideration of knowledge obtained during previous audits, easing barriers on the use of work of others and removing the requirements to evaluate management's process, the PCAOB has made significant improvements to the efficiency of the audit of internal control while, in principle, safeguarding the quality of the audit of internal control. We believe that it is appropriate to shift the focus of the audit of internal control from a bottom-up to a top-down approach. We further believe that auditors can and should be empowered to utilize reasoned professional judgment in the performance of the audit, and doing so does not constitute a relaxation or scaling back from AS No. 2 so long as the Proposal as finally adopted is properly implemented. We place significant reliance on the PCAOB's inspection function to facilitate proper implementation.

Despite these commendable aspects of the Proposal, we believe changes are warranted if the PCAOB is to fully realize the potential for improving the audit of internal control over financial reporting. Our comments and recommendations are set forth below.

As noted in the Proposing Release, the audit of internal control over financial reporting has produced significant benefits since the adoption of Section 404 of the Sarbanes-Oxley Act in 2002, but at significant cost.[3] In a period of heightened international competition among different capital formation markets, as well as domestic competition between the public and private capital markets, it is of critical importance that regulatory imperatives such as Section 404 be implemented and interpreted so as to promote benefits while balancing costs.

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[2] Securities and Exchange Commission Statement on Implementation of Internal Control Reporting Requirements, Press Release No. 2005-74 (May 16, 2005), *available at* http://www.sec.gov/news/press/2005-74.htm.

[3] The Securities and Exchange Commission made similar observations in its companion rulemaking proposal relating to Management's Report on Internal Control Over Financial Reporting. Release No. 33-8762 (Dec. 20, 2006) (the "*SEC Release*").

We have divided our comments into two categories. First, we identify significant comments relating to broad themes contained in the Proposal. These comments are organized by the importance we believe that each comment merits.[4] Second, we identify comments on drafting or analysis relating to specific paragraphs of the Proposed Standard or other components of the Proposal. We have organized these comments sequentially, following the order in which they arise in the Proposal.

Significant Comments

1. Incremental Compliance Costs. The Committee believes that companies and investors are very supportive of improvements to the process of auditing internal control over financial reporting. We believe it is important, however, that changes made in the interest of achieving improved efficiency and efficacy not force public companies to restructure their internal control over financial reporting or otherwise incur costs that come anywhere close to the costs incurred in connection with the "year one" implementation of Section 404. We further believe that the PCAOB shares this view. To assist companies and their auditors, we suggest that a clear statement be included in the final version of the Proposed Standard (and not just in accompanying press releases or similar materials) to the effect that the changes being adopted are intended to promote greater efficiency in the audit of internal control while preserving efficacy, and should be implemented in a manner that does not require public companies to significantly restructure existing procedures or to incur significant additional costs.

2. Definitions of Significant Deficiency and Material Weakness. The Committee agrees that the definitions of Significant Deficiency and Material Weakness require amendment, but disagrees that the existing framework underlying these definitions as set forth in AS No. 2 is fundamentally sound. We therefore suggest that more significant amendments than have been proposed by the PCAOB are warranted.

   In adopting AS No. 2, the PCAOB chose to use the same formulations of Material Weakness and Significant Deficiency as found in FAS No. 5, *Accounting for Contingencies*. The PCAOB stated that it believed that using terms with which auditors were already familiar would promote consistency in the evaluation of deficiencies.[5] While we have no doubt that auditors are fully familiar with these terms, the application of these terms to audits of internal control has resulted in the unintended over-inclusiveness and inefficiencies that the PCAOB and the SEC

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[4] We note that none of the topics that we identify as significant were part of the agenda at the PCAOB's Standing Advisory Group Meeting of February 22, 2007, at which various other aspects of the Proposal were discussed. The Committee urges the PCAOB to focus on issues raised in the comment process beyond the important issues discussed at the February 22, 2007 SAG meeting.

[5] AS No. 2, paragraph E73; *see also* PCAOB Release No. 2005-023 (Nov. 30, 2005) at pp. 16-17.

now seek to rectify. Simply changing the references in AS No. 2 to "more than remote" to read "reasonable possibility," when these terms are viewed as being synonymous in the accounting literature, does not address this issue. We also believe that there is no substantive justification for reliance on FAS No. 5 standards in the context of audits of internal control, particularly given the empirical evidence now available as to the outcome of the use of these definitions in this context.

The Committee therefore recommends that the definitions of both Significant Deficiency and Material Weakness be calibrated to the standard of "reasonable likelihood," on the basis that this is a higher standard than "reasonable possibility" but a lower standard than "probable."

We note that the concept of "reasonable likelihood" is familiar to auditors, companies and investors. It is the standard governing the disclosure of known trends or uncertainties in Management's Discussion and Analysis.[6] It also governs the analysis of whether an off-balance sheet arrangement requires disclosure. As stated by the SEC in 2003, disclosure of an off-balance sheet arrangement is required if the arrangement "[will] have, or [is] *reasonably likely* to have, a current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors."[7]

In addition, the PCAOB proposes to modify the definition of Material Weakness to provide that one or more Control Deficiencies constitute a Material Weakness. In contrast, AS No. 2 defines Material Weakness as one or more Significant Deficiencies. We agree with the PCAOB's observation that the existing definition has raised concern that auditors may be performing their audits at an unduly low level of detail so as to ensure that all Significant Deficiencies are identified.[8] The PCAOB proposes to rectify this concern by calibrating the definition of Material Weakness to a lower standard - that of Control

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[6] *See* Release No. 33-6835 (May 18, 1989) and Release No. 33-8056 (Jan. 22, 2002).

[7] Release No. 33-8182 (Jan. 28, 2003) at text accompanying note 98 (emphasis supplied). The "reasonably likely" standard was adopted after many commenters, including each of the four largest auditing firms, objected to the lower standard initially proposed by the SEC. The initially-proposed standard would have required disclosure if the likelihood of a material effect was more than remote; objections to this proposal pointed out that investors could be overwhelmed by voluminous disclosure of insignificant and possibly unnecessarily speculative information under the lower standard. *Id*. at notes 38-45 and accompanying text.

[8] Proposing Release, p. 10. While we do not believe rigid numerical standards for materiality should be adopted, we agree with the discussion regarding AS No. 2's tendency to force auditors to search for all Significant Deficiencies that is contained in Joseph A. Grundfest & Steven E. Bochner, *Fixing 404*, 105 MICH. L. REV. (forthcoming 2007, Issue No. 8) (manuscript at pp. 32-35, available at http://www.michiganlawreview.org/symposium/abstracts.htm#grundfest) ("*Grundfest & Bochner*").

Deficiencies—without explaining how this change will improve the efficiency of audits of internal control. The Committee is concerned that auditors may interpret this as requiring them to ensure that all Control Deficiencies are identified, which we believe will exacerbate existing tendencies to focus on deficiencies that are not sufficiently important to the company's overall system of internal control. Absent a clearer understanding of the reasons underlying this change, the Committee recommends that the PCAOB not make this modification. We also strongly encourage the PCAOB to clearly state in the final version of the Proposed Standard that the audit of internal control does not require that every Significant Deficiency (or Control Deficiency, if that standard is adopted) needs to be identified, and that this type of inquiry should not be undertaken by auditors.

Regardless of the standard adopted, the Committee believes further clarity can be added to the concept of aggregation. AS No. 2 provides that multiple Significant Deficiencies can, in the aggregate, constitute a Material Weakness (and similarly, multiple Control Deficiencies can, in the aggregate, constitute a Significant Deficiency). It is not clear how unrelated deficiencies are to be analyzed for aggregation purposes. It is certainly possible that one control can have an impact on the effectiveness of another seemingly related control – in this situation, we agree that aggregation can be appropriate. However, if two controls are wholly unrelated, it is difficult to see how they are to be aggregated, other than assigning a quantitative probability of misstatement to each, totaling all such probabilities and then determining whether the quantum is material. We believe this form of aggregation is not intended by the PCAOB, nor is it appropriate for the protection of investors. This ambiguity can be addressed by modifying the definitions to provide for aggregation of "related" deficiencies, with discussion of how deficiencies can be related (*e.g.*, they can arise in a similar reporting area, or can be sequentially linked such that a flaw in a particular control directly affects the effectiveness of a later control).[9]

Finally, we suggest that the PCAOB clarify that the definition of Significant Misstatement is meant to focus on those individuals principally responsible for oversight of the company's financial reporting taken as a whole. This would remove any ambiguity as to whether lower-level employees with responsibility for discrete components of the company's financial reporting are intended to be included in this definition.

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[9] We note that the SEC proposes in the SEC Release that aggregation should be limited to related deficiencies:

> Therefore, management should evaluate individual control deficiencies that affect *the same account balance disclosure, relevant assertion, or component of internal control*, to determine whether they collectively result in a material weakness.

SEC Release at text accompanying footnote 76 (emphasis supplied).

We thus propose the following revised definitions:

> A **material weakness** is a significant deficiency, or combination of related significant deficiencies, such that there is a **reasonable likelihood** that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.
>
> > Note: There is a **reasonable likelihood** of an event, as used in the definitions of *material weakness* and *significant deficiency* (see paragraph A12), when the likelihood of the event is "probable" or more than "reasonably possible" (as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*), although in the latter case it need not be more likely than not.
>
> A **significant deficiency** is a control deficiency, or combination of related control deficiencies, such that there is a **reasonable likelihood** that a **significant misstatement** of the company's annual or interim financial statements will not be prevented or detected.
>
> A **significant misstatement** is a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting taken as a whole.

3. Strong Indicators of Material Weaknesses (Paragraph 79 of the Proposed Standard). The determination of whether a Material Weakness exists is one of the most fundamental aspects of the evaluation of the effectiveness of internal control over financial reporting. We note that the Proposed Standard deletes the requirement in AS No. 2 that the presence of any of the six identified situations constitutes a Significant Deficiency. We understand that, in so doing, the PCAOB sought to indicate that auditors have the discretion to utilize their professional judgment to evaluate the significance of the discovery of any of the identified situations based on facts and circumstances. The Committee supports this change. We believe, however, that this change, without more, does not appreciably improve the existing treatment of strong indicators of Material Weaknesses under AS No. 2, as many of the other most important provisions of this part of the Proposed Standard are repeated from AS No. 2 without change.

   We also note that in several instances the terminology used to express a strong indicator of material weakness varies in substantive ways between the Proposed Standard and the SEC Release. We point out these and other substantive comments on Paragraph 79 of the Proposed Standard below.

   - The first sentence of Paragraph 79 of the Proposed Standard states that "the auditor should treat each of the following circumstances as a strong indicator that a material weakness in internal control over financial reporting exists." This language is unchanged from the corresponding language in AS No. 2. The Committee believes that this congruity may fairly be read to suggest that auditors lack the ability to exercise precisely the sort of professional judgment that the PCAOB seeks to encourage in the Proposed Standard, despite the deletion of the statement that the presence of any listed factor constitutes a Significant Deficiency. We recommend that language be added to Paragraph 79 stating that any of the identified circumstances may constitute a strong indicator that a Material Weakness exists, but that, based upon an evaluation of the facts and circumstances relating thereto, an auditor may conclude that no Significant Deficiency exists, or that if one does exist, it does not rise to the level of a Material Weakness.[10]

- We believe that the first identified strong indicator in the Proposed Standard under the "ineffective control environment" indicator (identification of fraud of any magnitude on the part of senior management) is too prescriptive. While we agree that fraud of any nature on the part of senior management is a serious matter, we believe it does not necessarily constitute a strong indicator of a Material Weakness. For example, discovery of the fraud by the normal operation of the company's internal control over financial reporting may well be a strong indicator of the effectiveness of internal control. Also, if the fraud in question was immaterial in amount and appropriate disciplinary action was taken by the company, we believe that these facts and circumstances could militate against a determination that a Material Weakness exists. We question whether the current formulation of this item permits this sort of analysis (even if our prior comment is accepted).

- The definition of "senior management" in the note at the top of page A1-30 of the Proposed Standard is unnecessarily subjective. Without further guidance, it will be difficult for auditors to develop a consistent interpretation of who in management plays a "significant" role in the company's financial reporting process. Moreover, as written, it is not clear whether "significant" modifies the company's financial reporting process as a whole or instead connotes a meaningful role in a particular sub-process. We suggest that this definition be modified to describe

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[10] We note that the language at page 11 of the Proposing Release helpfully suggests that the auditor possesses some degree of latitude in evaluating the import of the identification of one or more of the strong indicators. We find it difficult to gauge the relevance of this language, which is not proposed to be part of the auditing standard itself. Since the Proposed Standard includes many explanatory notes in the body of the standard (including in Paragraph 79), the relevance of this explanatory text in a location outside the actual standard is unclear. We suggest that language along these lines be added to the body of Paragraph 79, either as introductory text or as an explanatory note.

management that plays a significant role in the company's financial reporting process taken as a whole.

- We note that the second identified strong indicator in the Proposed Standard under the "ineffective control environment" indicator is phrased differently from the corresponding reference in the SEC Release (emphasis supplied):

  Proposed Standard: Significant deficiencies that have been *communicated to management and the audit committee* and remain *uncorrected* after some reasonable period of time.

  SEC Release: Significant deficiencies that have been *identified* and remain *unaddressed* after some reasonable period of time (page 45 of the SEC Release).

  We recommend that the PCAOB utilize the formulation set forth in the SEC Release. As this speaks to Significant Deficiencies, not Material Weaknesses, we believe that the PCAOB's suggestion that each Significant Deficiency must be formally communicated to the Audit Committee and corrected, rather than acted on, entails excessive detail. We also believe this approach is inconsistent with the PCAOB's goal of focusing auditors on Material Weaknesses.

- We believe that the Note to the second identified strong indicator (restatements of previously issued financial statements to correct a misstatement) should also explicitly exclude restatements due to clarification, or change in interpretation, of existing accounting standards by auditors or regulators. Given the complexity of financial statements and accounting principles, it is neither uncommon nor troubling that auditors and those responsible for the promulgation of GAAP from time to time issue clarifications or changes. Recent examples include the treatment of certain aspects of accounting for leases and derivative transactions. In these circumstances, the company has relied in good faith on prior positions or interpretations and the change does not reflect a flaw in its internal control. While one could take the position that neither of these circumstances constitute a "misstatement" in the prior accounting, the same can be said for the other examples in the Note (retrospective application of a change in accounting principle or voluntary change from one generally accepted accounting principle to another).

  We note that the version of this concept in the SEC Release refers to the correction of <u>material</u> misstatements (see SEC Release at p. 46), whereas the Proposing Release refers to the correction of <u>any</u> misstatement. We believe that the SEC version is the appropriate standard for this strong indicator.

- The next bullet point in Paragraph 79 (identification by the auditor of certain material misstatements in financial statements) could be read to include misstatements contained in drafts shared by the company with its auditors or proposed accounting treatments raised by the company with its auditors for discussion purposes. Any such implication could cause a reoccurrence of the chilling of communications between companies and their external auditors for fear that raising questions or sharing drafts could give rise to allegations of Material Weakness by the auditors. We believe that open dialogue between a company and its auditor in the context of the preparation of financial statements or the analysis of potential accounting treatments is in fact part of a company's internal control over financial reporting.[11] We recommend that the language in this paragraph be clarified to remove any such suggestion, preferably with citations to the authorities referred to in footnote 11 below.

- The next bullet point in Paragraph 79 (ineffective oversight by the audit committee) places the auditor in the position of evaluating the competence of the entity that supervises it. We believe this raises potentially troubling conflict and independence issues, despite the text in the note accompanying this item. We also believe that the last sentence of the first full paragraph on page A1-31 of the Proposed Standard poses the same potential chilling effect on communications between the audit committee and the auditor as noted above and is thus contrary to prior SEC and PCAOB guidance.[12]

- The next bullet point in Paragraph 79 (ineffective internal audit function) is not set forth in the SEC Release. We believe the definitive SEC and PCAOB pronouncements need to be consistent on this point.

4. Evaluating Identified Deficiencies (Paragraph 78 of the Proposed Release). Paragraph 78 of the Proposed Release identifies four categories of deficiencies, the occurrence of any one of which would "ordinarily result in at least significant deficiencies in internal control over financial reporting." We believe this language shares the same lack of scope for the exercise of professional judgment of the auditor as the strong indicators of Material Weakness provisions analyzed above. While the use of the word "ordinarily" could be read to connote the ability on the part of the auditors to exercise judgment, we believe that greater emphasis

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[11] See SEC Staff Statement on Management's Report on Internal Control Over Financial Reporting (May 16, 2005), Section G (available at www.sec.gov/info/accountants/stafficreporting.htm); PCAOB Staff Questions and Answers, Auditing Internal Control Over Financial Reporting (June 23, 2004) (Revised July 27, 2004), Question No. 7.

[12] See footnote 11, *supra*, and accompanying text.

of this point is warranted. We therefore recommend that an explicit expression of this concept be added to Paragraph 78.

5. Potential Chilling Effects on the Level and Extent of Communications Between Auditors and Management. Both the SEC and the PCAOB noted after the first roundtable on the implementation of internal control reporting provisions that an unintended consequence of Section 404 and AS No. 2 was a chilling effect in the level and extent of communications between auditors and management regarding accounting and financial reporting issues.[13] Both the SEC and the PCAOB clearly stated that neither Section 404 nor AS No. 2 should impair the free and open dialogue between management and their auditors. The Committee believes that, notwithstanding this background, in several instances the Proposed Standard contains references that could create a similar chilling in management/auditor communications. Several of these instances are noted above in our discussion of the Proposed Standard's treatment of strong indicators of material weaknesses. In addition, we note Paragraph 80 of the Proposed Standard, which refers to "misstatements detected during the financial statement audit" as a factor to be considered by the auditor in forming its opinion on the effectiveness of internal control.

   We believe that the PCAOB should make clear that the Proposed Standard as adopted is not intended to, and should not be read to, suggest that companies should not engage in open and frequent dialogue with their auditors during the audit process.

   We also note that this reference creates a lower standard than the similar concept expressed in Paragraph 79 of the Proposed Statement, which posits a *material* misstatement as a potential indicator of a Material Weakness. We believe the reference in Paragraph 80 should also be conditioned by materiality.

6. Inconsistent Use of Normative Standards. Throughout the Proposing Release and the Proposed Standard, the PCAOB uses varying normative standards, in particular the terms "should" and "must." As a matter of plain English, we understand the difference in the meanings of these words. If taken literally, however, the less directive standard of "should" could create confusion between audit clients and their auditors as to the intent of the PCAOB.[14] To the extent auditors may interpret provisions that are designed to promote efficiency as optional rather than required, this could compromise the goals of the PCAOB in its evaluation of the audit of internal control. Examples of potentially undesirable permissiveness introduced into statements that we would expect to be mandatory

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[13] Id.

[14] We note the statement of the PCAOB at page 30 of the Proposing Release that "the requirements have been articulated in a more readable manner that should be understandable to audit clients as well as auditors."

in nature include, but are not limited to, the following (in each quotation, emphasis is supplied):

- "[T]he auditor *should* continuously adjust his or her procedures to reflect information that the auditor has learned" (Proposing Release, Page 7, paragraph 1, line 6).
- "The auditor *should* use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses . . ." (Proposed Standard, paragraph 5).
- "The audit of internal control over financial reporting *should* be integrated with the audit of the financial statements" (Proposed Standard, paragraph 7).[15]
- "[T]he auditor *should* focus the majority of his or her attention on the areas of greatest risk . . ." (Proposed Standard, paragraph 8).
- "[T]he auditor *should* use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements" (Proposed Standard, paragraph 14).
- "The auditor *should* use a top-down approach to the audit of internal control over financial reporting . . ." (Proposed Standard, paragraph 16).
- "In subsequent years' audits, the auditor *should* incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary" (Proposed Standard, paragraph 65).

These "should" references suggest an unwarranted degree of optionality in light of numerous other statements in the Proposal that are expressed as mandatory statements. Examples of mandatory formulations (in addition to the formulation noted in footnote 15) include, but are not limited to, the following:

- "[T]he proposed standard states that to obtain evidence about whether a control is effective, the control *must* be directly tested" (Proposing Release, page 8, carryover paragraph, lines 6-7).
- "[T]o attest to and report on management's assessment, the auditor *must* test controls directly . . ." (Proposing Release, pages 15-16, in particular line 1 of carryover paragraph on page 16).
- "The auditor *must* test those company-level controls that are important to the auditor's conclusion . . ." (Proposed Standard, paragraph 17).

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[15] Note that this "should" reference is immediately followed by a sentence stating that "the auditor *must* plan and perform the work to achieve the objectives of both audits."

7. Account-balance Versus Overall Materiality The Proposing Release states that one of the goals of the Proposal is to clarify the role of materiality in the audit of internal control.[16] One of the concerns with AS No. 2 expressed by companies and auditors was the need to focus on individual account balance materiality in scoping the audit of internal control.[17]

   The discussion of materiality in the Proposed Standard itself (at paragraphs 14-15) is, however, silent on this issue. The Proposed Standard helpfully omits the first sentence of Paragraph 22 of AS No. 2, which stated that the auditor should apply the concept of materiality in the internal control audit at both the financial statement and individual account-balance level. However, this silence is not necessarily helpful, as the only remaining analysis of materiality in the Proposal requires the auditor to "use the same consideration of account-level materiality" in scoping the audit of internal control as is used in the financial statement audit.[18]

   The Committee believes that account-balance materiality should only be relevant in scoping the audit of internal control in limited circumstances. Just as the audit of the financial statements is designed to permit the auditors to express an opinion on the financial statements taken as a whole, the audit of internal control is designed to result in an opinion on the overall effectiveness of the company's controls. In the interest of furthering the ability of the auditors to exercise their reasoned judgment in a risk-based, top-down audit, we recommend that the Proposed Standard make clear that account-balance materiality should be relevant in scoping audits of internal control only when the account balance itself is presumptively material to the financial statements taken as a whole.

8. Walkthrough Requirements. The Committee believes that the PCAOB should not only permit, but encourage, auditors to rotate their performance of certain walkthroughs based on the auditor's risk assessment. We acknowledge that certain controls are so fundamental that annual walkthroughs are called for. We believe, however, that in many instances walkthroughs can be rotated without compromising the efficacy of the audit of internal control. In fact, we believe that permitting rotation would enable the auditors to focus more closely on the walkthroughs it does perform, thus increasing the quality of the audit. We expect that the PCAOB would mandate a minimum frequency for walkthroughs of significant controls (perhaps at least once every three audit cycles).

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[16] Proposing Release at p. 4.

[17] *See, e.g.*, Robert C. Pozen, *Why Sweat the Small Stuff?*, THE WALL STREET JOURNAL, Apr. 5, 2006, at A20.

[18] Proposing Release at p. 13; Proposed Standard at Paragraph 14. As support for this statement, footnote 7 of the Proposed Standard cites AU sec. 312, *Audit Risk and Materiality in Conducting and Audit,* which contains multiple references to the relevance of account-balance materiality in audits of financial statements.

9. US GAAP Reconciliations. In a concurrent comment letter that the Committee is submitting to the SEC relating to the proposed interpretation and rules governing management's report on internal control over financial reporting (a copy of which is being provided to the PCAOB), we recommend that the SEC should exempt the reconciliation to US GAAP from the scope of its Section 404 rules. The reconciliation exercise presents specific problems because it is often not integrated with the financial reporting system on which the primary financial statements rely. We similarly recommend that the PCAOB should exempt the US GAAP reconciliation from the audit of internal control. If neither the SEC nor the PCAOB provide exemptions, they should align their final positions on this issue.

10. Using the Work of Others. The Committee supports the PCAOB's proposals to remove barriers that currently limit the ability of auditors to use the work of others. In particular, the Committee strongly supports the elimination of the "principal evidence" provision contained in AS No. 2 and related standards. We suggest that the Proposed Standard as finally adopted, along with the adopting release, affirmatively encourage auditors to so rely, within the bounds of the new standard. On the face of the Proposal, it appears to be permissible for an auditor to elect not to utilize the work of any third party, even though expressly permitted.

11. Oversight by the PCAOB of Implementation of New Auditing Standard. The PCAOB has consistently included in its guidance relating to the audit of internal control statements to the effect that it will focus its inspections of internal control auditing on whether the firms efficiently achieved the objectives of the internal control audit.[19] No such statement is included in the Proposing Release. We believe it will be important for the PCAOB to continue to monitor the implementation of its guidance in this area as part of its inspection authority, and suggest that an explicit statement to that effect in the adopting release relating to the new standard would be useful.[20]

12. Effective Date. We understand that it will be impractical for companies and their auditors to adjust their existing internal controls and procedures for evaluating and auditing effectiveness in respect of current fiscal years. We therefore suggest that the Proposal take effect for companies' first full fiscal years after adoption. To facilitate advance planning, however, the Committee encourages the PCAOB (and the SEC) to act promptly to complete and adopt final versions of each component of the Proposal. In particular, the Committee urges the PCAOB to

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[19] *See, e.g.,* Statement Regarding the Public Company Accounting Oversight Board's Approach to Inspections of Internal Control Audits in the 2006 Inspection Cycle, PCAOB Release No. 104-2006-105 (May 1, 2006); Policy Statement Regarding Implementation of Auditing Standard No. 2, PCAOB Release No. 2005-009 (May 16, 2005) at p. 13 ("we intend to use our upcoming inspections to evaluate how firms have conducted the first round of audits under Auditing Standard No. 2").

[20] *See also* Grundfest & Bochner at p. 56.

request the SEC to adopt the shortest permissible comment period duration following the publication by the SEC of the final version of the Proposal.

Drafting Comments

- Paragraph 6 of the Proposed Standard. The first bullet point should be revised to make clear that knowledge obtained from ongoing, as well as completed, engagements is included.

- Paragraph 17 of the Proposed Standard. This paragraph contains new language to the effect that the auditor must test those company-level controls "that are important to the auditor's conclusion" regarding the effectiveness of internal control. The quoted language provides little guidance and could result in disagreement between an auditor and its client as to what extent the auditor should test company-level controls. In particular, the use of the word "important" (as opposed to "material" or "essential") suggests a particularly low standard might be imposed. We believe this ambiguity in relation to such a significant provision could compromise the efficiency of future audits of internal control, and suggest that greater clarity be provided in the Proposed Standard as finally adopted.

- Paragraph 20 of the Proposed Standard. The fifth bullet point presumes that in all cases management will face incentives and pressures to misstate the company's financial statements. The presumption encourages a pejorative approach to the audit that is inconsistent with the basic concept of "professional skepticism" that is contained in the auditing literature.[21] It is also important to note that, if this provision of the Proposed Standard is read literally, any incentive-based executive compensation structure could be characterized as presenting such pressures. While excesses have occurred in extreme cases, we do not believe it is appropriate for auditors to view any incentive-based executive compensation system as requiring that affirmative mitigating acts be taken.

- Paragraph 47 of the Proposed Standard. We suggest changing "could" in the third line to "would" to be consistent with the definitions of Material Weakness, Significant Deficiency and the general approach reflected elsewhere in the Proposed Standard.

- Paragraphs 57-59 of the Proposed Standard. The first sentence of Paragraph 59, standing alone, suggests that it is always better to test controls as close as possible to the date of management's assessment. This could lead auditors to

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[21] AU Section 230, *Due Professional Care in the Performance of Work* at Paragraphs .07-.09 ("the auditor neither assumes that management is dishonest nor assumes unquestioned honesty"). Some observers characterize this standard as constituting a "neutral" concept of professional skepticism. Public Oversight Board, THE PANEL ON AUDIT EFFECTIVENESS - REPORT AND RECOMMENDATIONS (2000) at Section 3.8 and footnote 2 thereto.

unnecessarily compress their audit of internal control into the end of the company's fiscal year, at a time when such compression can compromise management's and the auditor's ability to focus on other matters. Paragraph 59 should be expanded to state that, in balancing the timing of tests, the auditor also could focus on its risk assessment and determine that controls posing lower risk be tested earlier in the year, if doing so would enhance the efficiency of the internal control audit. The Proposed Standard could also permit rotation such that tests performed early in the year are then tested later in the year during the subsequent year's audit, and vice versa.

- Paragraph 76 of the Proposed Standard. As drafted, this paragraph suggests that a control can only be considered compensating if it would, with certainty, prevent or detect the misstatement. We believe this is an unworkable standard and suggest adding the phrase "be reasonably likely to" immediately preceding the words "prevent or detect" in the fourth line of this paragraph.

- Paragraph 79 of the Proposed Standard; first bullet point on page A1-32. The reference in the first bullet point on page A1-32 to the "risk assessment function" is unclear. We believe the PCAOB intends to refer to the risk assessment function within the company's financial reporting structure, but this reference could be read to refer to the company's overall business risk management function.

- Paragraph 84.f. of the Proposed Standard. This paragraph involves a formulation of relevant management that is broader than the formulation used in Paragraph 79, where the term "senior management" is defined. We recommend that this paragraph utilize that defined term (modified as suggested in this comment letter).

- Paragraph 90 of the Proposed Standard. As drafted, this paragraph could be read to prohibit the company from disclosing any of the written communications referred to in this portion of the Proposed Standard to third parties that may have a need to know and to whom the company would like to make disclosure (such as investment banks, potential counterparties or their counsel performing due diligence in connection with capital markets or M&A transactions). We believe that access on the part of relevant transaction participants to correspondence with the Audit Committee regarding the audit of internal control could prove to be useful to investor protection. We also note that Paragraph 90 could be read to include the written materials required to be provided to the Audit Committee by the auditors pursuant to Section 10A(k)(3) of the Securities Exchange Act of 1934. We do not believe auditors can condition the delivery of these statutorily-required communications upon a confidentiality obligation. We thus suggest that Paragraph 90 be deleted.

- Paragraph 96 of the Proposed Standard. The PCAOB proposes to change the content of the auditor's report on internal control to eliminate the requirement to evaluate management's evaluation process. As noted above, the Committee supports this proposal. We note that the first paragraph of the model text of an unqualified opinion in Paragraph 96 of the Proposed Standard includes a reference to the audit of management's assessment, as included in an accompanying report. We suggest that this formulation be conformed to the other references in the model text, which correctly state that the auditor has audited the effectiveness of internal control.

- Paragraphs 106-08 of the Proposed Standard. These paragraphs provide that an auditor must take into account in his or her opinion any subsequent adverse events occurring between period end-date and the date of the auditor's opinion. The inverse situation is not addressed. The Committee believes that the occurrence of a positive event after period end-date and prior to delivery of the opinion is equally relevant to investors. AS No. 4 (Reporting on Whether a Previously Reported Material Weakness Continues to Exist) provides for reporting on remediation of a Material Weakness after a period-end date but before the relevant opinion is delivered. We recommend that the PCAOB clarify that AS No. 4 continues to be applicable.

- Paragraphs A10 and A11 of Appendix A to the Proposed Standard. The references to "financial statements" in the second and third lines of Paragraph A10 and the third line of Paragraph A11 should both be modified by the phrase "taken as a whole." This will clarify that the respective defined terms are calibrated to the overall financial statements and not to account-balance entries.

- Paragraph B18 of Appendix B to the Proposed Standard. The word "may" at the end of the second line should be changed to "must" (or "should" if language is added to the Proposal to make clear that the normative standard "should" is to be interpreted as mandatory, not optional).

- Paragraph C14 of Appendix C to the Proposed Standard. This paragraph should be revised to permit the auditor to consult with the Audit Committee, not just management, prior to formally notifying the Audit Committee of the remaining material misstatement. This is consistent with the provisions of the Sarbanes-Oxley Act, now part of §10A of the Securities Exchange Act of 1934, providing that the auditors report to, and their work is overseen by, the Audit Committee.

- Appendix 3 - Proposed Rule 3525: Audit Committee Pre-approval of Services Related to Internal Control Over Financial Reporting. The Committee is concerned that item (c) (requiring the auditor to document the substance of its discussion with the Audit Committee) will unnecessarily create a potentially adverse litigation record. The auditor could, of course, document the fact that the discussion occurred and confirm that the Audit Committee will prepare minutes reflecting the substance of the discussion.

Conclusion

The Committee believes that the Proposal constitutes a significant improvement to AS No. 2. We commend the PCAOB and its staff for their efforts to improve both the efficiency and efficacy of this process. As discussed above, we believe that there are aspects of the Proposed Standard and the Proposal that merit further consideration by the PCAOB.

The implementation of Section 404 has become a hot-button issue, both politically and competitively. We share the PCAOB's and the SEC's desire to produce rules and standards that are readily understood by auditors, management and investors and that consistently result in efficient and effective audits on internal control and related disclosures. We believe that this can be achieved by significant, rather than incremental, change to AS No. 2 and related standards. We hope our comments are of use to the PCAOB and its staff in this process.

Members of the Committee would be pleased to answer any questions you might have regarding our comments.

Respectfully submitted,

Norman D. Slonaker
Chair of the Committee on Financial
Reporting

cc: <u>Securities and Exchange Commission</u>
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<u>Securities and Exchange Commission – Office of Chief Accountant</u>
Mr. Conrad Hewitt

ANNEX A

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* The Committee acknowledges the assistance of Jessica Milner in the preparation of this letter.

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February 23, 2007

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

By e-mail: comments@pcaobus.org

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 PCAOB Rulemaking Docket Matter No. 021

The New York State Society of Certified Public Accountants, representing 30,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the Proposed Auditing Standard and the related other proposals referenced above.

The NYSSCPA Auditing Standards and Procedures Committee deliberated the exposure draft and, with assistance from the SEC Practice Committee, prepared the attached comments. If you would like additional discussion with respect to the attached comments, please contact Robert W. Berliner, chair of the Auditing Standards and Procedures Committee, at (212) 503-8853, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

Thomas E. Riley
President

Attachment

new york state society of
NYSSCPA
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COMMENTS ON PCAOB PROPOSED AUDITING STANDARD

An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Proposals

PCAOB Release No. 2006-007

PCAOB Rulemaking Docket Matter No. 021

February 23, 2007

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Comments on PCAOB Release No. 2006-007

February 23, 2007

Comments Regarding the 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 opportunity for public comment, a period of slightly more than two months ending February 26, 2007, is too short to enable the NYSSCPA's Auditing Standards and Procedures Committee to develop detailed comments, particularly given that this period encompasses a considerable part of the public accounting "busy season." Nevertheless, we do have the following comments on what we consider to be overarching aspects of the proposed auditing standard that would supersede Auditing Standard No. 2.

1. We strongly support the removal of the separate opinion on management's assessment. We agree with the Public Company Accounting Oversight Board (the Board) that it is redundant to have a separate opinion on internal control. An opinion only on the effectiveness of internal control, and not on management's assessment thereof, is consistent with the auditor's opinion on financial statements and will more clearly communicate the scope and results of the auditor's work . Further, the auditor can perform an effective audit of internal control without performing an evaluation of the quality of management's assessment and that removal of the opinion on management's assessment will eliminate unnecessary audit work. However, it is important that the auditor understand the basis for management's assessment. Therefore, we recommend that the final standard require the auditor to understand management's process as part of planning the audit of internal control.

2. We consider that the emphasis on the importance of risk assessment in an audit of internal control over financial reporting is appropriate. We agree with the Board that focusing the auditor's attention on the areas of greatest risk is likely to produce a more effective audit of internal control and substantially decrease the opportunity for a material weakness to go undetected. We also agree that the proposed standard's emphasis on risk assessment and the use of professional judgment will enhance the efficiency of the audit of internal control.

3. The emphasis on a top-down approach utilizing entity-level controls will result in more efficient audits. However, in practice auditors have found it difficult to identify entity-level controls that could be relied upon to the degree contemplated

by the proposed standard. It would be useful if the final standard provided some examples of such monitoring controls and how their effectiveness could be evaluated. In particular, we believe that allowing the auditor to conduct walkthroughs at the level of significant processes will serve to reduce unnecessary efforts.

4. Focusing testing of multi-locations based on risk rather than coverage will enable the auditor to exercise more judgment and thereby enhance the efficiency of the audit of internal control. We suggest that the final standard include examples of items to consider when determining multi-location coverage. Examples of such items include the size of the location, its risk profile, capabilities of its accounting department, etc.

5. We disagree with the deletion of the statement that "each year's audit must stand on its own." This statement is consistent with the Board's decision not to permit cycling of tests and with standards for an audit of financial statements. Nevertheless, we believe that the proposed standard appropriately incorporates the value of cumulative knowledge in allowing the auditor to alter the nature, timing, and extent of testing of controls.

6. We support the Board's recognition "that a company's size and complexity are important and that the procedures an auditor should perform depend upon where along the size and complexity continuum a company falls." However, we do not believe the description in the proposed standard as to how auditors should scale the audit for the size and complexity of the company is sufficient. The Board should indicate that the procedures required in the audit of internal control of a non-accelerated public company should be related to guidance similar to COSO's "Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting." Towards the goal of reducing costs to non-accelerated public companies, additional guidance as to the requirements of the work to be performed is necessary in the final standard or, at a minimum, in the planned guidance on auditing internal control in smaller companies to be issued next year.

Comments Regarding the Proposed Auditing Standard – "Considering and Using the Work of Others in an Audit

The Proposed Auditing Standard should be adopted in its current form.

Comments Regarding Proposed Rule 3525: "Audit Committee Pre-approval of Services Related to Internal Control Over Financial Reporting

The Proposed Rule should be adopted in its current form.

Comments Regarding "Proposed Amendments to PCAOB Interim Standards"

It would be appropriate for the Board to consider further modifying its interim standards by adopting the Auditing Standards Board's risk assessment standards for audits of financial statements. Adopting these standards would be consistent with the Board's renewed emphasis on risk assessment espoused in the proposed auditing standard "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements."

From: Todd Nielsen [mailto:todd.nielsen@us.lawson.com]
Sent: Thursday, February 15, 2007 7:03 PM
To: Comments
Subject: Docket 21

To all,

I first would like to thank you for the opportunity to provide feedback. I think it's very important for the board to hear first hand from people who have been directly impacted by Section 404.

Let me start by saying flat out that my coworkers and I are utterly disgusted and outraged by what Section 404 has done to our workplace. There's really no other way to describe it. It is very unfortunate that what should have been an attempt to address fraud by executives turned into a massive misguided attempt to prevent any time of accounting error from ever occurring. That is impossible, and has resulted in incredible cost to U.S. public companies – not just in terms of audit $'s, but also in terms of lost efficiency, worker satisfaction, people laid off (to pay for all this), and even increased errors.

It's very important to distinguish between fraud by executives and true errors by accountants. They are very different things. The scandals at Enron and Worldcom were not errors by accountants. They were intentional fraud and/or mistatements by executives at those companies. All of this was directly or indirectly driven by the large sums of money the executives had at stake, which was all dependent on the financial results of the companies and meeting analysts earnings expectations.

The good news is that Sarbanes-Oxley has done a good job of addressing intentional financial mistatements (fraud) by executives. Most people could name the items needed to address this fraud without ever reading or knowing anything about Sarbanes. Definitely it needed to be made very clear to executives that fraud (ie. normally involving manipulation of earnings numbers) will no longer be tolerated. Along with that comes clear guidelines of what the penalties will be and the requiring of positive certification each reporting period that they have not committed fraud. Another big item was providing a mechanism for employees to report fraud without repercussion (although this can be a little dangerous since it can potentially be manipulated – but the good hopefully will outweigh the bad).

Aside from the items above, the other big item that needed to be addressed was the lack of audit scrutiny by the partners in the auditing firms. Again, money was the root cause of audit partners not taking measures to dig deep enough or push high enough on high level issues that normal audit procedures would not detect. The last thing the big CPA firms wanted to do was lose the audit engagement, since it was their doorway into big profit tax and consulting work. But clearly the rules on this have changed, and this problem area has been effectively addressed.

So the good news is that the root causes of what brought about Sarbanes-Oxley have been well addressed. Granted, there will be future intentional mistatements by executives – personal financial greed and pressure to meet the forecasts has not gone away. But at least the expectations and penalties are very clear now. So this is by no means an across the board indictment of all Sarbanes-Oxley.

But the bad news is that Section 404 went way beyond what was necessary and decided to take on the impossible (but extremely expensive) task of trying to prevent not only fraud/financial mistatement by executives, but all possible errors. This is absolutely insane. And it has caused incredible chaos at my company and the companies of my peers.

As I overheard my former boss say to an auditor out of frustration the other day, "I can't guarantee I'll never make a mistake." But unfortunately, that's what Section 404 has attempted to do. Again, this wasn't the problem in the first place. Intentional mistatement by executives isn't a "mistake."

And the sad thing is that my department is actually making mistakes now that we never did – directly as a result of Section 404. We have been mandated to have so much separation of duties that tasks that were once simple and straightforward have now become unduly complicated and involve a number of people. As a result, the work flow is constantly interrupted while waiting for someone else to now do their piece, which forces us to set things down and restart them constantly. And items such as journal entries often get keypunched three times because of the separation of duties/system accesses. We now have to deal with keypunch errors that never existed before.

These types of things have caused us to make numerous mistakes that we've never made in the past. And we've been given no leeway to use judgement anymore as to how much separation of duty we consider necessary for each area. Section 404 is quoted as a blanket statement over everything. It's very frustrating. We at the lower levels were not the problem in the first place, yet we are the ones suffering from the results of all this.

Section 404 has caused errors in many other ways – both direct and indirect. The amount of time it takes away from both the staff accountants and managers is obscene and directly impacts the quality of our work. We now have to find time to go over things constantly with regular internal auditors, our internal Sarbanes compliance people, and the external auditors. And of course now there are two external audits – one compliance and one financial. This time is stolen from the time we used to be able to spend on actual accounting work. As a result, my people are making mistakes they have never made in the past simply because they don't have sufficient time to concentrate on their actual work.

And simply working longer hours is not a quick fix. We have to remember that people only have so much mental energy to use each day. Again, if you have to spend half of every day digging things up and explaining things to the numerous auditors we now have to deal with, you are often half burned out by the time you get to your actual accounting work. It feels like the work itself has taken a huge back seat to the auditing of the work. Several people have noted that it feels like you do one small task, and then numerous auditors come out of the woodwork and audit it to death. And simply adding staff (which is very tough to get approved) isn't always the answer since there is only so much good meaningful work to do. These are real people, not machines.

And specifically for my company and accounting department, we are still slowly recovering from the fact that we were going through a massive systems implementation at the time that we were also implementing Section 404. So instead of our people being able to spend the time they needed learning all the intricities of the new system and making sure the initial setup was done correctly, we instead spent day after day in rooms with Sarbanes consultants explaining over and over again what we do and how everything works. As a result, numerous things were missed or done poorly in the implementation that would have been no-brainers if we had been allowed to spend the time needed. I think sometimes that people associated with Sarbanes forget that we actually have jobs to do. So now even after a couple years have passsed we are still trying to fix the initial systems setup and and learn how certain things work – things that would have been done easily while the systems implementation team was in place and ready to help.

Another depressing outcome of Section 404 is the massive amount of administration we now have to go through to do routine tasks. I currently serve as a supervisor, and rather than getting meaningful work done – my days are typically spent reviewing SOX narratives, preparing things to be signed by my manager, signing/dating/initialing paperwork, responding over and over again to the same compliance type questions, pulling items for the various auditors, re-explaining how things work to various auditors, etc. It has taken the quality of my workday and other managers and reduced it to endless administration.

Not a day goes by that someone in my area doesn't think about looking for a job at a non-public company. But we hate to be forced out of jobs that we used to get a great deal of satisfaction out of. Unfortunately, several very good people have left out of frustration over what Section 404 has done to their jobs. And ironically, by losing these intelligent knowledgable people, our risk of errors has increased. Again, part of Section 404 backfiring.

And perhaps that is what much of this boils down to. Section 404 has inadvertently led to a tremendous decrease in job satisfaction amongst accountants. Every single accountant I know that is impacted by Section 404 (at other companies also, not just mine) absolutely hates it. Hate is a strong word, but that is the sentiment. I have never seen so much frustration as I have with Section 404. We've always had good, motivated accountants that thrive on challenges. But Section 404 has taken a great deal of this away from them. It is punishing them for problems that they couldn't possibly have been further away from causing.

The reason I have taken the time to write the above items is that I think it's important to understand this in order to talk about the auditing standard. Ideally we would want much of Section 404 to be abolished and return the control of the Accounting Departments back to the controllers. The best way to minimize true accounting errors is the same as it has always been – hire intelligent motivated accountants and have intelligent motivated managers in place to oversee things. You can put all the rules and controls and narratives, etc., in place that you want, but "you can't legislate stupidity." True mistakes can and will continue to happen no matter how many controls you have. But if you have good people in place – and give them sufficient time to do their job (ie. not spending all their time on admin) – you should be able to minimize the materiality of most errors.

So the single biggest improvement we can make with regards to auditing is to minimize the time impact on the accounting departments. Having to explain the same things over and over again to multiple auditors – internal and external – steals time away from actually doing the work properly. Every minute spent making copies and pulling backup and re-explaining things is a minute we've taken away from our accountants concentrating on doing actual work. The media appears to only be focused on the external $ cost to companies – we seem to have completely ignored the incredible drag on our people's time and their own internal motivation to go to work and do a good job every day.

So anything you can do to decrease the time impact on our accounting departments will be incredibly appreciated. Again, most of the controls that have been added have little to do with the real issue of the large $'s at stake that drove executives to manipulate financial results and that drove CPA firms to not address the real risk areas in the first place. I guess the new joke is "how many accountants does it take to change a lightbulb?" Unfortunately, after Section 404 the answer might be quite high. You'd probably need one to authorize the lightbulb change, one to supervise the change, one to physically twist the bulb out, one to bring the new bulb over, one to screw the new bulb in, one to check off that the bulb was changed, and then a minimum of three auditors to verify that everyone checked the right boxes – regardless of whether the bulb was properly changed or not. So I guess the answer would be nine. But unfortunately this is no joke.

We will be anxiously awaiting news on what will hopefully be some good changes. Thank you for your time.

From: Jordan, David [mailto:David.Jordan@nike.com]
Sent: Monday, February 26, 2007 8:12 PM
To: Comments
Subject: Docket 21

January 19, 2006

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

Re: PCAOB Rulemaking Docket Matter No. 021.

We are pleased to have the opportunity to comment the Board's proposed standard for the audit of internal control over financial reporting. As we undertake our third year of compliance with the provisions of the Sarbanes Oxley Act we are particularly interested in interpretations that will support the ongoing cost-effectiveness of compliance programs. We continue to support the objectives of the Act and believe that cost-effective implementation is critical in sustaining achievement of those objectives.

In response to questions 13 and 14 of the Release, we believe that removing the requirement for an evaluation of management's process will not eliminate a meaningful amount unnecessary audit work. Under current standards, the external auditor already spends the overwhelming majority of effort conducting a redundant assessment of controls in parallel with management's assessment.

We believe, conversely, that true efficiencies can only be realized by *strengthening* the evaluation of management's process and by eliminating the external auditor's own opinion over internal controls.

- Focusing the auditor on management's assessment program, rather than on redundant assessment of internal controls, would provide incentive to management to create stronger and broader assessment programs, which in turn would identify and control significant risks as they emerge.
- Eliminating the redundant assessment by the external auditor would allow compliance programs to focus on improving governance and controls rather than on coordination among external auditors and internal assessment teams in order to contain costs.
- The need to support the external auditor's redundant assessment drives management to conduct more extensive separate evaluation-type testing than is required to perform an effective and competent assessment of its internal controls. The "assess the assessment" approach would support the efficiency of management's assessment by encouraging a combination of independent

evaluation testing, self assessment and monitoring based on risk and would allow management to take full advantage of the Commission's proposed guidance.
- Eliminating the redundant assessment by the external auditor would eliminate completely redundant controls testing in areas in which PCAOB standards require the auditor to perform substantive testing of financial balances regardless of the results of controls testing.

We anticipate that external auditors would still need to perform some level of controls testing to support their evaluation of management's program, but the scale and scope of such testing would be to test management's process, not to re-create it. In response to question 15, we believe the auditor's parallel opinion on internal controls detracts from the emphasis on management's responsibility for controls and implies incorrectly that the external auditor functions as an element of the company's internal control environment.

However, within the context of the parallel external auditor assessment of internal controls as proposed, we believe further efficiencies may be gained by aligning the framework for reliance on the work of others for internal control assessment with the guidance proposed by the SEC to guide management's assessment. In response to question 19, this may imply a separate framework for reliance upon internal controls evaluation as the auditor would need to consider procedures employed by Management, such as monitoring and self-assessment. In response to question 23, this also implies that the standard as proposed is too restrictive in that it does not allow auditor reliance on procedures employed by Management consistently with the SEC proposed guidance.

In conclusion, we believe that companies and capital markets will be best served by an interpretation of the Act that focuses the external auditor's evaluation on management's assessment and eliminates the auditor's redundant assessment. Absent that approach, we believe that alignment of the SEC's guidance for management and the framework for reliance on internal controls will be critical for efficient and effective implementation of the Act.

David Jordan CPA,
Director of Compliance
NIKE, Inc.

North Carolina State Board of Certified Public Accountant Examiners
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February 19, 2007

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

RE: PCAOB Rulemaking Docket Matter No. 021

To Whom It May Concern:

The North Carolina State Board of CPA Examiners (the Board) has reviewed the proposed auditing standards, *An Audit of Internal Control over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals,* and *Considering the Work of Others in an Audit,* as well as the proposed new independence rule, *Audit Committee Pre-Approval of Services Related to Internal Control* and the related amendments to the PCAOB's interim standards. The Board believes that the proposed Statements, rule, and amendments contribute toward improving the audit of internal control over financial reporting.

The Board offers the following comments:

Page A1-11 (18.)
Company-level controls should include controls over the execution, recording, and reporting of related-party transactions since, unfortunately, experience has shown that business structure and operating style are occasionally deliberately designed to obscure these type transactions.

Page A1-16 (34.)
The Board recommends that to ensure that the auditor understands the flow of major classes of transactions completely through to financial reporting the first bullet point be revised to read, "Understand the flow of major classes of transactions, including how these transactions are initiated, authorized, processed, recorded and reported."

Page A1-21 (52.)
The Board recommends adding a bullet point that reads, "Whether there have been programming changes during the reporting period that might affect the performance of an automated control."
Page A1-24 (62.)
The Board recommends that the first note be revised to read:

> Testing a single operation of an automated control might result in sufficient evidence that the control operated effectively, provided that relevant information technology general controls also are operating effectively and there were no programming changes affecting the automated control during the reporting period.

The Board wishes to commend the PCAOB for its work to make audits more efficient, effective, and useful. The PCAOB's regulations and standards are improving the areas of corporate governance, the quality and efficiency of important corporate processes and controls, and public company financial reporting.

Sincerely,

Leonard W. Jones, CPA lrh

Leonard W. Jones, CPA
President

JMB/lrh

February 26, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100F Street, NE
Washington, D.C. 20549-1090

Reference: File Number S7-24-06
Proposed Interpretation and Rule Concerning Management's Report on Internal Control Over Financial Reporting

and

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

Reference: PCAOB Rulemaking Docket Matter No. 021

Executive Summary

Northrop Grumman Corporation ("NGC") welcomes the opportunity to provide our comments to the Securities and Exchange Commission ("SEC") in response to its proposed interpretation and rule concerning *Management's Reports on Internal Control over Financial Reporting* ("ICFR") (the "Proposed Rules"). Given the important interrelationship between management's assessment of ICFR and the independent audit process, we are also providing comments with respect to the Public Company Accounting Oversight Board ("PCAOB") proposed auditing standard, *An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements*.

We appreciate the effort made by both the SEC and PCAOB to codify previous guidance with respect to a top-down, risk-based approach to the evaluation of ICFR. We believe the Proposed Rules present management with a practical approach in carrying out its responsibilities in the evaluation of ICFR. We also believe the proposed PCAOB auditing standard affords accounting firms the opportunity to apply a less prescriptive, though sufficiently robust, methodology as well.

Our primary concern is that the effectiveness of the Proposed Rules is dependent on the extent to which auditors modify their approach under the proposed PCAOB auditing standard, as. auditor behavior appears to be driven by the PCAOB inspection process, regardless of the written standards. Secondly, we are concerned that a top down risk-based approach may be difficult for the auditors to implement and consequently, specific guidance and examples may be necessary.

Alignment of PCAOB Examinations with a Risk-based Approach

Accounting firms have already expended significant resources and adapted staffing levels to implement an audit approach that meets the requirements of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS2"), and we believe results of PCAOB inspections may have been an important consideration in developing their methodology. While the proposed PCAOB auditing standard should permit the accounting firms to modify their audit approach to accommodate the more practical intent of the new rules, including a greater emphasis on the top-down, risk-based approach to evaluating ICFR, we think it is unlikely accounting firms will change their audit approach until they are confident PCAOB inspections will be similarly focused.

From a practical standpoint, continuation of existing audit practices by accounting firms will impact management's ability to implement the Proposed Rules as companies will continue to support the auditor's work and are unlikely to be comfortable with potential divergences from auditors' reports with respect to the nature and number of deficiencies reported to the Audit Committee. It is also possible that differences in approach may *increase* audit work if accounting firms decrease reliance on management testing solely because of dissimilar reductions in testing by management in certain areas.

Based on our review of PCAOB inspection reports and discussions with accounting firms, it appears that up to now a prescriptive and detailed approach is followed during most inspections, with equal attention to all aspects of the audit. While we believe such inspections are intended to provide a valuable service to investors, many of the reported findings do not appear to reflect inadequacies in the overall quality of audit work performed, but rather differences in professional judgment.

To date, we believe there may not have been sufficient dialogue between the PCAOB and accounting firms with respect to the PCAOB's inspection approach. We recommend such communication be initiated as soon as practicable to ensure firms have a clear understanding of the effect the proposed PCAOB auditing standard will have on the PCAOB's inspection process. We also recommend the PCAOB adopt a more timely and focused, risk-based approach to its inspections, which should enable inspectors to vary their procedures based on specific circumstances, similar to the approach recommended in the proposed PCAOB auditing standard.

Clarification of Reliance on Certain Process and Company Level Controls

We are pleased with the PCAOB's proposed change in its auditing standard to emphasize that strong company level controls ("CLCs"), with a direct link to process level controls, are likely to reduce auditors' testing of controls at the process level. We also appreciate that the PCAOB has modified its description of control selection to direct auditors' attention toward controls that sufficiently address the risk of material misstatement, regardless of the nature of the control.

It has been our experience that the audit plans of the independent auditors are developed with the expectation that routine transactional controls, general IT controls, higher level detective controls, and CLCs will be evaluated concurrently and, therefore, results of testing one control are unlikely to influence testing of a complementary control. Furthermore, CLCs are typically evaluated too late in the process to influence the auditor's testing of other controls. We believe a more efficient, cost-effective audit could be achieved if higher level detective controls within business cycles and CLCs, especially those providing direct assertion-level comfort such as controls to monitor results of operations and the period end financial reporting process, were tested early in the audit cycle, and their effectiveness considered when determining the scope of any remaining testing requirements.

We agree that CLC's can have a pervasive effect on the entire control structure, but do not believe accounting firms place sufficient reliance on certain CLCs, such as detailed analytic reviews, when considering their overall scope of work. As a result, management may not have fully developed these controls. The Proposed Rules appear to support increased reliance on effective higher level controls, and with assistance by accounting firms, we believe management can develop more meaningful controls in this area. Once such controls are established and utilized by management, we would expect that the accounting firms would be able to place reliance on these controls and thereby reduce their testing requirements for controls operating at a lower level of materiality.

We also believe auditors could better demonstrate a risk-based approach in their selection of individual controls to test within processes. For example, when determining their scope of work, auditors do not appear to evaluate the likelihood of failure for a routine control based on the extent to which a process, key personnel, and other qualitative factors have remained consistent between annual tests. In addition to the historical effectiveness of routine controls, complementary or redundant detective controls which operate at a higher level of materiality are also frequently not considered. We recommend further clarification and examples be provided within the Proposed Rules with respect to the correlation between effective CLCs and required testing of certain routine transactional controls.

With the advent of AS2, each accounting firm interpreted the rules and developed materials independently at a significant cost; these materials were also used by issuers in the absence of other guidance. We expect a similar effort may be expended with the release of the Proposed Rules. Consideration should be given to a joint effort between issuers, the PCAOB, and accounting firms to identify areas in which further clarification and examples may be helpful to develop tools to assist with consistent compliance. We believe resulting supplemental information in the form of checklists, guidelines or templates should be published with the Proposed Rules to enable management and accounting firms to better understand and take advantage of key changes that could increase efficiency in their approach, while ensuring all compliance requirements are met.

Summary

Although we are generally satisfied with the interpretative guidance provided by the SEC and believe the PCAOB has made a significant effort to direct the auditor's attention toward the most important controls which can prevent or detect a material misstatement, significant concerns remain as to the implementation of the Proposed Rules and the proposed PCAOB auditing standard.

Areas which we believe provide opportunities for further improvement include increased coordination between auditors and the PCAOB in the inspection process, further clarification of the relationship between CLCs and process level testing, and a collaborative approach to the development of tools to assist management and auditors in their compliance activities.

We appreciate the opportunity to share our comments and would be pleased to discuss these matters with you further. If you have any questions regarding the information included in this letter, please contact Ken Heintz, NGC's Chief Accounting Officer, at (310) 201-3312 or Kenneth.Heintz@ngc.com at your convenience.

NORTHROP GRUMMAN CORPORATION

By: /s/ KENNETH N. HEINTZ
Kenneth N. Heintz
Corporate Vice President, Controller and Chief Accounting Officer

cc: Office of the Secretary, PCAOB

THE OHIO SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

February 26, 2007

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

The Auditing Standards Task Force of The Ohio Society of CPAs reviewed the proposed auditing standard, "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals," and submits the following comments for your consideration.

Overall Comments:

The task force supports the movement of the standard to a more risk-based approach to audits of internal control over financial reporting. In particular, provisions of this standard that will be of benefit include removing some limitations to relying upon the work of others, and allowing greater use of professional judgment, which will drive greater efficiencies.
Becoming more principles-based introduces greater flexibility, which all parties want, but at the cost of the introduction of greater variation in practice and potentially greater risk. It's important to point out that clarification of the auditor's responsibilities via the standard is only part of the solution. For these changes to result in efficiencies in practice, Board inspections need to closely align with the use of professional judgment in applying a risk-based approach that the standard intends. For example, as auditors are exercising greater professional judgment, inspections performed by the PCAOB need to support judgments that were made, so long as they are in line with the intent of the standards and have a reasonable basis for support.

Throughout the standard, task force members commented on the inclusion of concepts of "efficiency," for example, referring to an auditor "only" doing something (for example, paragraphs 3, 8, and 16 in the proposed standard). This concept would be precedent setting in an auditing standard, and we believe is inappropriate. Building efficiency considerations into the standard is understandable in the context of minimizing excess procedures and scaling to less complex entities. However, while efficiency considerations may have a place in implementation guidance related to the standard, they should not be part of the standard itself. It is more appropriate for an auditing standard to address procedures in terms of consistency or quality.

Members also questioned whether this standard supersedes any previously existing implementation guidance. In particular, as referenced throughout the comments, much of the May 16, 2005 guidance was considered to still be

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applicable in the context of this proposed standard, and in many sections, it is recommended that certain sections of the guidance be incorporated.

We appreciate the opportunity extended by the PCAOB for our review and comments in response to the proposed auditing standard. Should the PCAOB wish to further discuss any or all our feedback, we would be pleased to do so.

A. Focusing the Audit on the Matters Most Important to Internal Control

Directing the Auditors' Attention Towards the Most Important Controls:

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

   The proposed standard is consistent with the May 16, 2005 guidance, and therefore may not lead to significant changes in practice. It clarifies the need to focus on key controls. Consider incorporating language from Q&A #38 in the May 2005 guidance, which offers a more detailed and specific explanation of a top-down approach.

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

   The proposal clarifies the need to assess controls on the basis of risk of material misstatement. The proposal is not as clear on the need to establish controls specifically focusing on the prevention and detection of fraud. If that is the intent of the draft, the proposal should clarify the focus on fraud controls. In PCAOB Auditing Standard No. 2, paragraph 24 on fraud considerations provided some guidance in this area.

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

   Yes, although the May 16, 2005 guidance has already helped auditors with this focus.

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?*

   The proposal is clear on the expectation to gain an understanding of company-level controls in achieving an understanding of the control environment, but is not sufficiently clear on how the auditor takes company-level controls into consideration in assessing the level of testing of other controls. In many cases, company-level controls have an indirect influence on specific controls. We questioned whether there is any instance where a company-level control would prevent or reduce testing a lower-level key control, and concluded such circumstances would be very limited. Additional clarification is necessary on circumstances under which company-level controls could reduce the scope of testing, especially of a lower-level key control, and how the auditor takes those controls into consideration in reducing or eliminating testing.

<u>Emphasizing the Importance of Risk Assessment:</u>

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?*

   We suggest the risk assessment guidance provided in the May 16, 2005 guidance be incorporated in the auditing standard. With this proposal and the SEC proposed interpretive guidance, we envision greater divergence between the external auditor and management in assessing what risks are significant. While the potential for differing assessments is not necessarily a negative consequence, the draft should provide additional guidance on how the auditor and management reach consensus on key controls (in the absence of such guidance, the auditor assessment will prevail.)

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

   It is possible in a situation with strong company-level controls and testing in prior audits, cumulative knowledge and experience could permit conducting a walkthrough in subsequent audits for a lower risk control. Examples of such circumstances in the standard would be beneficial (and those circumstances should be limited.) A walkthrough should never be sufficient for first-time testing of a key control, and conclusions regarding the effectiveness of the related control should be revalidated periodically by testing beyond a walkthrough.

<u>Revising the Definitions of Significant Deficiency and Material Weakness:</u>

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?*

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?

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?*

   (7,8, and 9) We don't believe the new definitions improve the ability of an auditor to preemptively or more consistently identify potential material misstatements. The degree of subjectivity in the definitions continues to provide for a high degree of judgment and interpretation, and greater subjectivity will not likely reduce the aggressiveness of application.

<u>Revising the Strong Indicators of a Material Weakness:</u>

10. *Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present?*

    Yes.

    Will this change improve practice by allowing the use of greater judgment?

    The change clarifies the role of judgment that was already permitted in AS2, but will not likely change current practice.

    Will this change lead to inconsistency in the evaluation of deficiencies?

    Additional guidance would be beneficial. Many firms and issuers have found the guidance on the evaluation of deficiencies in the paper "Framework for Evaluating Control Exceptions and Deficiencies" prepared by the largest CPA firms useful in providing common ground for management and auditors in this respect.

<u>Clarifying the Role of Interim Materiality in the Audit:</u>

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

    As noted in response to question 5, management may make a differing assessment of significant locations, processes and controls from external auditors. However, a common occurrence will be that management will perform testing of key controls as identified by the external auditors to reduce overall costs (provides auditors with an opportunity to use their work). There needs to be a process for management and auditors to reach consensus regarding significant locations, processes and controls.

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?*

    References to interim financial statements should be removed from the definitions. Due to the cyclical nature of controls testing activity, it is difficult to pinpoint the effect of the deficiency on the interim financial statements, unless the deficiency resulted in an audit adjustment or the need for a restatement. Removal will not affect the scoping of the audit, as the audit is scoped to conclude on internal control as of the balance sheet date. Eliminating the requirement to evaluate the significance of all control deficiencies against interim materiality would be consistent with the objective of reducing unnecessary work.

B. Eliminating Unnecessary Procedures

Removing the Requirement to Evaluate Management's Process:

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

    The opinion required on management's assessment process provides little value and adds confusion to the marketplace, therefore it should be eliminated.

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

    The evaluation of the quality of management's assessment process is a critical part of gaining an understanding of the organization that is used as a basis for scoping the engagement.

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?*

    Yes. Some parties have been confused by the two opinions, and this change will clarify the subject of the auditor's opinion.

Permitting Consideration of Knowledge Obtained During Previous Audits:

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

It would be helpful to have examples of how cumulative knowledge can be reflected in adjusting the scope of testing.

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.

<u>Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage:</u>

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?*

    Yes, consistent with the shift in emphasis to risk-based assessments, and consistent with the May 16, 2005 guidance. This increase in effectiveness will likely be offset by greater variability in practice due to the increased emphasis on auditor judgment.

<u>Removing Barriers to Using the Work of Others:</u>

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?*

    Two separate frameworks would be confusing and may be misleading. Both the work of the external auditor and that of management point to the reliability of the financial statements. A single framework is preferred, emphasizing the consideration of competence and objectivity. Consider an update of SAS 65 as a potential solution (versus issuing a separate auditing standard).

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?*

    Yes; however, the identification of relevant activities should be performed in conjunction with the evaluation of competence and objectivity. In other words, auditors should only consider relevant activities where there is an opportunity to relay upon them.

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, although these matters are often shared between management and auditors today.

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

    While the provision may have been necessary for initial implementations, it is no longer necessary. Professionals are able to determine when they have gathered sufficient evidence to support their opinion.

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 proposed framework is appropriate.

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

    The factors identified are adequate.

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?*

    This factor could be perceived as intrusive, to the point where qualified individuals will opt out of this role. This factor should be included as one of the considerations in evaluating competence and objectivity, but does not deserve special prominence.

<u>Recalibrating the Walkthrough Requirements:</u>

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

    No. This clarifies what for many is current practice.

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?

Yes, but as outlined in question 6, only for certain mutually agreed-upon low risk processes. Higher risk areas should have an external auditor walkthrough, based upon the auditor's discretion.

C. Scaling the Audit for Smaller Companies

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?*

    The proposed standard provides guidance on how to apply the fundamental concepts already existing in AS2 to a control environment in which, for example, an entity cannot maintain as well-defined segregation of duties or as many detailed controls. It's important to clarify whether publication of this standard supersedes already existing guidance, or how it may be applied for such entities. For example question #53 in the Q&A guidance would be relevant to this section.

    The discussion of evidence would benefit from additional clarification of how the auditor should compensate for reduced evidence. Even if a purpose of the standard is to require less evidence in a small company environment, it would be helpful to establish some acceptable level of documentation – what are the minimum elements that need to be present?

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

    None were noted.

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?*

    The standard is reasonably clear on the complexity factor.

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?*

    Unless market capitalization and revenue thresholds are to be used to exempt certain levels of companies from the requirements of the standard, these are not meaningful measures. More appropriate would be measures of complexity, such as number of processes, locations or layers of management.

D. <u>Simplifying the Requirements</u>

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?*

    Auditors' interaction with audit committees improved with the introduction of AS2, including required content and frequency. Nothing should be changed at this time.

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?*

    Assuming a final standard can be available in the second quarter, the optimal effective date would be for calendar year-end 2007 audits. Should the standard be issued later than the second quarter, consider an effective date for years ending June 30, 2008 or thereafter, with early adoption encouraged.

If you have any questions about the above comments or deliberations of the task force, please contact me at the following telephone number or e-mail address.

Sincerely,

Gary L. Sandefur, CPA
The Ohio Society of CPAs
Auditing Standards Task Force
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26 February 2007

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Subject: PCAOB Rulemaking Docket Matter No. 021

Overall general comments: The task of crafting a statement that is reflective of the specific guidance that should be provided is not simple. I applaud your diligence and insight.

1. The perception of what is provided is critical. I am, therefore, concerned that this rewritten statement of Auditing Standard 2 seems to focus on *efficiency* and on reducing the demands of the earlier statement. That perception was noted by some members of SAG at the February session last week..

2.There continues to be what appears to be indifference or reluctance to face what is revealed from your own reports. For example, your comments re inspections (January 22, 2007) note that auditors in some cases failed to undertake brainstorming sessions, or there was no documentation of such sessions. Mr. Somers of the POB spoke at the American Accounting Association some years ago, in which he discussed investigating audit failures to understand what happened as he noted was a process similar to the kind of investigation of an airline's crash to determine cause. His idea, as you know, was never implemented. To date, there is much relief that inspections aren't at all what SOX stated in Section 104 . . .*to access the degree of compliance.* . Any one reading an inspection report, you quickly read

> *. . a Board inspection report should not be understood to provide any assurance that the firm's audits, or its issuer clients' financial statements, are free of any deficiencies not specifically described in an inspection report.*

3.It is amazing that there is so much difficulty re fraud detection. In Dicksee's Manual on Auditing as noted in his 1900 edition (which was essentially what Montgomery published in the U. S. with permission and support from Dicksee), the first of three objectives of undertaking a financial audit was: *To detect fraud.*

Do you have information that the audit failures at Enron, Tyco, WorldCom were unfair because the audits were performed appropriately in accordance with the guidance, but fraud was not disclosed. What is the evidence of the Big-Six that supports the idea that auditors aren't being paid enough for an annual financial audit to *expect* that fraud be detected. (I have restated the Big-Six comment in a most colloquial style, so it may not be completely fair. . .)

While one SAG member said something to the effect that partners should be the ones judging risks in a client's functions, it is strange that there have been instances of relatively inexperienced auditors realizing that something was "strange." For example, at Crazy Eddie a brand new young auditor resigned from the firm because he was so stunned at the indifference of the partner to respond to information he had gathered during his first two weeks ever on an audit. Two young men in California who were just getting underway in their own practice were employed by ZZZZBest, but after one month they sensed that there were serious problems in the operations. They resigned; came to New York City to continue their practice. Yet, a major firm accepted the restriction on when they might observe a restoration project and didn't find any fraud. Did they see it and just passed on it? Did they not see it? Why didn't they question the basis of selecting a restoration site?

My two anecdotes are not sufficient for generalizations, but they hint at a valuable hypothesis that might have been the basis of serious review of some of the several seriously deficient audits of the last 6 to 8 years. SAG functions with the black box of seemingly no knowledge of actual performance of audits.

Now, the Big 6 U. S. firms are suggesting, among a list of possibilities, undertaking a forensic audit. Do they have information that is proprietary that shows clearly that the audits they did at Tyco, Adelphia, Ahold, Parmalat were properly done but that they were not successful in identifying fraud? Given the level of knowledge we have of audit quality that has been revealed through some court hearings and SEC proceedings to date, the suggestion of a forensic audit is premature. Why isn't attention on doing a quality annual audit? There is sufficient guidance that if fraud is perceived to have occurred additional steps are warranted.

4. While there appears to be less than effective audits, to date the public accounting firms registered with you seem to be doing very well. Is there any need to continue with another set of standards? Do we really need inspections? It appears that there has been fully satisfactory response to internal control problems that were confidentially provided to the firms. I must say I am not sure what is meant by the statement in PCAOB Release 104-2006-78, p. 3)

> *. . .have crafted and undertaken important steps that, if conscientiously implemented, will have beneficial efforts on audit quality.*

Who will determine if the firms do conscientiously implement the steps? Do you just accept what they stated? Will this process be as effective (or ineffective) as the peer review process under POB? Do you see the inspection as similar to the pre peer review that many firms undertook. I noted that one SAG member said that PCAOB did inspections; the SEC does enforcement. Who determines that enforcement is to be considered?

As long as your inspections are so gentle – and maybe in the future they will be more like a compliance audit and, therefore, follow some clearly stated assumptions about the process – there is serious questions about the value of any changes in standard. As some of your SAG members said last week, there had been sufficient guidance, and even statutory requirements.

Your task is difficult. It appears that there is considerable evidence that there was not adherence to the statutory requirements for internal control (since December 1977) and there has not been adherence to the reasonably well written standards and related statements as reflected in your accepting ASB's standards as interim standards and have not, to my knowledge, rewrote all those standards and doing so does not appear to be a priority item on your agenda.

So focusing on standards seems questionable. Until there is a rigorous, but impeccably fair and just inspection process the total task of the PCAOB is not likely to meet the demands for quality audits.

Some minor points:

1. Should the language always be technically clear? One minor illustration: In para. 41, is the phrase "*important* to the conclusion. . . " do you mean *material or significant to providing reasonable assurance about the controls* . . . .

2. *Professional skepticism* is a fundamental attitude that requires absolute internalization on the part of every auditor. At some point you use the term *neutral* which is a reasonable qualifier similar to the term *indifferent.* I find that research chemists and research physicists who are grounded in statistics understand the technical meaning of the terms *neutral and indifferent.* Many auditors are not so knowledgeable about statistical and general research methodologies. Should your guidance be more informative for auditors?

   This isn't great, but consider: *Professional skepticism* is a mental attitude of suspended judgment about whether the client's financial statements are free of fraud or are not free of fraud. That suspended judgment is transformed into a judgment after obtaining sufficient competent evidence to support the statement of a conclusion.

3. There seems to be insufficient of understanding of "reasonable assurance" in many places. (In your October 2006 SAG meeting, as I recall, a member asked something to the effect "couldn't we have a higher level of assurance?")

   "Reasonable assurance" is not low level. A confidence level of 95 percent (if an audit is based on a statistically driven strategy) is high level of reasonable

> assurance. This level is implied in SAS No. 39, I would say. Of course, this applies to material matters. Some of the SAG members seemed to think that it is reasonable because you can't possibly find petty fraud. Yet, the guidance is referring to *material*.
>
> "Absolute assurance" is a hypothetical level, not only for audits but for endless phenomena in our world. It would be delightful if I could get *absolute assurance* that if I completed a highly touted course in Spanish or French or Italian that I would speak sufficiently to be taken as a native, I would be thrilled!

I keep wondering – and I know nothing about group activity – that a smaller group of SAG members would really think through carefully and be far more sensitive to the empirical evidence that is available – or could be gathered – and, thus, an advisory board would be far more helpful to your staff than the present meetings appear to provide.

Best wishes in your difficult task.

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TRANSMISSION COVER SHEET

January 24, 2007

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

From: Richard M. Orin

Subject: **PCAOB Rulemaking Docket Matter No. 021**
Public comment on the publication of the Proposed Auditing Standard
in the PCAOB Release No. 2006-007of December 19, 2006

From: Richard M. Orin, Esq.,CPA

To: Public Company Accounting Oversight Board

Subject: Public comment on the 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 Rulemaking Docket Matter No. 021

My name is Richard M. Orin. I have several decades of experience as an attorney and certified public accountant. I am a founding member and past president of the American Association of Attorney-Certified Public Accountants. I have lectured on tax, accounting, and accounting ethics at the University of Missouri-Columbia, Southern Methodist Unversity School of Law, New York University, Baruch College and the City University of New York. I am the President of The Foundation for Accounting Practitioners and am currently the sponsor of the annual symposium on accounting ethics at the University of Missouri-Columbia (which has featured speakers such as Barbara Hannigan of the PCAOB and Lynn Turner of the Commission). I am deeply interested in the success of the mission underlying the Sarbanes-Oxley Act, as well as in making the appropriate adjustments for smaller public companies, and would like to submit the following comments for your consideration.

<u>Office of the Secretary, PCAOB</u>

a. Comment - Risk Assessment

The standards should closely resemble SAS's 104-111 in order to produce the most effective audit. The auditor must consider the substantive audit procedures performed on the financial statement in the evaluation of the internal control audit. The risk-based audit approach focuses the audit on tests of significant or high-risk balance sheet accounts. However, the integrated audit approach of combined detailed testing of internal controls should not be overlooked but be selectively included by the auditors so that audits are not predictable and management is required to maintain their internal control systems documentation on an updated basis for SOX compliance.

b. Comment - Materiality

The planning and performance of the internal control audit must use the same materiality standard as that used in the audit of financial statements. The auditor must consider both quantitative and qualitative factors in assessing an item's materiality. Internal control can provide only reasonable assurance in any event considering the limitations inherent in all internal control systems. They involve continuous reassessment in the planning, mapping and assessments of internal controls.

c. Comment - Auditor Evaluation of Management Process

The auditor must perform an audit of internal control without evaluating the management process. However, the adequacy of management's evaluation will affect the extent of the work to be done by the auditor. The company's monitoring activities and its competence and objectivity will directly impact upon the time and efforts required of the auditors.

d. Comment - Audit for Smaller Companies

The procedures that an auditor must perform recognize a company's size and complexity. The reliance on principles requires auditors to consider the unique facts and circumstances of each company. Accordingly, the audit must be scaled to be appropriate to the attributes of the smaller company. However, it is typical that senior management may be extensively involved in day-to-day activities which would require the auditor to tailor the type and extent of controls and procedures to this most significant factor. The extensions for non-accelerated filers through December 31, 2007 and the increase in the qualified companies doing SOX compliance consulting work should result in less deadline pressure and reduced overall cost.

e. Comment - Reliance on Prior Audits

The reference to reviewing prior workpapers from past audits by the same firm of auditors negates the objectives of a "fresh look" by the auditors. The Board should reconsider its position of <u>rotation of auditors (the same firm) vis-à-vis rotation of auditors (a different firm)</u>. Only through the engagement of a different auditing firm can true "independence" of auditors be maintained by a complement of experienced personnel with industry knowledge. Auditing is not <u>rocket science</u> and competent professionals can be trained and educated to perform as expert auditors from different firms.

f. General Comment

1. Lest the Board forget that the preponderance of fraud, deficiency and internal weakness is committed by the senior management of the public companies:

   (a) CEO's involved in 72% of fraudulent financial statements

   (b) CFO's involved in 43% of fraudulent financial statements

   (c) Either involved in 83% of fraudulent financial statements.

   Ineffective internal control substantially opens the gates of fraud, deficiency and material weakness to middle management and others.

2. Although the complaint that compliance with the internal control provisions of the Act has required greater effort and resulted in higher costs, the facts do not bear this out. An analysis shows that although audit fees paid to the big four (five) accounting firms from 2001 to 2004 have increased from $1,991 billion to $4,029 billion, the total fees paid the big four (five) for the same period increased from $4,844 billion to $4,901 billion. A mere overall increase in cost of outside accounting fees for the four years of 1.2%.

Pension Reserves Investment Management Board

84 State Street, Second Floor
Boston, Massachusetts 02109

Timothy P. Cahill, Chair
Michael Travaglini, Executive Director

February 23, 2007

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, D.C. 20006-2803
Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

On behalf of the Pension Reserves Investment Management (PRIM) Board, which manages some $46.7 billion on behalf of past and present public employees in the state of Massachusetts, I wish to share our views on the PCAOB's proposed auditing standard for implementation of Section 404, the internal controls provisions of the Sarbanes-Oxley Act of 2002.

First, allow me to share PRIM's strong support for Sarbanes-Oxley, which we believe has played a critical role in re-establishing public trust in U.S. capital markets and the reliability of financial data provided by publicly-traded companies following the financial frauds at Enron, Worldcom and other major corporations. Looking back, it is evident that these frauds were easier to perpetrate and more difficult to uncover because of weaknesses in the companies' internal controls over financial reporting. We believe that Sarbanes-Oxley, particularly Section 404 requirements for enhanced management reporting and an independent external audit of internal controls, has substantially strengthened the internal controls of companies that have filed reports under Section 404.

At the same time, we recognize that implementation of the new law has not been perfect. We applaud the Board's efforts to improve both the auditing standard for Section 404 and its implementation by independent auditors. We believe that the proposed new rules should eliminate unnecessary work, enhance efficiency and reduce Section 404 costs for many public companies.

But much as we support efforts to reduce unnecessary costs, we also believe that investor protection must remain the Board's overriding objective in implementation of Sarbanes-Oxley. We further believe that the Board's current proposals maintain the appropriate balance, and we urge the Board to resist any adjustments that might expose investors to unnecessary risks in the name of cost-cutting. We must not allow cost considerations to become the driving force behind Sarbanes-Oxley or Section 404.

PRIM believes that investors in both small and large companies are equally entitled to appropriate assurances about a company's financial data and internal controls. Smaller companies have historically been somewhat more prone to both financial fraud and misstatements than larger companies. This tendency has been exacerbated by the relatively slower implementation of Section 404 for the smallest companies. According to recent data collected by Audit Analytics, the number of restatements by companies with market cap of less than $75 million continued their steady growth during 2006. Restatements by these smaller companies climbed by 42 percent last year and accounted for more than two-thirds of all restatements by U.S. public companies. While we agree that audits should be scalable to reflect company size, scalability does not mean a lower standard should apply.

We certainly agree that auditors should strive for efficiency and seek to avoid unnecessary work and expense in performing internal controls audits. But, in our view, it is even more important that the audit is performed effectively. Efficiency must not take precedence over effectiveness. We urge the Board to make clear that it will stand by auditors' exercise of reasonable professional judgment in achieving an effective audit.

In particular, we believe decisions about the reliance on the work of others fall squarely in the realm of professional judgment. Excessive reliance on others' work could compromise the effectiveness of the audit.

In addition, we urge the Board to reject any suggestions for selective or rotational testing of key controls. We believe that key controls must be tested by the auditors every year. It would violate our collective obligations to investors and undercut the core goal of Section 404 to permit any unverified *assumption* that key controls are operating as intended.

Once again, we commend the Board on its efforts to properly balance competing imperatives. Moving forward, we urge the Board to resolve conflicts between efficiency and effectiveness by standing firmly on the side of investor protection. Short-term cost savings have their appeal, but the long-term consequences of stripping away needed protections would be enormous. Strong capital markets are essential for America's economic prosperity. The markets, in turn, depend on investor confidence. To keep capital markets and our economy strong, we urge this Board and all policymakers to continue to stand up for investors.

Sincerely,

Michael Travaglini
Executive Director
Pension Reserves Investment Management Board

February 26, 2007

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

Dear Board Members:

We appreciate the opportunity to comment on the PCAOB's proposed standards. We support the PCAOB and SEC's efforts to continuously enhance the guidance available to companies and auditors in this complex and challenging area. It is critical that the PCAOB and SEC's proposed guidance align. Although we did not note any inconsistencies in topics between the PCAOB's auditing standards and the SEC's interpretative guidance, it does appear that the PCAOB's proposed auditing standards are more detailed.

<u>Proposed Interpretive Guidance</u>

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

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

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

   We believe that the proposed standard is very clear and concise. In developing the proposed standard, it is evident that the Board was cognizant of the complexity of AS No. 2 and has taken into consideration the comments received since its inception. The Board has made a significant effort in simplifying the requirements to make them more understandable, presenting them in a manner that reflects the logical flow of the audit process and emphasized the core objectives of an audit of internal control over financial reporting.

We agree that the top-down approach should eliminate some unnecessary procedures since in practice, the application of the prior standard seemed to follow a much more detailed and prescriptive approach. As discussed in the standard, there was a tendency to spend time testing many controls that were not subject to the highest risk of material misstatement. In addition, we believe that the auditor will be focused on testing controls designed to prevent or detect fraud since these areas would tend to carry the highest risk of material misstatement.

The discussion on company-level controls is particularly important in implementing a top-down approach. In practice, it seemed that the company-level controls were typically identified and tested by management and the auditors after the identification and testing of detailed process level controls. As the proposed standard indicates, if there is a strong reliance and a direct link between company-level controls and process level controls, the auditor will likely be able to reduce the testing of controls at the detailed process level. As a result, there could be significant time saved in this area.

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?**

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

As indicated in our responses above, we believe that the proposed standard does provide appropriate discussion and emphasis on the linkage between risk assessment and the relationship to amount of evidence that is required.

We believe that walkthroughs are an invaluable technique to obtain an understanding of the process flow and related controls in a particular area. As certain controls are deemed lower risk, we are supportive of walkthroughs as sufficient enough to test the design and operating effectiveness. In addition, the proposed standard indicates that auditors may rely on others to perform walkthroughs whereas AS No. 2 required that the auditors had to perform such procedures themselves in order to obtain "principal evidence". This is a very positive change and will lead to a reduction in time.

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?**

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?**

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 the proposed changes to the definitions of significant deficiencies and material weaknesses will ease the process of evaluation of deficiencies. In practice, this evaluation is extremely difficult, and we believe that the terminology "more than remote likelihood" forced management and auditors to spend a significant amount of time evaluating deficiencies that could never rise to the level of a significant deficiency nor material weakness. This is a very positive change and will allow the use of judgment in order to reach the appropriate conclusions about deficiencies identified.

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?

As indicated above, the process for evaluating and classifying deficiencies is difficult. It requires a review of specific facts and circumstances, as well as the use of judgment. There are situations where a deficiency, although exhibiting strong indicators of a material weakness (as previously defined in AS No. 2) could be deemed a deficiency. The prior standard did not allow for this possibility and forced a conclusion of either a significant deficiency or material weakness. We believe this change coupled with the other positive changes in the proposed standard will allow for a greater use of judgment.

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

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?

We do not believe further clarifications to the scope of the audit of internal control are necessary.

We would not recommend removing the reference to interim financial statements in the definitions of significant deficiency and material weakness. The evaluation of deficiencies should be performed on both the interim and annual financial statements. In the financial statement audit, the auditor is required to analyze and measure uncorrected misstatements on both interim and annual financial statements. Since the audit of internal control is integrated with the audit of the financial statements, we feel that this evaluation should be performed on a consistent basis.

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

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's 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 support the change to eliminate the auditor's requirement to evaluate management's process and issue an opinion. We agree that it will more clearly communicate the scope and results of the auditor's work.

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

We believe that the auditor's use of cumulative knowledge is an invaluable tool in planning and executing the audit. As the auditor is appropriately allowed to utilize cumulative knowledge in the financial statement audit, we found that it was inconsistent that AS No. 2 did not allow this practice in the audit of internal control. We fully support this change in the proposed standard.

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?

Since the auditor will be able to use cumulative knowledge, walkthrough procedures may be sufficient evidence for areas that historically had few or no deficiencies and are considered to be low risk. As stated earlier, we believe that walkthroughs enable a visual understanding of a particular process and the related controls.

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?

Yes, the proposed standard's approach to scoping multi-location engagements should enable a more efficient use of resources. This change is consistent with the overall objective of the proposed standard – a focus on the areas with the greatest risk of material misstatement. Although we support this change, we are concerned that the auditing profession will still require a certain "quantified level of coverage" in order to be satisfied that no areas were omitted in the scoping analysis. This will require a significant use of professional judgment and will likely cause difficulties in reaching consensus.

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?

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?**

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

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

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?**

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

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 the proposed standard's single framework for using the work of others is appropriate for both an integrated audit and an audit of only financial statements. This approach will enable one set of requirements to be followed.

    The proposed standard appears to include an appropriate list of factors necessary to assess competence and objectivity. We note that a high degree of professional judgment and detailed documentation supporting the conclusions will be necessary.

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

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?**

    See our responses to questions 5-6 and 16-17 above.

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?**

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

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?

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

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 certainly agree that there are different considerations for smaller, less complex companies and that AS No. 2 was written for the large company in mind. The proposed standard is clearly a principles-based standard. Since the scoping and execution of an audit of internal control requires a significant amount of judgment, the proposed standard and the measures and attributes described should assist the auditor of smaller, less complex companies and allow them to determine the appropriate level of procedures that need to be performed in order to support their opinion.

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?

No, we do not believe additional information is needed.

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?

We believe that the Board should finalize the issuance of the standard so that it will be effective for 2007 audits. In order to effectively implement the new standard, it must be issued and effective no later than June 30, 2007 to enable the planning process to incorporate the new requirements. We are concerned that if this deadline is not met, the auditors will not be able to implement for the 2007 year-end.

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that you may have. Please do not hesitate to contact me at (914) 253-3406.

Sincerely,

Peter Bridgman.

Peter A. Bridgman

cc: Marie T. Gallagher, Vice President & Assistant Controller

Pfizer Inc.
235 East 42nd Street
New York, NY 10017-5755

Loretta V. Cangialosi
Vice President and Controller

February 26, 2007

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, D.C. 200006-2803

Reference: **PCAOB Rulemaking Docket Matter Number 021**
Proposed Auditing Standard, An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements

Pfizer is a research-based, global pharmaceutical company with its principal place of business in New York. We discover, develop, manufacture and market leading prescription medicines for humans and animals. The Company's 2006 total revenues were $48.4 billion and its assets were $114.8 billion. We appreciate the opportunity to present our comments and observations in response to the Proposed Auditing Standard, as we firmly believe that strong internal controls over financial reporting are essential to the integrity of an entity's financial statements.

We applaud the Public Company Accounting Oversight Board (PCAOB) for being responsive to the feedback provided by issuers, auditors, investors and others. We all recognize the opportunities and challenges of ensuring that auditors have sufficient guidance to perform quality internal control audits in as efficient a manner as possible. This proposal strikes a reasonable balance, providing adequate latitude for auditors to use their judgment while providing clear guidance for auditors to consider risk and other relevant factors in designing their audit approach. Barriers to the implementation of a top-down, risk-based approach have included: the prevalence of required audit coverage ratios adopted by external audit firms, the limited impact of prior-year testing experience in determining the nature and extent of current-year testing, a focus on detailed transaction testing and we believe, an overly conservative approach currently mandated by the language of Auditing Standard No. 2 (AS2) to rollforward testing. In our view, the proposed guidance indicates that two common practices leading to inefficiencies are inconsistent with the top-down, risk-based approach: the use of coverage ratios; and the requirement that testing satisfy all financial statement assertions, not just the most relevant ones. We strongly support the emphasis provided to allow auditors to vary the evidence obtained regarding the effectiveness of internal controls based on the risk associated with the individual control and the guidance provided surrounding rollforward testing.

Pfizer has adopted a reliance model whereby our external auditors rely on the work of our internal auditors. Under this model, our internal auditors' work follows the requirements of AS2. Thus, for us to be as efficient as possible in our evaluation process, it is crucial that the SEC and PCAOB guidance align. Unfortunately, we believe the proposed auditing standard appears more stringent than guidance issued by the SEC. We have reviewed the SEC guidance and would be anticipating changes in our planned scope and testing approach for 2007, but our auditors have not shared our enthusiasm. One example of the perceived gap is in the significance of prior experience in designing a testing approach. We see the SEC guidance as supporting the reduction of testing in areas where previous test results have been good, especially if controls have not changed. We are looking at an approach under which we would identify areas that have consistently performed well under SOX testing and, if there were no significant people, process or system changes, we would modify our testing approach to reflect the lower risk. That might entail reliance on walkthroughs or other less intensive procedures. However, we do not find support for this type of a change in the PCAOB proposed auditing standard. More importantly, the SEC guidance supports a top-down approach that should enable issuers to place reliance on strong entity-level controls to reduce process-level testing, but the PCAOB standard does not provide a clear basis for such reliance by auditors. We will most likely follow the new PCAOB guidance, if adopted, so as to not incur incremental costs by doing management's assessment one way and having the external auditors perform their assessment in another way.

We are concerned about the risk of a disconnect between the PCAOB stand-setters and the PCAOB inspectors and the consequences of any such disconnect on issuers. Our understanding was that a goal of the inspections was to drive consistency and identify overly conservative interpretations of the auditing standard. However, the 2005 inspection reports seemed to focus more on identifying gaps in the audit approach. In fact, during this year's audit cycle we found our auditors doing more transaction level testing in limited amounts in various low risk areas. When questioned as to why this was being done, we were advised that the PCAOB inspectors believed, in general, that audits did not have enough transaction testing to complement analytical reviews and controls testing done under SOX. I admit that this may have been an interpretation of what inspectors actually said, but it is important for the PCAOB to understand the potential unintended consequences of its inspectors' comments. We believe that it is critical that the PCAOB and its inspectors be aligned on the interpretation of the standards it sets.

External auditors are anticipating guidance from their national office and waiting to see what feedback is received as part of this comment process. We believe that it would be prudent for the PCAOB to monitor guidance delivered by the firms' national offices to ensure that they are adopting an approach consistent with the spirit and letter of the proposed standard rather than converting the guidance to a "one size fits all" approach.

Our comments related to specific questions posed in the proposed auditing standard are included in the attachment to this letter. We respectfully request that the proposed guidance be issued as soon as possible. We have completed much of our planning for 2007 and are just beginning our management testing. We would appreciate the opportunity to reflect the guidance in the proposed standard in our assessment approach early enough to allow us to achieve additional efficiencies this year. From a practical standpoint, it will be difficult for us to gain additional efficiencies in our 2007 management testing if the guidance is issued much later than June 30, 2007.

Once again, we appreciate this opportunity to comment and would be pleased to discuss our observations with you at any time.

Very truly yours,

Loretta V. Cangialosi

Loretta V. Cangialosi
Vice President and Controller

cc: Alan Levin
Senior Vice President and Chief Financial Officer

David Shedlarz
Vice Chairman

Attachment
Proposed Auditing Standard, An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements

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

Yes, the proposed guidance provides a clear description of how to use the top-down approach. The proposed guidance indicates that two common practices leading to inefficiencies are inconsistent with the top-down, risk-based approach: the use of an arbitrary coverage ratio applied across the financial statements; and the requirement that testing satisfy all financial statement assertions, not just the most relevant ones.

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

Yes, we believe it does.

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

The top-down approach as described should focus the auditor's attention on the most important controls. However, we remain concerned that the proposed standard does not clearly provide a methodology to ensure that the benefits of strong company-level controls translate into efficiencies in the Section 404 effort. See our response to the next question.

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?

The proposed standard does not clearly provide a methodology to ensure that the benefits of strong company-level controls translate into efficiencies in the Section 404 effort. It is clear that the most serious and well-known failures of controls that precipitated the introduction of Section 404 have occurred at the top, but we find that testing of controls at lower levels remains the major focus of the compliance effort. There is insufficient detailed guidance to enable companies with strong company-level controls to significantly reduce account and transactional control testing. While we understand that indirect controls may be less effective in preventing or detecting a misstatement, real world evidence supports the fact that without such controls, the risk of misstatement increases significantly. We struggle with the fact that the guidance does not seem to give credit to this fact in the amount of testwork necessary

The proposed standard should include specific examples of how strong company-level controls could reduce or eliminate further testing in certain areas. For example, how does a strong compliance mindset by senior management result in reduced testing in the procure-to-pay transaction cycle? This year we plan to pursue more thoroughly documenting our IT company-level controls as we feel we have the opportunity to modify our scope and testing approach to reflect the strength of these controls. However, the proposed standard provides little support for us to cite to our management or our externals auditors that the modifications we propose are appropriate.

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?

The proposed standard appropriately incorporates risk assessment. We strongly support the emphasis provided on allowing the auditor to vary the evidence obtained regarding the effectiveness of internal controls based on the risk associated with the individual control. The SEC appeared to place a greater emphasis on focusing on controls that have changed. To align better with the SEC, it would be helpful if the risk assessment approach in the proposed standard placed greater emphasis on this as well. We believe the greater risk lies in controls that have changed.

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

The performance of a walkthrough is clearly sufficient to test the design of controls**.** We would be conservative in identifying controls where a walkthrough would be sufficient to test for operating effectiveness. Company-level controls are well-suited to using a walkthrough to test both the design and operating effectiveness of a control. For low-risk process-level controls, if a walkthrough does not identify changes from the prior year and the controls have operated effectively in prior years, a walkthrough may be sufficient. We support providing the auditor the latitude to consider this option.

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 changes to the definitions are positive and will reduce the confusion over determining when something rises to the level of a significant deficiency. However, we do not think this will have much impact on the amount of effort expended in identifying and analyzing 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?

Yes, an auditor should be allowed to use their judgment and conclude that no deficiency exists when one of the strong indicators is present. This approach provides the auditor an appropriate level of judgment and reflects the fact that standard-setters cannot anticipate the variety of circumstances an auditor may face in a large, complex organization. As the evaluation of each deficiency requires a good deal of judgment, inconsistency cannot be eliminated.

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

We believe the work eliminated will be minimal as our external auditors indicate they spent very little time in this area.

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

We perceive a gap between the SEC and PCAOB guidance regarding the significance of prior experience in designing a testing approach. We see the SEC guidance as supporting the reduction of testing in areas where previous test results have been good, especially if controls have not changed. Some issuers will want to use a rotational testing approach or rely on walkthroughs in such cases, but we do not find support for this in the PCAOB proposed auditing standard. We note that the proposed standard does not clearly reject the practice that “each year must stand on its own”. Given past practice, we would like to

Attachment
Proposed Auditing Standard, An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements

see positive confirmation that this is not required as this is an approach that auditors may be particularly hesitant to embrace. Specific examples may be helpful to clarify what is considered appropriate practice.

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 proposed standard's approach for determining the scope of testing in a multi-location engagement should result in more efficient multi-location audits by putting greater focus on risk assessment and emphasizing that auditors use judgment rather than shortcut approaches such as coverage ratios.

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

In the spirit of auditor judgment, we do not believe the principal evidence provision that was in AS No. 2 is necessary to adequately address the auditor's responsibilities to obtain sufficient evidence.

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?

Including, as a factor of objectivity, a company's policies addressing compensation arrangements for individuals performing the testing seems unwarranted and will add complexity to the determination. The individuals performing testing are generally at a fairly low level in an organization. Thus, they not subject to unique compensation arrangements.

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

Requiring a walkthrough only for all significant processes should reduce the number and detail of the walkthroughs performed without impairing audit quality.

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?

Pfizer has adopted a reliance model whereby our external auditors rely on the work of our internal auditors. This has been very effective in reducing our costs of compliance with no decline in the quality of the audit. Thus, we believe it is appropriate for the auditor to be allowed to use others as direct assistance in performing walkthroughs, consistent with their ability to rely on the testing of others within proper parameters.

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?

We respectfully request that the proposed standard be issued as soon as possible. We have completed much of our planning for 2007 and are just beginning our management testing. We would appreciate the opportunity to reflect the guidance in the proposed standard in our assessment approach early enough to allow us to achieve additional efficiencies this year. From a practical standpoint, it will be difficult for us to

Attachment
Proposed Auditing Standard, An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements

gain additional efficiencies in our 2007 management testing if the guidance is issued much later than June 30, 2007.

PXP

Winston M. Talbert
Executive Vice President and
Chief Financial Officer

February 23, 2007

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

RE: File Number S7-24-06 Proposed Interpretive Guidance – Management's Report on Internal Control Over Financial Reporting; PCAOB Rulemaking Docket Matter No. 21 – *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

Dear Ms. Morris and Office of the Secretary:

Plains Exploration & Production Company ("PXP") supports the Securities and Exchange Commission's proposed guidance and the Public Company Accounting Oversight Board's proposed auditing standard referenced above. These actions further align the efforts of management and their external auditors to achieve the goals of Section 404 of the Sarbanes-Oxley Act of 2002. We believe that the introduction of a more "top-down, risk-based approach"[1] to the evaluation of internal controls over financial reporting will enable companies such as ours to allocate their audit and accounting resources in a more efficient manner.

PXP endeavors to maintain the highest standard of ethical conduct in all of our activities, and it is our policy to fully and fairly disclose our financial condition to our stockholders and other stakeholders. We believe that Section 404, while sometimes misapplied in terms of scope and detail, has served to help restore faith and credibility in the domestic capital markets and provided investors with comfort in making investment decisions. We expect that an emphasis on risk assessment will place companies and their auditors on common ground in determining the extent of testing necessary and level of detail required to support an effective internal control environment. Given a model that is scalable to the specific industry and issues of the registrant, Section 404 can achieve its

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potential of providing assurance to investors while effectively balancing the costs and the benefits of management's evaluation of internal controls.

We appreciate the opportunity to provide feedback on these proposals and would welcome the opportunity to provide further information or answer any questions.

Sincerely,

Winston M. Talbert
Chief Financial Officer

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[1] Management's Report on Internal Control Over Financial Reporting, Release Nos. 33-8762; 34-54976; File No. S7-24-06, 17 (December 20, 2006)

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803
comments@pcaobus.org

Regarding: PCAOB Rulemaking Docket Matter No. 021

I appreciate the opportunity to comment on the Board's Proposed Auditing Standards, "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements," (Proposed Standard 1) and "Considering and Using the Work of Others in an Audit" (Proposed Standard 2). The integrated audit has reemphasized the importance of

(a) Managers' use of risk management in financial reporting systems, and
(b) Auditors gaining a fuller understanding of the client's systems and processes in performance of the annual audit.

The following general and specific comments are intended to address how the proposed standards guide managements and auditors.

Issue 1: **Should the audit focus on attestation to management's evaluation of the organization's internal controls, or on attestation to the quality of the organization's internal controls, or to both?**

Both attestations serve crucial roles. The Sarbanes-Oxley Act makes formal management's responsibility to assess internal controls and report on its assessment to stakeholders. This responsibility parallels management's requirement to produce periodic financial reports. Just as financial reports are audited for adherence to standards after management performs its own quality control procedures on them, management's assertion of the quality of internal controls over financial reporting should have an independent attestation as well.

In addition, the integrated audit represents an important step towards returning the annual financial statement audit towards stakeholder expectations. Historically, auditors obtained a full understanding of the client and its internal controls, and determined substantive tests based on the extent to which they could rely on the controls. In the 1990s, auditors did not strive to obtain as full of an understanding, relying more strictly on substantive tests. This approach arguably led to a decline in audit quality. AS no. 2 reestablished the importance of examining internal controls to more fully understanding the client, and to properly designing financial statement audit tests. Proposed Standard 1 should keep this requirement untouched.

AS no. 2 formally states that both attestations are equivalent in terms of the amount of effort and assurance provided (paragraph 19). It should not take significant incremental effort for the auditor to provide the attestation to management's assessment when the auditor is already examining internal controls.

Responses to specific questions:
13. Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?
It should reduce audit work only nominally. A proper audit of internal controls supporting the financial statement audit should provide sufficient evidence to attest to management's assessment as well.

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?
Yes, but they should perform both as part of the audit engagement.

Issue 2: **Concurrent issuance of Proposed Standards 1 and 2 implies that efficiency gains in the audit of internal controls should largely come from auditors' reliance on the work of others, especially management, rather than from proper implementation of the top-down audit approach.**

Even though the auditor would no longer render an opinion on management's assessment, the release text and both Proposed Standards give the impression that auditors should significantly increase reliance on management's assessment and supporting work to make the audit more efficient. Managers may therefore feel justified in seeking a lower-cost engagement, with less audit effort and relying more on organizational work, at the potential sacrifice of audit effectiveness. The Proposed Standards may therefore provide a means to reduce audit quality in competitive segments of the audit market. The Board should clearly emphasize that efficiency gains are expected to come primarily from use of the top-down approach. The Proposed Standards should also underscore that reliance on others, especially client personnel, should not come at the cost of audit quality.

Issue 3 (addresses question 32 posed in the release): **Paragraph 9 of Proposed Standard 1, which discusses "scaling the audit" for smaller, less complex companies, should *not* cite the SEC Advisory Committee's criteria as to what constitutes a "smaller" company.**

The Board should not suggest a set of "bright-line" criteria by which auditors would determine the scale of the audit; it is inconsistent with proper use of the top-down audit process documented in the standard. The auditor should gain a full understanding of the client, its industry, markets, operations, systems, and processes. This understanding should drive the auditor's choice of risks and controls on which to concentrate. Use of rules of thumb or shortcuts undercut the judgment of the auditor in designing an effective, yet properly-scaled audit.

Response to specific question:
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?

No. The standard lists several overly-simple generalities about small businesses compared to larger businesses. Emphasis is too strongly placed on encouraging auditors to trust inquiry and observation of top managers, and not to pursue further evidence, because of a potential lack of documentation of the controls, or of the business process in general. While top managers do tend to be closer to the operations of small businesses, they are still sufficiently busy and distant to be unable to observe much of what happens. The lack of resources available to small businesses to invest in "harder" controls makes them especially susceptible to certain risks; for example, studies have shown that many frauds occur in smaller companies. Certainly auditors should consider that controls will generally not be as strong in smaller companies. However, smaller companies should still be expected to identify their most significant risks when making control-related expenditures. The auditor's judgment, based on an understanding of the client's business and processes, should drive the scope of the controls audit.

Issue 4 (addresses questions 27 and 28): **Proposed Standard 1 should *not* allow the auditor to rely on the work of others in performance of walkthroughs. AS no. 2's requirement that the auditor perform all walkthroughs should be kept.**

Proposed Standard 1 targets walkthroughs as another means to obtain efficiency in the integrated audit, presumably while maintaining audit quality. Walkthroughs are required for significant processes, and are now potentially conductible by others and relied upon by the auditor, with proper supervision. The requirement that walkthroughs only be performed for significant processes is sensible on its face, as long as the auditor properly assesses risks for processes. However, walkthroughs are one of the most effective inquiry and observation-based tools to learn about and confirm the auditor's understanding of client processes and controls. The auditor uses this understanding to determine the scope of further compliance tests and substantive tests. It is important for the auditor to obtain direct evidence during this phase of the audit to design high-quality audit tests. Reliance on others in performing this crucial step of the audit improperly trades off efficiency for effectiveness.

Once again, I appreciate the opportunity to comment on the Proposed Standards, and support the PCAOB's efforts to ensure audit quality.

Respectfully submitted,

Paul W. Polinski, Ph.D., C.P.A.

Disclaimer: The views expressed in this document are mine, and are not necessarily representative of those of my employer Grant Thornton, its partners, professionals, and staff.

PPG Industries, Inc.
One PPG Place   Pittsburgh, Pennsylvania 15272

William H. Hernandez
Senior Vice President, Finance

February 26, 2007

Ms. Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: File Number S7-24-06
and PCAOB Rulemaking Docket No. 021

Dear Ms. Morris:

PPG Industries, Inc. (PPG) is pleased to submit comments regarding the Security and Exchange Commission (SEC) proposed interpretive guidance related to Section 404 of the Sarbanes-Oxley Act of 2002 and the proposed amendments to Rules 13(a)-15 and 15(d)-15 of the Securities Exchange Act of 1934 and Rile 2-02(f) of Regulation S-X. We have also incorporated comments related to the Public Company Accounting Oversight Board (PCAOB) newly proposed Auditing Standard, Rulemaking Docket No. 021. PPG Industries is a leading diversified manufacturer that supplies coatings, glass and chemical products and services around the world. The company employs approximately 32,000 employees and operates over 100 manufacturing locations worldwide.

PPG continues to support the SEC and the Public Company Accounting Oversight Board (PCAOB) in its efforts to strengthen the integrity of financial statements. PPG is a company with a long-standing history of commitment to strong internal controls. We have been diligent in balancing the cost of controlling and mitigating the risks we face with the benefits derived from those efforts, ensuring that PPG most appropriately manages the use of our shareholders' investments. These new proposals will enable management to increase the benefits of compliance and conduct a more effective and efficient evaluation of internal control over financial reporting.

PPG, like many other companies registered with the SEC, competes in a world market. Performing unnecessary and, in many cases, duplicative compliance activities that do not address the "true risks" we face will lead to costs that outweigh the benefits intended with compliance. These new proposals will allow corporations to increase their focus on shareholder interests and improve U.S. global competitiveness.

For your consideration, PPG respectfully offers the following comments strongly supporting the new guidance and audit standard.

<u>Alignment of Management and Auditor Evaluation Approach</u>

PPG is a focused and results directed company that understands our responsibility for providing reliable financial information to the investment community. As a result of this, PPG, not unlike other SEC registrants, has adopted the top-down risk based approach in evaluating our internal control over financial reporting. Also, in line with the spirit of "monitoring" put forth in the COSO framework, we believe evaluating the effectiveness of internal controls should focus on testing of the company-wide and higher level controls. The new SEC guidance and the PCAOB standard allows for increased focus on the high risk areas and higher level controls eliminating unnecessary testing of lower risk controls conducted only to satisfy an arbitrary coverage requirement. This would eliminate the excessive time and effort of both management and external auditors on testing controls related to routine procedures and place emphasis on the strength of the overall control environment.

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The new auditing standard will require the auditors to use the same top-down risk based approach as management increasing the focus on the most important controls and not "large portion" coverage. The auditor focus will be more appropriately aligned with the objective of preventing and detecting fraud. It will also provide management with easier implementation of enhancements to the compliance effort through the use of continuous monitoring, reliance on prior year work, and self assessments. All of which will more align cost with the benefits derived, yet also maintain the focus on a strong control environment.

<u>External auditor assessment of management's evaluation process</u>

The requirement for the external auditors to opine on the effectiveness of the internal control structure, as well as opining on management's assessment of the effectiveness of the internal control structure, results in significant amounts of redundant and non-value added effort on the part of both the external auditors and management. The elimination of an attestation by the external auditors of management's assessment would greatly reduce this wasted effort.

<u>Elimination of unnecessary auditing</u>

The new standard provides auditors with the means to expend appropriate focus on those controls important to the prevention and detection of fraud and to eliminate procedures that are not necessary to achieve the intended benefits. The new standard allows for more efficient audits by permitting consideration of prior year work, multi-location testing requirements based on risk not coverage and removing the barriers to using the work of others.

<u>PCAOB Inspection Process</u>

PPG wholeheartedly supports the new auditing standard proposed by the PCAOB; however, the implementation of the standard is what matters most. The Board has indicated that it would use the inspection program to ensure firms are conducting their audits in the most efficient manner as would be required by the new standard. The inspection program should be a powerful monitoring tool over how auditing is performed both from a risk perspective and an elimination of unnecessary auditing. It is critical to meeting this objective of conducting audits as efficiently as possible, that the Board sets a strong tone that firms are required to follow the standard. The inspections program should be enhanced to increase the timeliness of the inspections and availability of the information obtained in that process.

Thank you for the opportunity to comment on the recent proposals related to Sarbanes-Oxley Act. If you have any questions or require additional information, please contact John M. Stephenson, General Auditor at (412) 434-3890.

Sincerely yours,

William H. Hernandez es

cc: J. M. Stephenson

DRAFT

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February 26, 2007

Via e-mail to 'comments@pcaobus.org'

Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006

RE: PCAOB Rulemaking Docket matter No. 021

Dear Sir/Madam:

The PPL Corporation (PPL) respectfully submits the attached comments, in question and answer format, in response to the request for comment as outlined within the *Proposed Auditing Standard – an Audit of Internal Control over Financial Reporting That is Integrated with an Audit of Financial Statements.*

PPL Corporation is an international energy and utility holding company, headquartered in Allentown, PA. Through its subsidiaries, PPL generates electricity from power plants in the northeastern and western U.S.; markets wholesale or retail energy primarily in the northeastern and western portions of the U.S.; delivers electricity to approximately 5.1 million customers in Pennsylvania, the U.K. and Latin America; and provides energy services for businesses in the mid-Atlantic and northeastern U.S. PPL is a $6.9 billion corporation that ranked 350 on the Fortune 500® for 2006. PPL's four principal business subsidiaries are PPL Generation, PPL EnergyPlus, PPL Global and PPL Electric Utilities. PPL employs about 12,600 people on three continents.

We appreciate and support your efforts to provide the accounting community with a more efficient approach to meet the compliance requirements of Section 404 of the Sarbanes-Oxley Act. We also appreciate the opportunity to provide feedback on the proposed audit standard.

Respectfully submitted,

Dustin W. Wertheimer
Controller-PPL Global

Attachment

PPL Corporation
Response to PCAOB's Proposed Auditing Standard No. 5

Below are PPL's responses to the questions listed in the PCAOB Rulemaking Docket Matter No. 021. Also provided are specific comments on other areas of the proposed standards.

Questions & Responses

1. **Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?** The top-down approach description in the standard clarifies that the auditors should be scoping the audit to detect the possibility of a material misstatement. However, it is unclear how the assessment of company level controls can be used to develop or limit the scope of the audit. Illustrative examples would be helpful in clarifying this area (paragraphs 16, 17).

2. **Does the proposed standard place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud?** Yes. The new standard clarifies that the audit of internal control over financial reporting (ICFR) should ensure that controls are adequate to prevent or detect in a timely manner fraud that could cause a material misstatement (paragraphs 34 and 45). The standard also appropriately addresses the need to assess programs and controls that address risks related to fraud, and specifically those controls that address the risk of management override of controls. Additionally, the standard addresses the impact on the scope of the audit should controls related to fraud be found to be deficient.

3. **Will the top-down approach better focus the auditor's attention on the most important controls?** Yes, PPL believes that it should. However, some additional language emphasizing a focus on material controls should be included in paragraph 44, which discusses the process for selecting which controls to test. Alternatively, the definition of a relevant assertion could be reiterated in paragraph 44.

4. **Does the proposed standard adequately articulate the appropriate consideration of company-level controls and their effect on the auditors work, including adequate description of when the testing of other controls can be reduced or eliminated?** No, not completely. Although the guidance does provide detail with regard to defining company-level controls and the control environment, it does not provide details about how the assessment of company-level controls specifically impacts the decisions as to which transactions and controls should be included in the scope of the audit. Please consider specifically addressing how the company-level controls will impact the selection of controls in paragraph 41-46.

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?** Yes, the proposed guidance does provide the auditor with a risk-based approach to determining the adequacy of the evidence related to the effective operation of controls in paragraph 52. However, the note at the bottom of that paragraph states that less evidence is necessary to determine that a control is deficient than to determine that it is effective. Our concern is that auditors may interpret this note to mean less evidence means less effective. This is not congruent with the SEC's proposed guidance to management which emphasizes

management's flexibility in assessing controls and maintaining evidence. PPL is concerned that this note may drive auditors to a more conservative approach with regard to the evidence required to be created, and maintained by management. For example, PPL believes that an auditor would gain sufficient evidence about the effectiveness of a control activity involving a supervisor's review of a report by interviewing the individual who performs that review and looking at review notes on the report. PPL is concerned that an auditor may conclude that the evidence is not sufficient, and therefore the control is not effective, if the report is not signed and dated. Again, our opinion is that less evidence does not necessarily mean that a control is less effective.

6. **Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?** (paragraph 26, 47-50) Yes. The proposed standard should emphasize that for controls that have sufficient risk to require testing, but are on the lower end of the risk scale, a walkthrough could provide sufficient evidence at greater efficiency.

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 has improved, but additional clarity, such as examples, need to be provided surrounding what is important enough to merit attention by those responsible for oversight of the company's financial reporting. In practice, most firms have established a threshold for what they believe is significant. The new definition should not change those thresholds.

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?** It appears that most material internal control weaknesses have been related to material misstatements. However, from that observation you cannot conclude whether auditors are appropriately identifying weaknesses in the absence of actual material misstatements. The revised standard, with its focus on using a top-down approach and scoping at the level to identify material weaknesses, will allow auditors to do a more thorough review of key controls as less effort will be expended on reviewing lower risk controls. This should increase the likelihood of the auditor detecting material weaknesses before a misstatement occurs.

9. **Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analyzing deficiencies that do not represent a reasonable possibility of material misstatement to the financial statements?** The change to the definitions does not raise the auditor's threshold for classifying deficiencies. However, the concept of scoping to detect deficiencies that could result in a material misstatement should reduce the amount of effort dedicated to identifying and analyzing deficiencies. In addition, the concept should be reiterated in paragraph 43, which provides guidance related to selecting which controls to test.

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?** No, if one of the strong indicators exists, there is at least a deficiency. However, judgment will need to be utilized to evaluate whether a deficiency is classified as a significant deficiency or material weakness. For example, one strong indicator of a significant deficiency provided in the standard is the situation where the deficient control is related to period end financial reporting. In this situation there could be varying degrees of a deficiency which range from a lower risk error, such as a missing explanation on a work paper, to a higher risk error occurring in the analysis of the financial results. Each of these deficiencies should not be equally classified. The use of professional judgment will naturally produce some inconsistencies, but that is more acceptable than the inefficiency caused by utilizing a checklist evaluation approach that focuses on immaterial issues and does not incorporate the auditor's judgment.

11. **Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?** Yes. The definition of relevant assertions should be reiterated in the guidelines numerous times. In addition, the message in paragraph 70, related to the level at which an auditor plans and performs an audit, should be reiterated in paragraph 6. Additional guidelines should be provided related to the tie in of company-level controls to the scope of the audit of transactions.

12. **Should the reference to interim financial statements be removed from the definitions of significant deficiency and material weakness? If so, what should be the effect on the scope of the audit?** Yes, the reference to interim financial statements should be removed. Because the audit of internal controls provides an opinion on the effectiveness of those controls as of the fiscal year end, the assessment of the impact of control deficiencies should be limited to the annual financial reports.

13. **Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?** Yes. Currently the audit of management's assessment process is inefficient and redundant. Since the ultimate objective of SOX 404 compliance is for registrants to have effective controls, the audit should focus on that objective.

14. **Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?** Yes. If management has an ideal assessment process, but the controls are not effective, then the audit of management's assessment process is not beneficial to the users of the financial reports. The elimination of the audit of management's assessment process will not make the audit less effective. Again, since the ultimate purpose of the audit is to determine that management maintains effective ICFR, an audit of management's assessment process is unnecessary.

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?** Yes. Eliminating the requirement for an opinion on management's assessment of ICFR

provides for a clearer and more focused scope and therefore the results related to that focused scope will be more easily interpreted by the user of the company's financial reports.

16. **Does the proposed standard appropriately incorporate the value of cumulative knowledge?** Yes. The auditors will be able to consider their cumulative audit knowledge and experience in determining the level of risk associated with a control. For lower risk controls the auditor should be able to reduce the level of evidence needed to determine that the control is operating effectively.

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?** Consistent with paragraphs 52 and 66, a walkthrough should produce sufficient evidence of operating effectiveness in areas were the controls were effective in prior periods, the controls are low risk based upon the factors listed in paragraph 52, and where there have been no significant changes to ICFR.

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?** Yes. Instead of obtaining a prescribed level of coverage, auditors can use their judgment in assessing the risk at each location.

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?** A single standard will meet both the needs of the financial audit as well as the audit of ICFR. The proposed guidance is a substantial improvement over the limits that are established under the current guidance. This improvement should lead to significant cost reductions for many registrants.

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?** The definition of relevant activities is adequate.

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. The auditor should have a full understanding of the relevant activities in order to efficiently plan and perform the audit.

22. **Is the principal evidence provision that was in AS No. 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?** No, that provision limited the auditor's use of professional judgment when determining the level of reliance that could be placed on the work of others. There should be no difference between using the work of others in a financial statement audit or an audit of ICFR.

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 proposed standard does provide very good guidelines for evaluating competence and objectivity in paragraphs 14 and 15 in Appendix 2. However, the guidance in paragraph 15, section b, may cause the auditors to avoid using the work of others that are not part of a formal internal audit function.

24. **Has the Board identified the right factors for assessing competence and objectivity? Are there other factors the auditor should consider?** See answer to question 23 above.

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?** Factors related to compensation of individuals who are performing testing should be addressed as part of the assessment of the individuals' objectivity. This will help ensure that the individuals are truly unbiased in their assessment of controls.

26. **Will requiring a walkthrough only for all significant processes reduce the number and detail of the walkthroughs performed without impairing audit quality?** Yes. The language in the new standard provides the auditor with the opportunity to use their professional judgment to limit the walkthroughs to only those processes that are material to the audit. This will eliminate unnecessary efforts.

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?** Yes, the auditors should be able to rely on walkthroughs performed by other competent objective professionals if the auditor applies the guidance in paragraph 21.

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?** Yes

29. **Are there other attributes of smaller, less-complex companies that the auditor should consider when planning or performing the audit?** None noted.

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?** None noted.

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**? Yes.

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?** No

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?** The Board should structure the date to be effective for audits of companies with a fiscal year ending after December 15, 2007.

General Observation

There appears to be increased elaboration for the application of the standard in audit areas impacting "smaller and less complex company(ies)." In some instances, the same elaboration would not be appropriate for larger companies.

Other Comments Related to Specific Portions of the Standard

paragraph 12: For smaller less complex companies, the proposed standard states that "the absence of documented evidence of a control is not determinative that the control is not operating effectively." PPL believes that this statement is relevant for the audit of larger companies as well. The auditor should have the flexibility to be able to use professional judgment to determine through discussions and alternative evidence as to whether a control is operating effectively. In our experience, a signature and date on a document is not always the best evidence that a control has operated effectively.

paragraph B26: Related to service auditors' reports, the proposed standard states "Additional procedures are necessary if a significant period of time has elapsed between the service provider auditor's report and the registrant's fiscal year end." The standard should more specifically define a significant period of time.

PRICEWATERHOUSECOOPERS

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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: PCAOB Rulemaking Docket 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

Dear Sir:

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") proposed auditing standard, *An Audit of Internal Control over Financial Reporting That Is Integrated with An Audit of Financial Statements* (the "standard"). We support the Board's objective to issue a principles-based standard designed to focus the auditor on the matters of highest risk that are most important to evaluating whether internal control over financial reporting is effective. The standard provides the auditor with an increased opportunity to apply appropriate professional judgment which will contribute to a more effective and efficient audit of internal control over financial reporting.

The Sarbanes-Oxley Act of 2002 (the "Act") has been a catalyst for improved financial reporting which has helped to restore investor confidence and increase the transparency and reliability of financial information relied upon by investors and other stakeholders. We believe, if implemented appropriately, the principles in the standard will preserve investor protection while improving the efficiency of implementation of Section 404 of the Act.

PricewaterhouseCoopers is committed to delivering a high-quality and efficient top-down, risk-based audit of internal control over financial reporting that is integrated with an audit of financial statements. The standard, when combined with the proposed Securities and Exchange Commission's ("SEC") interpretive guidance, *Management's Report on Internal Control over Financial Reporting* ("management's guidance"), will contribute to increased efficiency and a reduction in the total costs of compliance with Section 404 of the Act. The degree of benefit will vary significantly from company to company and will be dependent upon many factors, including the extent to which a top-down, risk-based approach was previously implemented.

PRICEWATERHOUSECOOPERS

In the sections below, we include a discussion of some of the more significant matters related to the standard. Observations and recommendations on certain other matters addressed in the Board's invitation to comment are included as an Appendix to this letter.

Principles-based Standard

The standard's focus on principles, rather than prescriptive requirements, will increase appropriately the use of reasonable professional judgment to plan and perform the audit. . For example, the standard expands the opportunities to apply professional judgment based on an auditor's assessment of risk when determining the scope of the audit, as well as the sufficiency of evidence needed to determine the effectiveness of internal control.

The application of reasonable professional judgment is an integral part of any audit, including an audit of internal control over financial reporting. The extent to which an auditor applies judgment is influenced in part by the degree of acceptance of those judgments by various parties, including regulators. The PCAOB's actions have had and will continue to have significant impact on an auditor's ability to apply professional judgment. We encourage the inspection process to consider and support the auditor's increased use of professional judgment that will enable the auditor to achieve the desired improvements in the efficiency of audits.

Scalability to All Companies

We support one auditing standard that is scalable to the size and complexity of a company and allows the auditor to align the level of effort with the level of risk and complexity. We believe the standard is appropriately scalable to companies of all sizes and complexity. The standard, along with the COSO guidance for smaller public companies and the forthcoming PCAOB guidance on auditing smaller public companies will contribute positively to the scalability of compliance with Section 404. We believe these combined efforts will result in a reduction of the cost of implementation for non-accelerated filers.

Correlation with Management's Assessment

The most effective and efficient Section 404 process results from a coordinated approach between management's assessment and the audit of internal control over financial reporting. As the ultimate goal of both processes is a conclusion about the effectiveness of internal control over financial reporting, we believe conceptual alignment in the approaches employed by both management and the auditor is an essential element of this cooperative effort. We note that the description of company or (entity) level controls and the list of strong indicators of material weakness are not the same in the standard and management's guidance. Ensuring alignment in these areas will improve efficiency and reduce the confusion that could result from different interpretations of what should be parallel guidance.

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Use of the Work of Others

We recognize the increased efficiency that can result from greater reliance on the work of others who have sufficient competence and objectivity. The competence and objectivity model included in the Board's proposed auditing standard, *Considering and Using the Work of Others in an Audit*, will facilitate the auditor's use of judgment in making decisions regarding the extent to which reliance can be placed on the work of others in the integrated audit. We have included recommendations to improve clarity in this area in the Appendix.

Company-level Controls

Strong, comprehensive company-level controls can significantly reduce the risk of material misstatement of the financial statements. The top-down approach appropriately directs the auditor to consider company-level controls when performing an audit of internal control over financial reporting as a means of increasing effectiveness and efficiency. Because of the significant risk for confusion as to how the evaluation of company-level controls can result in increasing or decreasing the testing that the auditor otherwise would perform on controls at the process, transaction or application levels, we believe it is critical that the PCAOB clarify the principle for determining the range of impact that company-level controls can have on the audit of internal control over financial reporting. The principle should include a description of direct and indirect controls and a discussion of the importance of the consideration of the precision at which the company-level controls operate. It should also be aligned with the corresponding discussion in the SEC's guidance for management. We believe it would be useful to include in the standard a principles-based continuum for considering the impact of company-level controls on the auditor's testing of controls at the process, transaction or application levels. We have included our specific recommendations in the Appendix to this letter.

Interim Materiality

Although we believe that reliable interim financial information is critically important to the capital markets, we recommend that the Board eliminate the requirement to evaluate the significance of all control deficiencies against interim results. While the standard directs the auditor to plan and scope the audit of internal control over financial reporting using the same materiality considerations he or she would use in planning the audit of the company's annual financial statements, the references to interim financial statements in the definitions of material weakness and significant deficiency has in some cases resulted in the perception that the audit scope should consider interim results. We believe the elimination of the references to interim financial statements in the definitions may enhance understanding of the symmetry between the scope of the audit and the evaluation of deficiencies and therefore improve efficiency. Furthermore, we believe it is equally important that the approach to and definition of materiality be consistently applied

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throughout the audit of internal control over financial reporting and the audit of the annual financial statements.

Effective Date

Minimizing the disruption from implementation of the standard is important to all constituents. Toward that end, we encourage the Board's expedient consideration of these proposals and others received in the comment period to allow for the release of the standard as soon in 2007 as possible. A timely release of the standard will allow for maximum efficiency to be achieved for years ending in 2007, when practical, even if the standard was to be required for years beginning after December 15, 2007.

Conclusion

We support the effort by the PCAOB to issue a principles-based standard that relies on a top-down, risk-based approach, and the resulting expansion of the opportunities to apply well-reasoned professional judgment. We believe that the expanded use of appropriate judgment will have a meaningful impact on improving the efficiency and effectiveness of the integrated audit.

* * * * *

We would be pleased to discuss our comments and to answer any questions that the PCAOB staff or the Board may have. Please do not hesitate to contact Vincent Colman (973-236-5390) or Jim Lee (973-236-4478) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

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APPENDIX

Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals

In the text that follows we offer our responses to the Board's invitation to comment, grouped by category, and in some cases expanding upon our observations and recommendations highlighted in the comment letter.

Top-down, Risk-based Approach

A top-down, risk-based approach is an efficient and effective means to auditing internal control over financial reporting by focusing the auditor's attention on those controls that are most important to the auditor's conclusion about whether the company's controls sufficiently address the risk of material misstatement. The standard not only clearly describes how to use such an approach but we also believe that the structure of the standard facilitates the auditor's execution of a top-down, risk-based approach. The assessment of risk underlies the entire audit process and has a pervasive impact on the audit. The standard appropriately focuses on the direct correlation between the level of risk and the level of evidence necessary to conclude that a control is operating effectively.

While the identification of the most important controls requires considerable judgment, the principles outlined in the standard provide the auditor sufficient flexibility to vary the scope, nature, timing, and extent of procedures in order to eliminate unnecessary procedures as appropriate. The top-down, risk-based approach also facilitates scaling the audit to the size and complexity of each company by focusing on the company-specific risks of material misstatement. The standard enhances the auditor's ability to tailor the audit to a company's specific facts and circumstances, including its complexity, size, risk assessment, company-level controls, results of management's testing, and experience from prior year audits.

In addition, the application of the standard's top-down, risk-based approach to multi-location audits will improve the efficiency of such audits by permitting the auditor to exercise judgment to select locations based on the assessed risk of material misstatement to the financial statements.

Company-level Controls

As mentioned in our comment letter, we believe it is important to clarify the description and range of impact of company-level controls and align it with the corresponding description in the SEC's guidance for management. Toward that end, we believe it would be useful to include in the standard a principles-based continuum for considering the impact of company-level controls on the nature, timing and extent of the auditor's testing of controls at the process, transaction or application levels. The continuum should consider whether a company-level control is directly or indirectly related to a relevant assertion for a significant account as well as the precision at which the company-level control operates. We believe that the concept of a continuum best describes the relationship between the consideration of the precision of company-level controls and the extent of testing, if any, necessary for lower-level controls.

We envision the continuum to extend between (1) a direct company-level control that is designed to operate at a degree of precision that would, by itself, prevent or detect on a timely basis material misstatements to one or more relevant assertions, and (2) an indirect company-level control (e.g., the control environment) that is not directly related to any relevant assertion for any specific significant account and, therefore, would not by itself prevent or detect on a timely basis material misstatements to one or more relevant assertions. In our experience, indirect controls are significantly more prevalent than direct company-level controls.

The standard should acknowledge that it would be sufficient to only test a company-level control when the company-level control operates effectively at a degree of precision that would, by itself, prevent or detect on a timely basis material misstatements to one or more relevant assertions. When the direct company-level control does not operate at that appropriate degree of precision, it would be necessary for the auditor to test process, transaction or application level controls. The standard should acknowledge that the consideration of controls that are not at the appropriate level of precision (i.e. indirect company-level controls) factor into the determination of the nature and extent of testing. Examples may be an effective way to illustrate these important concepts.

In addition, we recommend that the Board include in paragraphs 17 and 18 of the standard (i.e., the point at which identification of company-level controls is initially discussed) the emphasis on the precision of company-level controls included in paragraph 43 of the standard.

Walkthroughs

We concur with the Board that walkthoughs are an effective means for the auditor to evaluate the design of controls surrounding a significant process, as well as to identify significant changes from the prior year. We support the increased opportunities to use the work of others and believe it is appropriate for the auditor to use the direct assistance of others in performing certain walkthroughs.

The auditor's assessment of risk and consideration of knowledge gained in prior years' audits are important considerations in determining the extent to which walkthroughs alone can provide sufficient evidence of operating effectiveness of certain controls. For example, we believe that when a company has a strong control environment, it may be appropriate for the auditor to rely upon walkthrough procedures as sufficient evidence of operating effectiveness for lower risk automated application controls and routine, lower risk manual controls.

We agree that aligning the level of effort with the level of risk is essential to performing an effective and efficient audit. We believe that the standard's modifications to the walkthrough requirements will help to improve this alignment.

Evaluation of Deficiencies / Strong Indicators

The evaluation of deficiencies identified in an audit of internal control over financial reporting is a subjective assessment which requires considerable judgment. The revised definitions of material weakness and significant deficiency provide additional clarity and will improve application of the terms, which may help to reduce unnecessary effort in testing and in evaluating certain deficiencies. The focus on testing only the most important controls may reduce the effort spent analyzing deficiencies that could not rise to the level of a material weakness.

The strong indicators of a material weakness are important considerations in determining whether a material weakness in internal control over financial reporting exists. We agree that the standard will allow greater judgment in evaluating whether or not a deficiency exists even though a strong indicator of a material weakness (e.g., restatement of previously issued financial statements) is present.

The challenge in allowing greater judgment is addressing the range of acceptable conclusions when subjective decisions are made by different individuals. We believe, however, that applying professional judgment to specific facts and circumstances when a strong indicator is present will result in improved reporting of deficiencies in that it will support the reporting of only those deficiencies that truly represent a risk of material misstatement.

Evaluation of Management's Process

An understanding of management's assessment process is inherent in the audit of internal control over financial reporting. Since the auditor must understand management's assessment in order to properly plan and perform the audit of internal control over financial reporting, including determining the extent to which he or she will rely on the work of others, we support the elimination of the requirement to perform a separate evaluation of management's process.

Use of the Work of Others

We recognize the efficiency improvements that can result from increasing reliance on the work of others who have sufficient competence and objectivity. The proposed competence and objectivity model provides the auditor with appropriate factors to consider in determining the appropriateness and extent of relying on the work of others.

To further clarify the auditor's opportunity to rely on the work of others, we recommend that the proposed standard incorporate the concepts found currently in paragraphs 21 and 22 of AU Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, regarding the consideration of materiality and the extent of reliance on the work of others in high risk areas or areas where the evaluation of audit evidence is highly subjective.

We also believe that it is inefficient to consider relevant activities performed by others, as contemplated in paragraphs 3 to 6 of the standard, prior to the determination of whether there are sufficiently objective, competent personnel on whose work the auditor can rely. Obtaining an understanding of all relevant activities only to subsequently find that those activities cannot be considered in determining the nature, timing and extent of the auditor's own procedures because of a lack of sufficient objectivity or competence, will not promote efficiency. As a result, we recommend that these paragraphs be moved to follow the auditor's assessment of objectivity and competence.

In addition, in the release accompanying the standard, the Board noted that it has received comment letters indicating that some believe that the "principal evidence" provision included in AS 2 may have impacted the understanding of the amount of reliance that could be placed on the work others. The elimination of this phrase, as proposed by the Board, is appropriately responsive to those comments and yet will not have an adverse impact on the quality of the audit of internal control over financial reporting provided sufficient competent evidence is obtained by the auditor as required by paragraph 9, and the considerations in paragraphs 21 and 22 of AU Section 322 are included in the final standard as recommended above.

Documentation

Audit documentation facilitates the planning, performance, and supervision of the audit in addition to providing a written record of the basis for the auditor's conclusions. The requirement for adequate documentation is already a significant component of the cost of an audit. The Board's Auditing Standard No. 3, *Audit Documentation* ("AS 3"), provides general requirements for the nature and extent of documentation the auditor should prepare in connection with an audit. We are concerned that the standard's pervasive use of "should" statements may unintentionally increase the documentation burden on the auditor by requiring the documentation of individual, specific scoping or testing matters already effectively addressed in the auditor's overall documentation of the top-down, risk-based approach. For example, although a risk assessment is a fundamental part of the overall audit planning process, paragraph 51 implies that the risk of a control's failure resulting in a material weakness needs to be assessed and documented for each individual control. We recommend that the Board reconsider how its use of "should" statements in the standard may create undue documentation burdens because of the documentation requirements under AS 3.

Communicating Certain Matters

We recognize the value and importance of communicating, in writing, to management and the audit committee significant deficiencies and material weaknesses identified during the audit. We believe, however, that the requirement to communicate, in writing, to management *all* deficiencies in internal control over financial reporting identified during the audit represents an unnecessary administrative burden. It is common practice for the auditor to verbally communicate all deficiencies identified during the course of the audit to management, regardless of magnitude. While the standard is clear that material weaknesses and significant deficiencies must be communicated in writing to management and the audit committee before the issuance of the auditor's report, the written communication of deficiencies that are neither significant deficiencies nor material weaknesses typically occurs after the auditor's report is issued. As a result, this represents a requirement with little, if any, incremental value given the insignificance of many control deficiencies. We believe the requirement to communicate such matters in writing is inconsistent with the Board's objective to focus the audit on the matters most important or of greatest risk to internal control. Accordingly, we recommend the Board limit the required communication to only those matters deemed to be significant deficiencies or material weaknesses. This change would also be consistent with the PCAOB's interim standard AU sec. 325, paragraph 7, for an audit of financial statements only, which makes the communication of these matters subject to the judgment of the auditor, and does not include a requirement that the communication be in writing.

Procedures in the Roll-forward Period

We recognize the importance of applying professional judgment in all aspects of the audit, including when determining the roll-forward procedures necessary when the auditor obtains evidence of the operating effectiveness of controls at an interim date. Paragraph 64 of the standard describes appropriate factors the auditor should consider in determining the extent of such procedures, and includes consideration of the length of the remaining period. When the assessed risk of controls is higher or the remaining period is significant, it is likely that additional procedures will be necessary to obtain evidence of the effectiveness of controls closer to the as of date when the initial testing was performed at an interim date. We are concerned that the use of the words "if any" in paragraph 63 (and the note to paragraph 63) of the standard as it relates to the need to conduct roll-forward procedures, may be misunderstood to imply that roll-forward procedures are to be performed on an exception basis when evidence about the operating effectiveness of controls is obtained at an interim date. Accordingly, we believe the elimination of the words "if any" would clarify the Board's intent that the auditor fully consider the paragraph 64 factors when determining the nature, timing and extent of roll-forward procedures required.

Pre-approval of Services Related to Internal Control Over Financial Reporting

The principles described in the Note included in the proposed Rule 3525 text are also included as part of the SEC's Preliminary Note to Reg. S-X, Section 210.2-01 ("Rule 2-01"). We encourage the PCAOB to mirror the SEC's treatment of these principles by describing them in the adopting release or preamble to the ethics and independence rules rather than in the text of Rule 3525. We addressed the value of including this type of discussion of overriding principles outside of the rule text in our September 25, 2000 response to the SEC's draft amendments to Rule 2-01, File No. S7-13-00.

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Re: PCAOB Rulemaking Docket Matter No. 021

The Procter & Gamble Company 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 That Is Integrated with An Audit of Financial Statements,* and *Considering and Using the Work of Others in an Audit* ("proposed standards").

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 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 guidance has moved to a more principles-based approach that will allow companies to apply the principles in assessing individual company situations. We support the top-down, risk-based approach and encourage the clear communication of the expectation that the guidance provides flexibility to support other approaches that companies may have chosen to adopt.

In addition to our support for the proposed guidance, we have concerns surrounding the alignment between management guidance and external audit standards. We believe that the proposed PCAOB standards, although improved from the existing PCAOB Audit Standard No. 2 ("AS2"), are still more detailed and prescriptive than the proposed SEC guidance. These differences are likely to result in external audits that are more conservative than management assessments and are likely to perpetuate inefficient audits by creating two distinct evaluation approaches.

Related to the ability for companies to implement the proposed guidance successfully in alignment with their external auditors, the auditors must be assured that the inspection practices of the PCAOB will align with the proposed auditing standards. If the auditors do not receive that assurance, they 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 auditors do not change their approach, companies will continue to incur additional costs and fail to achieve the objective of more efficient and effective assessments. We discuss alternatives in the appendix that may help achieve this objective.

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 also have several suggestions for clarifications or enhancements to the proposed guidance itself. 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 rotation testing of controls that have operated effectively in the past and have not changed;
- Increased reliance on entity-level controls to reduce process-level testing;
- Focus on the evaluation of control deficiency against an annual materiality definition and not an interim threshold. The complete controls evaluation is performed and reported annually; the evaluation of whether a control deficiency could result in an error to future interim or annual statements should be evaluated against an annual materiality definition.

We believe these suggestions are critically important to have a meaningful impact in striking the right balance between costs and benefits of internal controls assessments.

ALIGNMENT BETWEEN MANAGEMENT AND EXTERNAL AUDITORS

Management guidance and external audit standards must be aligned. We believe that the proposed PCAOB standards, although improved from the existing PCAOB Audit Standard No. 2 ("AS2"), are still more detailed and prescriptive than the proposed SEC guidance. In the absence of management guidance, companies have had to adhere to some rules under AS2 to satisfy the requirements of the external auditors.

We expect that to change, but it will require a principles-based approach to the requirements. With the flexibility to focus on a top-down, risk-based approach to detect only material weaknesses, we anticipate that companies may be able to drive to a more cost-effective approach that focuses on high risk areas. However, there may be other more detailed approaches that are adopted to meet the internal objectives of maintaining and monitoring a company's control environment. Having the flexibility to implement the most cost effective approach to balancing internal and external objectives can be achieved by being clear on the minimum objectives of the regulatory requirements and allowing flexibility in meeting those. This will result in 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 audit standards are aligned with management guidance. The external 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 eliminated, 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.

Further, we do not believe that additional, prescriptive guidance over management's evaluation approach is required, rather the guidance that allows judgment and principle to be used in achieving stated minimum objectives.

CLARIFICATIONS AND ENHANCEMENTS

Focus on changes in controls

The proposed guidance encourages the use of prior knowledge and assessment results to guide the risk assessment and testing approach. After the initial assessment, subsequent reviews of risk and design can be focused on changes in risks and controls. Prior testing results can be used to guide the risk assessment of both the significant accounts and the controls.

We support the focus on changes in controls and believe that it could lead to the logical conclusion that a control would not need to be tested or assessed each year. In spite of the discussion about incorporating prior year information and results to guide the extent of testing, the proposed guidance does not address the current practice of "each year standing on its own," requiring some type of assessment of each control each year. By contrast the PCAOB proposed standards specifically provide for benchmarking of automated controls. We suggest that the SEC consider where and how management might be encouraged to benchmark or rotate testing of controls in all areas. If management could confirm that the control design had not changed and that the control had been operating effectively in prior assessments, we should have the freedom to forego annual testing of that control, particularly for lower risk controls, in favor of a rotational testing plan.

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 material future financial reporting 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.

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.

Annual vs. interim financial statements considered in evaluating deficiencies
The definition of "material weakness" in the proposed guidance (page 13) includes a misstatement of the company's "annual or interim financial statements." Management's assessment and evaluation for deficiency is an annual assessment of the operating effectiveness as of the end of the fiscal year. We believe that reporting at fiscal year end is pragmatic…being forced to evaluate and report on an interim basis, however, leaves no room for remediation. We believe that the evaluation of whether the control deficiency could result in an error to future interim or annual statements should be evaluated against an annual materiality definition. Said another way, companies should not be held to a more demanding threshold on our interim reporting simply because our earnings (which drive materiality determination) during interim periods are a fraction of the annual amount). We believe that the deficiency evaluation should only consider the impact on annual financial statements. Basing materiality upon impact to the annual financial statements is also believed to be most consistent with the proposed guidance that also 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 all of these reasons, we suggest that the reference to interim financial statements should be removed from the definition in the proposed guidance.

Definition of "significant" deficiency
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. In addition, the language in paragraph A12 has changed to define a "significant deficiency" as a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting. We believe that the premise of the standard is the assessment of the control environment as measured against an investor mindset (preventing errors that could be material to an investor). Prudent internal officials likely have a much different view of potential control issues than an investor would for any number of reasons. Thus, introducing an internal view is inconsistent and could lead to a much broader and more detailed executional expectation.

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.

Detection of Fraud
The proposed guidance states on paragraph 23 that, along with other factors, management should consider the risk of material misstatement due to fraud in its risk assessment. This clarification is helpful as it has been unclear whether companies should be identifying and assessing controls that would detect ANY fraud committed by a senior executive. Contradicting that point, however, is the language on page 45 which says that fraud of any magnitude on the part of senior management is an indicator of a material weakness. It may 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).

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 external auditors' standards of testing and documentation. However, the elimination of the opinion will give companies the flexibility to make that decision without being compelled to conform their assessments to AS2 standards.

Deficiency evaluation
The change in the likelihood component of the material weakness definition from "more than remote" to "reasonable possibility" should reduce the time spent on evaluating deficiencies. Although the proposed guidance includes indicators of material weaknesses and a description of typical significant deficiencies (footnote 74), it does not address quantitative guidelines for determining materiality thresholds. The guidance could be clarified by specifying that materiality for deficiency evaluation should be aligned with financial statement materiality.

The proposed guidance includes factors to consider in evaluating the likelihood and magnitude of a control deficiency or combination of deficiencies. Many 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 guidance can be used in lieu of the framework and recommend that the guidance include a statement that allows flexibility in using a deficiency evaluation framework and encourages judgment of factors provided in the proposed guidance.

Effective date
We hope that we have clearly communicated our support for the proposed guidance. To allow companies to realize the expected benefits in the near future, we suggest that the proposed guidance and the proposed standards should be implemented as soon as possible.

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

Sincerely,

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February 26, 2007

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Re: 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 Other Related Proposals**

We respectfully submit our comments on PCAOB Release No. 2006-007 in the role of advisor to our clients as they evaluated the effectiveness of their internal control over financial reporting (ICFR) and formulated an assertion with respect to such ICFR in accordance with The Sarbanes-Oxley Act of 2002, and specifically with Section 404 of the Act. While we are neither a registrant nor an accounting firm, we are offering insight arising from a multitude of experiences as an advisor to hundreds of companies in achieving compliance with Section 404 and/or determining how to improve their compliance processes. In conjunction with these experiences, we have been exposed to all of the major accounting firms.

We support the Public Company Accounting Oversight Board's (PCAOB) efforts to align Auditing Standard No. 2 with the interpretive guidance proposed by the Securities and Exchange Commission (SEC or Commission). We also agree with the overall objective of a top-down, risk-based approach. To that end, we offer the following comments and observations for the Board to consider.

Clarify meaning of "Significant Accounts"

The Board should make it explicit that designating all accounts above a quantitative threshold as "significant" is inconsistent with a risk-based approach. The Board should spell this out as clearly as possible that this is not acceptable practice because it treats every account above the quantitative threshold as equivalent in terms of financial reporting risk. For example, we are concerned that some auditors could read the PCAOB's proposed guidance as saying "quantitative first" and then "qualitative as additive only", meaning consider qualitative factors to add items into scope if they fell below the selected quantitative threshold. We don't agree with that approach, which is currently predominate in practice, because it is inconsistent with a risk-based approach.

If the PCAOB wants to eliminate the above practice, we recommend that the Board include in the new AS5 the explicit guidance in Question 41 of the PCAOB staff questions and answers issued in May 2005, which states: "Paragraph 65 of Auditing Standard No. 2 describes quantitative and qualitative factors that the auditor should evaluate together when determining whether an account is significant. It is important for the auditor to take into account the total mix of information that is available in determining an account is significant. Accordingly, quantitative measures alone are not determinative of whether an account should be identified as significant." That guidance

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is crystal clear and we are unsure why the Board didn't include equivalent guidance in the proposal.

Consider the Implications of Auditing in a "Walk-Around" Environment

We recognize the direction the SEC and PCAOB are headed in terms of a scalable audit for small companies without multiple layers of management and multiple business units. We understand the points of view regarding management's daily interaction with the business and the implications of such interaction on the nature and extent of controls documentation. However, it is unclear to us how an auditor can audit in a "walk-around" environment, because the audit tests would be principally limited to inquiry and observation. Accordingly, we have two concerns that are not addressed by the standard:

- First, if a company chooses to rely upon the daily interaction and "walk around" by management, how will this activity be effectively supported by management and independently validated by the auditor?
- Second, both the SEC and PCAOB have clearly stated that more emphasis needs to be placed on controls to prevent fraud – particularly the risk of management override of established processes and controls leading to material financial reporting fraud. It is reasonable to assume that the risk of management override increases in environments where management has more hands-on oversight, responsibility and direct influence. This is the environment in which the auditor must determine whether it is appropriate to rely upon the review and "walk around" of management as a reliable entity-level control. While this point reflects the reality of a small company environment, it nevertheless seems incongruent with the emphasis on sufficient controls to prevent and detect management override and fraud.

In these environments, most auditors would likely expand the scope of the financial statement audit to include extensive substantive tests of account balances with little or no reliance on internal controls. The auditor would probably not rely on the control environment, regardless of management's assessment of that environment. Auditors could be placed in a dilemma of issuing the opinion on ICFR based primarily upon either (a) the lack of evidence that material errors or fraud exist based on a largely substantive testing-based audit of the financial statements or (b) the application of inquiry and observation procedures. We do not believe that inquiry and observation procedures provide a sufficient basis for an opinion on ICFR. We also are concerned that a default conclusion on the effectiveness of the control environment on the basis of a substantive financial statement audit would be potentially misleading. Notwithstanding these concerns, the irony is that a scalable audit of ICFR in a "walk around" environment could very likely involve a combination of inquiry and observation procedures PLUS extensive substantive audit tests as part of the integrated audit. The default nature of the resulting conclusion on ICFR could give rise to a differently articulated opinion than the one currently required by the PCAOB.

We realize that there are initiatives underway by the Committee of Sponsoring Organizations (COSO) and the PCAOB that may shed light on the practical application of a scalable audit. Therefore, it would be premature to suggest actions to address the above points until those efforts are completed. While the Board's guidance in paragraphs 9 through 12 of the proposed standard is a good start, we are not convinced it is sufficient to equip auditors on how to address these environments in a manner that achieves the objective of reducing the disproportionate costs borne by smaller companies. We agree with the PCAOB that additional guidance is needed and that the Board's work with its task force of small company auditors and obtaining further input from smaller companies will help.

Clarify the Auditor's Role in Obtaining an Under-standing of Management's Assessment Process

On page 16 of the PCAOB's release, the Board states:

> Under the proposed standard, an auditor still would need to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which he or she will use the work of others.

We agree with this assertion. However, we cannot find where it is made explicit in the proposed standard. We believe it is important that the auditor obtain this understanding to reduce the risk of a significant disconnect between his or her assessment and management's assessment of ICFR.

Other Comments

Following are additional observations:

Consider use of "most" vs. "majority": The Board should further expand the directive on page A1-7 of the proposed standard that "the auditor should focus the majority of his or her attention on the areas of greatest risk to substantially decrease the opportunity for a material weakness to go undetected." The question arises as to what constitutes a "majority?" Is it 51 percent? If 51 percent is an acceptable interpretation of a "majority", does that mean that 49 percent of the effort can be allocated to areas where there isn't a reasonable possibility of a material weakness going undetected or a potential for material error or management override or fraud? We recommend that the Board's term should be "most" rather than "the majority" to minimize the potential risk to interpret "majority" in a manner that is inconsistent with the Board's intent.

Allow flexibility for auditor reliance on self-assessment results in certain situations: Under the proposed guidance, external auditors will not be able to rely on self assessment results if performed by someone not totally objective of the process under review (i.e., which is typically the manner in which self assessment programs are applied). What if Internal Audit were to perform reviews and reperformance over-testing on a subset of areas in which a self assessment program is applied, with the objective of evaluating the overall quality of the self-assessment program? In low risk areas, we believe that such an approach would justify the auditor's redirecting his or her focus on areas involving greater risk. We have also seen instances where self-assessment is used in lieu of refresh testing at year-end to roll-forward interim testing.

We suggest that the Board consider lightening the restriction on the auditor's use of self-assessment results. For example, self-assessment might be the basis by which management determines that there has been no change since the prior year in areas involving low risk. The use of self-assessment as a change recognition process should be a factor in considering prior year testing scopes and results when assessing current year risk.

Allow the auditor to exercise judgment in using walkthroughs: The PCAOB proposal does not allow for reduction in the scope of walkthroughs based on past performance or external auditor knowledge of the area. As everyone knows, walkthroughs are most time consuming. In areas that are extensively audited by the auditor annually and, as a result, the audit team is very knowledgeable of the process activities and relevant systems, it is unclear to our clients as to the benefit from a walkthrough other than to ensure there aren't any undocumented changes since the prior year. However, if that is the case, there are less costly and more top-down alternatives to ascertaining whether changes have occurred. Additionally, in those areas that are very low risk and do not change significantly year after year (for example, fixed assets), the value derived from a walkthrough is questionable. It may be helpful for the Board to provide further guidance to allow the external auditor to exercise some judgment in determining the areas in which to perform a walkthrough and the frequency of walkthroughs.

Provide examples of reliance on company-level controls: While the proposal allows for greater reliance by external auditors on company-level controls, this has not been an area of significant reliance by external auditors in the past. Greater clarity on example controls, control requirements (e.g., the evidence standard), and the appropriate linkage to process-level transaction processing controls that would justify the reduction of testing of those controls would help greatly in establishing more traction of the top-down approach in practice. We understand that the COSO Monitoring Project has been organized to provide such examples.

Segregate Section 404 related findings from other findings: As companies apply the top-down, risk-based approach, it is reasonable to expect them to reduce the population of key controls on which they will rely for purposes of evaluating the effectiveness of ICFR. This reduced control set is the direct result of an effective application of a top-down, risk-based approach. This development may lead to situations where the auditor identifies control issues that may not be relevant to the performance of the audit client's population of key controls selected by management for purposes of Section 404 compliance and agreed to by the auditor during the evaluation of controls design effectiveness. We agree that management has a responsibility to review all of the auditor's "management letter" observations and recommendations to ascertain whether those observations and recommendations have Section 404 implications. However, we also believe that it would helpful if auditors clearly delineated

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the control issues they identify as part of an integrated audit between (a) control deficiencies pertaining to the key controls relied on by management for Section 404 purposes and (b) deficiencies in other controls. If all of the auditor's findings relating to control issues are grouped together, regardless of their relevance to the audit client's key controls, the auditor's communications to management and the audit committee may create confusion as to the most relevant matters from a Section 404 compliance standpoint.

Reconsider management's need to report all control deficiencies to the external auditor. Paragraph 84(e) of the proposed standard states that management should disclose "to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's evaluation…" While we agree that management should report all significant deficiencies and material weaknesses to the external auditor, as required by this same paragraph, reporting all control deficiencies could have the unintended consequence of focusing the external auditor on matters that are clearly immaterial to the financial statements and irrelevant to the SEC's goal for the Section 404 evaluation process, which is as follows (from page 13 of the Commission's proposed interpretive guidance):

> [T]he central purpose of the evaluation is to assess whether there is a reasonable possibility of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's ICFR.

As an alternative, the external auditors could inquire of management whether there were any control deficiencies that were particularly difficult to classify as a significant deficiency versus a control deficiency.

We appreciate the opportunity to submit our comments and feedback. We hope they are helpful to the Board and to its staff. If the staff would like to discuss any of the points made in this letter, please contact Jim DeLoach at (713) 314-4981.

Very truly yours,

Protiviti Inc.

By: James W. DeLoach, Jr.
Managing Director

From: Rod Scott -RGSA [mailto:rodscott@rgscottassoc.com]
Sent: Thursday, February 15, 2007 4:32 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 021

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803
PCAOB Rulemaking Docket Matter No. 21

Sirs:

I developed and teach a seminar entitled "Sarbanes-Oxley Act: Assessing IT (Information Technology) Controls" for the Institute of Internal Auditors. I have taught versions of this seminar over 40 times, involving over 700 companies. My comments and suggestions are drawn from the experiences of these organizations and my own research and consulting experiences.

In general, the individuals assessing the IT controls have had to interpret the implications for information technology from the PCAOB Standards and SEC Rulings, which are written from a financial perspective and knowledge base. They have also had to deal with external auditors who lack the skill set to adequately understand the risks involved in the information technology of the organization. Yet it is estimated that 30-60% of the assessment work requires information technology expertise. The proposed Standards have done nothing to bridge this gap. The following comments and suggestions are provided in the hope that the scope and responsibilities for Sarbanes-Oxley can be clarified while continuing to achieve the benefits of assuring reliable financial information.

Proposed Standard: "***An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements***"

Issue 1- Section 404 of the Act states *"each registered public accounting firm that prepares or issues the audit report for the issuer* ***shall attest to, and report on, the assessment made by the management of the issuer."***

The intent of this Section of the Act, clearly, was to require Management to understand their internal controls and provide assurance to the investors that the internal control of the organization resulted in accurate and reliable financial information.

The external auditors' role has been interpreted by PCAOB to be responsible for an independent audit of the internal controls of the organization, rather than attesting to and reporting on the assessment made by Management.

Section 103 of the Act states that *"each registered public accounting firm shall…*

(iii) describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b), and present …

(II) an evaluation of whether such internal control structure and procedures—

(aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
(bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer;"

This Section has led to the excessive audit fees for Sarbanes-Oxley which has subliminated the benefits of improved reliability and transparency of the financial reporting information.

In the Information Technology area, Section 103 has been responsible for innumerable tests, required by the external auditors, which do not contribute to Managements' understanding of their 'key' internal controls. External auditors have required the programming of routers to be tested, reviewed system development procedures when the financial systems are 25 years old and many other 'war stories' too numerable to mention.

This proposed Standard continues to make the public accounting firm responsible for assessing the internal controls of the business which is an interpretation of Section 103 and not supported by Section 404 of the Act. Instead, a more reasonable interpretation of the Act should require the public accounting firm to attest to the assessment made by Management. This is the single most costly impact of Standard No. 2 and has not been rectified in the proposed Standard. It has created excessive fees by the public accounting firms and has caused Management, in many cases, to incur excessive costs in trying to satisfy the inconsistent requirements of the public accounting firms. If not addressed, organizations face two internal control reviews, one by Management and one by the external audit firm. This will continue to impose excess costs on the process.

The proposed Standard should be amended to require only the attestation to the Management Assessment and not require an independent appraisal of the internal controls of the organization by the external auditor.

Issue 2- Additionally, the proposed Standard has been generalized and much of the detail in Standard No. 2 was eliminated. One of the major cost drivers to date has been the inconsistent interpretation by the external auditors of the requirements. It is certain that if the Standards continue to lack detail on critical issues the amount of interpretation done by the external auditors will increase and, if their role is not changed as suggested above, the costs of the Sarbanes-Oxley assessment will not be reduced.

Issue 3- The emphasis on the importance of risk assessment is the major improvement in the proposed Standard. While it is supported in the proposed Standard and in SAS No. 109 it is only discussed at a very general level. The 'devil is in the details' as far as information technology is concerned.

¶31 of AU sec. 319 states *"The auditor should consider whether specialized skills are needed in the performance of an audit."* As a practical matter most external audit teams assign the responsibility for information technology to a person trained in accounting and little or no in-depth knowledge or job experience in Information Technology. Even certification via a fifty dollar, two hundred question multiple-choice exam does not prepare such a person for the requirements of analyzing risk and testing the complex information technology environments of most organizations. This makes the achievement of meaningful risk analysis difficult. As a result, the auditor tends to follow a prescribed set of controls rather than apply ¶15 and ¶31 of AU sec. 319.

The proposed Standard does not provide an adequate level of guidance for assessing information technology risk. The staffing of the external audit teams is unlikely to change so the risk analysis of information technology will likely remain contentious and continue to be responsible for excessive costs.

Issue 4- The SEC definition of internal controls, in Ruling 8238, states *"… our definition of the term "internal control over financial reporting" reflected in the final rules encompasses the subset of internal controls addressed in the COSO Report that pertains to financial reporting objectives. Our definition does not encompass the elements of the COSO Report definition that relate to* ***effectiveness and efficiency*** *of a company's operations and a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements."*

Standard No. 2 did not recognize this exclusion in it's' definition of internal control and this has driven behavior in the assessment of information technology internal controls. Standard No. 2 included this statement:

"50. Some controls (such as company-level controls, described in paragraph 53) might have a pervasive effect on the achievement of many overall objectives of the control criteria. For example, information technology general controls over ***program development, program changes, computer operations, and access to programs and data*** *help ensure that specific controls over the processing of transactions are operating effectively."*

This section has been interpreted as **the definitive statement** on Information Technology General Controls, yet "program development" and "computer operations" are vague terms from a financial reporting perspective and are primarily issues of effectiveness and efficiency, which contradicts the SEC Ruling 33-8328.

The ISACA organization used this interpretation as the basis for the General Controls in their white paper "IT Control Objectives for Sarbanes-Oxley". Price Waterhouse Coopers interpreted this wording similarly in their monograph "Sarbanes-Oxley Act: Section 404, Practical Guidance for Management July 2004". KPMG similarly endorsed this concept in their document "Sarbanes-Oxley Section 404: An Overview of the PCAOB's Requirements". Deloitte has endorsed the PCAOB definition in its document, "Taking Control". Due the broad base of these organizations, a major impact has resulted on the Sarbanes-Oxley assessment effort throughout the country.

The proposed Standard no longer contains this statement but neither does it clarify that issues of efficiency and effectiveness are out of scope. This exclusion of efficiency and effectiveness issues requires emphasis in the proposed Standard to assure that the attestation to Management's Assessment does not continue to suffer from the scope 'creep' that has occurred due to the application of a broader definition of "internal control".

Issue 5- Standard No. 2 put a false reliance on SAS 70 reports and this has been continued in the proposed Standard. The Information Technology services that organizations use today vary from simple payroll functions to the complete outsourcing of hardware, software, security, etc... In many instances these services are provided by a service organization to hundreds, sometimes thousands, of clients. It is reckless to assume that a single sample of controls (SAS 70), by a CPA, could satisfy the assessment of all of the clients' controls over financial reporting in a heterogeneous environment that characterizes most IT services organizations. Yet, B19-29, in the proposed Standard, continues to ignore this major problem. Instead, simple but infeasible alternatives are prescribed which have generally meant that internal controls over IT at service organizations is not subject to the same rigorous requirements that would be expected if the processing were done within the organization.

Proposed Standard: *"Considering and Using the Work of Others in an Audit"*

This entire proposed Standard supports the assessment of internal controls by the external auditor. As discussed above, this activity is interpreted as a requirement of the Act and the focus should be redirected to attesting to the Management Assessment of internal controls. The elimination of the requirement for principal evidence was a good start but there is a need to go further and eliminate the need for an internal control review by the external auditor under Sarbanes-Oxley.

The proposed Standard has an inappropriate tone to the view of the work of others. In the code of conduct example, competency and objectivity, by those assigned from the organization, allows the external auditor to rely on the determination of the existence of the code of conduct but NOT the judgment on how it is applied. If competency and objectivity are adequate, then judgment should be reliable as well. In the information technology assessment work, quite often the individual assigned by the organization is

the only competent individual to assess controls in their area of responsibility, such as a network engineer.
In my opinion, the proposed Standards are an improvement over AS2 but in their present form, will not achieve the goal of eliminating excessive costs of Sarbanes-Oxley Assessment of internal controls.

Sincerely,

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To: Office of the Secretary
Public Company Accounting Oversight Board

Re: PCAOB Rulemaking Docket 21
From: Monica Radu
Date: February 4, 2007

Dear Board Members,

Thank you for the opportunity to comment on the Board's Proposed Standard, it is greatly appreciated.

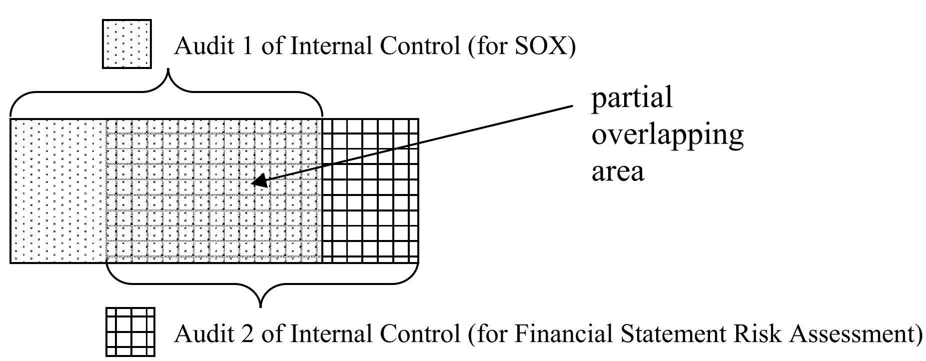
Scope of Comment
I would like to comment on appendix B, paragraphs B1-B11, "Integration of Audits", which is describing the interrelationship of two Audits of Internal Control namely:
Audit 1: an Audit of Internal Control over Financial Reporting (for SOX Audit) and
Audit 2: an Audit of Internal Control for Internal Control Risk Assessment (for Financial Statement Audit).

Thesis
I would like to propose that the distinction between the two Audits is only in the purpose for which they are used, not in the work performed. Therefore, they are in fact one and the same Audit of Internal Control, which satisfies two purposes; and by performing the work described in the Proposed Standard, both purposes would have been accomplished.

Background
The Proposed Standard is making a between two Audits of Internal Control:
Audit 1: an Audit of Internal Control over Financial Reporting (for SOX Audit) and
Audit 2: an Audit of Internal Control for Internal Control Risk Assessment (for Financial Statement Audit).

This distinction can be seen in paragraphs such as B4: "This requires that the auditor test the design and operating effectiveness of controls he or she would not test if expressing an opinion only on the financial statements" or B5: "the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements". Based on these paragraphs, the Proposed Standard's current view of the two Audits of Internal Control can be graphically represented as follows (with some overlap but also some differences):

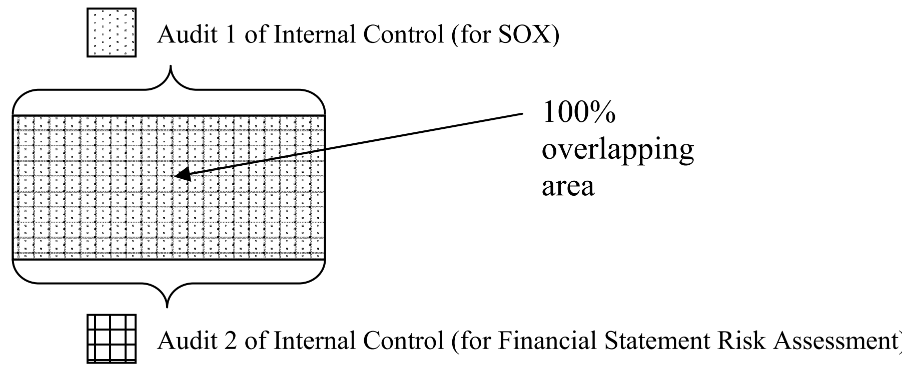
Current view:



Argument

I would like to propose that the two Audits of Internal Control are one and the same Audit of Internal Control. The reasons are stated in paragraphs I, II and III below. A graphical representation of the proposed view is as follows:

Proposed view:



Reason I. The same work is performed for both Audits. This is evidenced by:

A) the same methodology (the Proposed Standard and SAS 55, SAS 78, and AU 319)
The methodology described in the Proposed Standard for Audit 1 of Internal Control (for SOX), is the same as the methodology established in SAS 55 and 78, and AU section 319 for Audit 2 of Internal Control (for Financial Statement Risk Assessment).

B) the same underlying base (Financial Statements and Disclosures)
Both Audit 1 and Audit 2 are of Internal Control over Financial Reporting (preparation of Financial Statements and related Disclosures)

C) the same materiality threshold level (reasonable possibility of material misstatement)
Both Audit 1 and Audit 2 use the same materiality considerations, per the Proposed Standard paragraph 14: "in planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements".

D) the same scope (based on B) and C) above, combined)
As both the underlying base and the materiality threshold level are the same for both Audits, it means that their scope is the same (the same assertions, processes, accounts, disclosures, classes of transactions, risks, controls, etc are relevant for both Audits)

E) by definition
By definition, "Assessing control risk is the process of evaluating the effectiveness of an entity's internal control in preventing or detecting material misstatements in the financial statements" (AU 319.64) By this definition, Control Risk Assessment (Audit 2 of Internal Control) is also exactly what the evaluation of Internal Control over Financial Reporting (Audit 1 of Internal Control, for SOX) is.

Reason II. By deductive reasoning, each of the two Audits of Internal Control implies the other one.

Part II. A) Audit 1 implies Audit 2.
Based on AU 319.04, "The auditor may assess control risk at the maximum level because he or she believes controls are unlikely to pertain to an assertion or are unlikely to be effective, or because evaluating the effectiveness of controls would be inefficient."

Based on AU 319.04, above, there are three instances when the auditor may assess risk at maximum:
1) "controls are unlikely to pertain to an assertion" This instance does not apply, because as shown in I. D), both Audits have the same scope, therefore the same assertions pertain to both.
2) "controls are unlikely to be effective"
3) "evaluating the effectiveness of controls would be inefficient." This instance no longer applies, since evaluating the effectiveness of controls is now required by law (the Sarbanes-Oxley Act of 2002).

Only instance 2) applies, which shows that when controls are unlikely to be effective, then control risk is at maximum (in other words, ineffective Audit 1 implies ineffective Audit 2), and when controls are effective, none of the instances applies to set control risk at maximum, so it must be set at below maximum (so effective Audit 1 implies effective Audit 2).

Part II. B) Audit 2 implies Audit 1.
According to AU 319.70, "Assessing control risk below the maximum level involves:

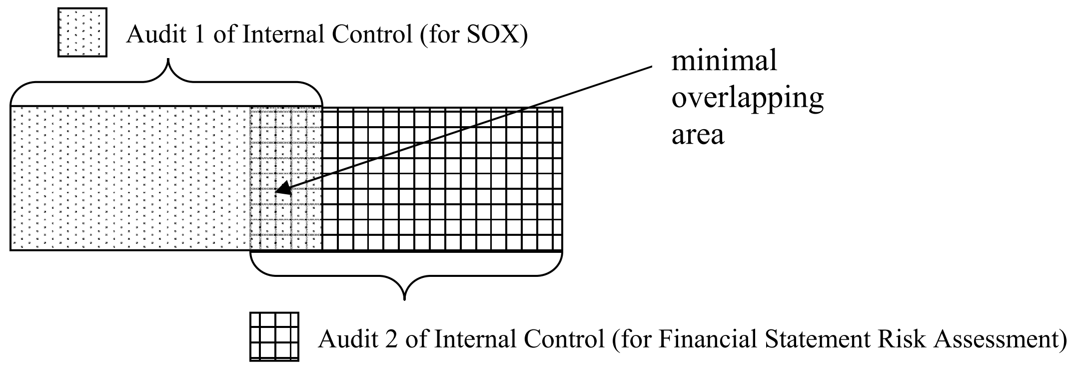
-identifying specific controls relevant to specific assertions (in the Proposed Standard, this is in paragraphs 16-46)
-performing tests of controls (in Proposed Standard paragraphs 47-69)
-concluding on the assessed level of control risk (in Proposed Standard paragraphs 70-79)

By performing this work for Audit 2, the auditor would have also performed at the same time the work described in the corresponding paragraphs in the Proposed Standard related to Audit 1, in other words, Audit 2 implies Audit 1.

Based on both **Part II. A) and II. B)** above,
Audit 1 implies Audit 2 and
<u>Audit 2 implies Audit 1</u>
Based on both, it results that Audit 1 = Audit 2

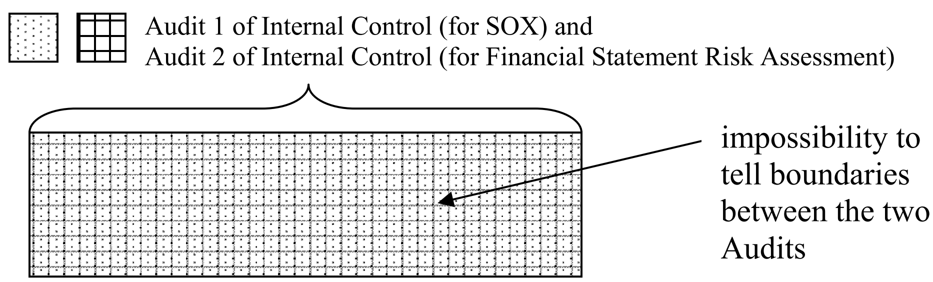
Reason III. Differentiation between two Audits of Internal Control is a loophole that can be used, and is already used, to nullify the benefits of the Proposed Standard.
I hope the Board considers the fact that it will be a hard battle for companies' management to decrease the amount of their work based on the Proposed Standard, because of the various interest groups such as internal or external auditors, who may want to perform more work than needed in order to maintain their overstaffed departments, their influence in the company, or their high fees.
Differentiation between two Audits will allow these groups to keep total work levels the same, but just re-partition them. The amount of work performed that cannot be attributed to Audit 1 of Internal Control, will still be performed, but attributed to Audit 2 of Internal Control. A graphical representation of this is as follows:

Misuse of Proposed Standard:

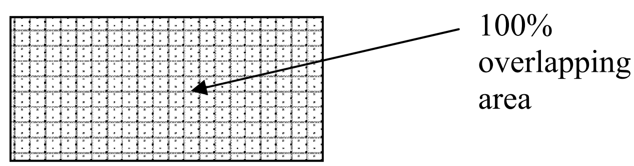


In practice, as auditors are instructed to integrate the two Audits, the two are blended together in such a way that it is hard to separate which controls they are auditing for which Audit, resulting in a integrated Audit that is much larger than what the Proposed Standard intends. This is already happening in industry in planning 2007 audits. A graphical representation of this is as follows:

Misuse of Proposed Standard: (with integrated Audits):



Compared to the Audit size of the Proposed view:



Conclusion

The two Audits of Internal Control are, in fact and in practice, one and the same Audit of Internal Control, based on sameness of methodology, underlying base, materiality threshold, scope, by definition and by deductive reasoning. Considering this, and to prevent misuse of the Proposed Standard, I hope that the Board will indicate in the final Standard that the two Audits of Internal Control are one and the same Audit of Internal Control, which can and should be used for two purposes: to form an opinion on Internal Control over Financial Reporting and to support the auditor's Assessment of Control Risk as well. <u>In the case of an effective Internal Control over Financial Reporting, no additional work is necessary to be performed to Assess Control Risk at lower than the maximum.</u>

Sincerely yours,

Monica Radu
MonicaRadu1@gmail.com

RAM Energy Resources, Inc.

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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

We appreciate the opportunity to provide comment on the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("AS No. 5"). Our comments are offered on behalf of RAM Energy Resources, Inc.

We are considered a 'non-accelerated filer.' We are an independent oil and natural gas company engaged in the acquisition, development, exploitation, exploration and production of oil and natural gas properties. We have approximately $160 million in assets and approximately 100 employees. Our revenues were approximately $70 million in 2006.

The SEC has also recently issued proposed interpretive guidance for management regarding its evaluation of internal control over financial reporting. The two proposals increase the burden to comply in some instances. We request the AS No. 5 be aligned with the proposed SEC guidance to streamline SOX compliance and ensure a consistency of approaches between external audit firms and management.

The PCAOB and SEC proposals require a full-blown external audit of internal control. We believe the increased audit fees cause an erosion of shareholder value, and a shift to private from public financing. We request that requirements imposed on public accounting firms under the Sarbanes-Oxley Act be limited, to enforce the notion that internal control is a management responsibility that management considers necessary to enhance and protect shareholder value.

Respectfully submitted,

Sabrina Gicaletto

Sabrina M. Gicaletto
Controller

NYDIA M. VELAZQUEZ, NEW YORK
CHAIRWOMAN

STEVE CHABOT, OHIO

Congress of the United States
U.S. House of Representatives
Committee on Small Business

2361 Rayburn House Office Building
Washington, DC 20515–6315

March 9, 2007

Christopher Cox, Chairman
Security & Exchange Commission
100 F Street, NE
Washington DC 20549

Mark W. Olson, Chairman
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006

Dear Chairmen Cox and Olson:

The House Committee on Small Business is concerned about the impact of Section 404 of the Sarbanes-Oxley Act of 2002 (SOX 404) on small companies. From the perspective of the Committee, there exists a compelling record demonstrating that the regulatory burden and the costs of complying with SOX 404 are disproportionately high for small companies. We were therefore encouraged that the Securities and Exchange Commission (SEC) has attempted to ease the regulatory burden of SOX 404 on small companies by issuing new interpretive guidance for management regarding internal control evaluations. We are also encouraged that the Public Company Accounting Oversight Board (PCAOB) has incorporated provisions into their new proposed auditing standard that are meant to simplify small firms' compliance with SOX 404 and has attempted to tailor the new standard to reflect the attributes of these smaller, less complex, companies.

We remain concerned, however, that the current deadlines by which many small companies, specifically non-accelerated filers, must comply with the new management guidance and proposed auditing standard do not provide sufficient time to examine fully whether the new guidance and auditing standard significantly reduce the compliance costs for small companies. We believe an examination of the new guidance and audit standard to ensure that the cost of compliance are not disproportionately burdensome to small companies is important and should occur before non-accelerated fliers are directed to comply. **Based on the feedback we have received from small companies, we urge the SEC and the PCAOB to issue a delay that would clarify that non-accelerated calendar year filers would have:**

- **At a minimum – until the due date for their 2008 annual report to file their management internal control reports; and,**

- **At a minimum – until the due date for their 2009 annual report to file the auditor's attestation report.**

In our view, a delay that allows the SEC and the PCAOB to examine fully the impact of the new management guidance and audit standard, particularly the new standard's effectiveness in lowering compliance costs for accelerated filers, before non-accelerated filers are directed to comply with the new guidance and standard, makes not only good common sense but is necessary to ensure that the guidance and the standard will be cost-effective. Issuing a delay would recognize that:

1) The small companies which have not yet had to comply with SOX 404 must prepare for the new management guidance and auditing standard many months in advance of the earliest deadline;

2) Those small companies will expend valuable time and resources to comply with new guidance and standards; and

3) The new guidance and standard will not – by the time of the earliest deadline – have had the benefit of thorough field testing and evaluation.

Issuing a delay would also recognize the value of the feedback that the SEC and PCAOB will receive from accelerated filers, audit firms, and the PCAOB's efficiency inspectors. We believe strongly that the SEC and PCAOB's compliance dates for non-accelerated filers should allow the agencies the opportunity to revise the guidance and/or audit standard in light of the feedback from these groups. **Indeed, we further recommend that the SEC and PCAOB set the final date for compliance by non-accelerated filers only after receiving feedback from the accelerated filers, auditing firms, and the PCAOB's efficiency inspectors with respect to the compliance costs and effectiveness of the new guidance and audit standard**.

We thank you for your continued work on behalf of our nation's small companies and look forward to hearing from you.

Sincerely,

Nydia M. Velázquez	Steve Chabot
Chairwoman	Ranking Member

Reznick Group

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

RE: Rulemaking Docket 021: Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements

Dear Members of the Board:

Reznick Group welcomes this opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (PCAOB) on the concepts and questions contained in the above referenced "proposed standard" or "AS5."

Reznick Group is a national accounting, tax and business advisory firm that specializes in providing sound, strategic business counsel. The firm works with clients in a broad spectrum of industries, specifically in providing services to real estate professionals; lenders and investors; corporate executives, business owners and entrepreneurs; government professionals; nonprofit professionals; and healthcare administrators.

As always, we are supportive of any rule making that further demonstrates the profession's resolve to independence and objectivity while also reducing the burden of compliance.

General Comments

Reznick Group strongly supports the need for effective internal controls over financial reporting. We believe that, on balance, the proposed standard would continue to improve the effectiveness and efficiency of audits of public company's financial reporting.

We believe it is appropriate and more efficient for the auditor to integrate their audit procedures and opine on a company's internal controls over financial reporting and the financial statements without issuing a separate opinion on management's annual internal control evaluation process. We are hopeful that this will lead to additional audit efficiencies and reduced audit expenses.

We support the PCAOB's position that the auditor should consider the size and complexity of a company, and consider ways of streamlining and eliminating unnecessary procedures, while planning and performing the audit of internal controls. We applaud the PCAOB for acknowledging that smaller, less-complex companies should have smaller, simpler audits, and that the auditors should expect and accept that smaller company's control activities may be different and documentation of those controls less formal than found in some larger companies.

Reznick Group

While we believe that AS5 is a significant step in the right direction, as with Accounting Standard No. 2, the way the accounting firms interpret and apply AS5 will be based on how they anticipate their compliance will be evaluated by the PCAOB. We encourage the PCAOB to take the lead and adopt the spirit and philosophy of the proposed standard while conducting its inspections.

Specific Comments

Some more specific comments and suggestions for the PCAOB's consideration follow:

- Auditing standards consider inquiry, observation, inspection of documentation, and reperformance as appropriate tests of controls. We are aware that many auditors focused primarily on existence of documentation and have essentially taken the position that in the absence of documentary evidence, controls must be presumed to be ineffective. Some additional guidance to clarify the PCAOB's intention would help increase understanding and consistency between auditors.

- It would be helpful if the PCAOB would provide additional explanation on the role and importance of information technology (IT) general controls as they relate to internal controls over financial reporting. Additional guidance would also be helpful that explains the relationships or dependencies between IT general controls and application controls, particularly in smaller companies, including examples of situations where an IT general control deficiency could result in an application control breakdown, in turn leading to a material misstatement. Some guidance or examples of the relationships between application controls in prepackaged software and IT general controls necessary to support them would also be helpful.

- Paragraphs 45 and 78 refer to anti fraud "programs and controls." We encourage the PCAOB to further explain its expectations for an anti fraud "program." The current wording may lead auditors to seek an undefined yet specific anti fraud "program" above and beyond the company's controls to prevent and detect fraud.

- Some companies have been reluctant to consult with their auditors and other advisors about internal controls due to fear that such a conversation might be construed as evidence of a material weakness. We encourage the PCAOB to further clarify this point so as to encourage management to have an open dialogue with their auditors on all matters including seeking advice to assist in maintaining sound internal controls.

Reznick Group

Conclusion

Reznick Group strongly supports the need for effective internal controls over financial reporting. We believe that, on balance, the proposed new rules would continue to improve the effectiveness and efficiency of public company financial reporting. We look forward to further guidance from the PCOAB, and will continue to participate in the positive evolution of audit practices that promote ethical and effective financial reporting.

We would be pleased to discuss our comments further. Please contact Kurtis Wolff at (404) 250-4148.

Reznick Group, P.C.

Bethesda, Maryland
February 26, 2007

-----Original Message-----
From: Robert Richter [mailto:rfrich@ix.netcom.com]
Sent: Monday, February 26, 2007 4:13 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No .021

To the PCAOB Board members and staff:

I have the following comments on the proposed standard on the audit of internal control.

The PCAOB deserves credit and appreciation for dealing with the challenge of reducing the time and costs involved in reporting on internal control, and in simplifying the guidance for auditors.

One area the PCAOB has properly chosen to address, and the focus of my comments, is the requirement for dual auditor opinions on internal control - one on management's assessment and the other on internal control effectiveness. The proposal would eliminate the opinion on management's assessment, with the result that auditors will give an opinion on whether internal control is effective. But I believe the PCAOB should have opted for the other choice - reporting only on management's assessment.

Management's assessment as stated in its report is a management assertion. Reporting on a management assertion is a fundamental and common objective of auditing. When auditors report on financial statements, they report on whether management's assertions as expressed in the financial statements are fairly stated. But, if auditors state whether internal control is effective, the auditor is making the assertion (along with management).

This distinction may be considered a nuance, but it is not trivial.

The auditor’s reporting on internal control should parallel the reporting on financial statements. That is, the auditor should report simply on whether management's assessment of internal control is fairly stated, just as it reports on whether the financial statements, a management assertion, are fairly stated.

The proposal states, in section II.B (page 14), that it “would eliminate the requirement to evaluate the process management used to evaluate its internal control,” which it indicates is an unnecessary procedure. The idea is that it is not necessary if the auditor directly evaluates and reports on internal control. But the proposal also calls for the auditor to understand management's assessment process. It says “the quality of management's process is inherently linked to the amount of work the auditor will need to do.”

I do not know to what extent reporting only on management's assessment would reduce audit time in relation to that required to report on internal control effectiveness. But I do believe that any reduction in total audit time is likely to be optimized where the objective of the reporting is on management's assessment.

The primary responsibility for maintaining adequate internal control rests with the company, and management. There is no compelling need for the auditor to take on part of that responsibility, which would result from a requirement for the auditor to report on internal control effectiveness. The concern by management that auditors have been dictating the nature of internal controls will continue.

If the auditor in fact or in effect shares responsibility with management, there is a question as to whether the auditor can be considered independent.

Section 404(b) of the Sarbanes-Oxley Act requires that the auditor “attest to, and report on, the assessment made by management.” There has been no demonstration of a need to go beyond that requirement.

Section 103(a) of the Sarbanes-Oxley Act requires that the auditor’s report present “an evaluation” of whether the internal control structure meets specific objectives, which are the same as those specified in Section 13 (b)(2) of the Exchange Act. The PCAOB stated in Paragraph E16 of Release 2004-001 (AS 2) that “the Board also interpreted Section 103 to provide further support that the intent of Congress was to require an opinion on the effectiveness of internal control over financial reporting.” This interpretation is questionable, however, because it is inconsistent with the wording of Section 404.

The PCAOB also concluded in AS 2 that the degree of work required in either reporting situation would be the same. That is a questionable premise. It is one thing to test effectiveness of internal control directly, and quite another to test the testing performed by someone else.

What this boils down to is how much assurance investors are willing to pay for. That issue is or particular importance for smaller public companies.

I appreciate your consideration of my comments.

Sincerely,
Robert F. Richter, CPA

ROCK-TENN COMPANY

February 26, 2007

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street NW
Washington, DC 20006

Re: PCAOB Rule Making Docket Matter no. 021

Dear Sir or Madam,

We acknowledge that, on December 19, 2006, the Public Company Accounting Oversight Board (PCAOB) voted unanimously to propose for public comment a new standard on auditing internal control over financial reporting. We also recognize that on December 13, 2006, the SEC voted unanimously to take action to improve the cost effectiveness of the implementation of the Sarbanes-Oxley Act (Sarbox) Section 404 by proposing interpretive guidance specifically to assist managements of public companies to plan and perform their own evaluations of internal control over financial reporting (ICFR).

We further understand that the proposed new audit standard by the PCAOB would replace Auditing Standard No. 2 (AS 2), such that the proposed new standard is intended to focus auditors on the "most important matters", eliminate certain "unnecessary" audit procedures, provide direction on how to scale an audit for a smaller and less complex company, and simplify and significantly shorten the text of the standard.

We understand that the PCAOB (and the SEC) are seeking comments on each of their proposals by February 26, 2007 and that the PCAOB will consider all comments received. We submit our comments for your consideration.

Rock-Tenn Overview

Rock-Tenn Company is NYSE registered company, with revenues for its 2006 fiscal year ended on September 30, 2006 of $2.1 billion. Our current equity market capitalization is approximately $1.4 billion. Our business is paper and paper products manufacturing, where being the lowest cost provider is very often the critical factor in obtaining business from existing and new customers. We compete against private and smaller public companies that do not have the cost burden of compliance with Sarbox. We compete against large well-capitalized global companies, including competitors in Asia that do not have the cost burdens of Sarbox.

The arrival of Sarbox and the subsequent workloads and additional costs that it has placed on our company have been substantial. In fact, the following comments were included in the annual letter to the Shareholders attached to our fiscal 2005 annual report – "Throughout Rock-Tenn we will continue to focus on ...reducing the cost of our financial processes. We believe we can significantly reduce our support costs and our excessive Sarbanes-Oxley compliance costs (which were $4.5 million to third parties alone for fiscal 2005's certification)." While we did reduce compliance costs from these levels in fiscal 2006, the effort was still significant and we expect to incur significant costs this fiscal year.

P.O. Box 4098 • Norcross, Georgia 30091 • 770-448-2193

Summary

While we believe that the PCAOB and SEC are now beginning to move in the right direction, we continue to believe the proposed changes do not move nearly far enough to provide for significant reductions in the cost of compliance and that such costs will continue to far outweigh any benefit. Absent more substantial change, we believe the new proposals will do very little to materially reduce the cost of Sarbox compliance.

Based on their initial review of the new proposal, our auditors have indicated to us that they do not expect a dramatic reduction in external annual Sarbox compliance costs to result from the new proposal.

The two most important issues that must be addressed in order to reduce compliance costs are a) the definition of materiality and b) the depth of testing required.

Materiality

We strongly support the PCAOB's initiative to (1) clarify the terms "material weakness" and "significant deficiency", by using definitions more in line with the familiar language associated with FASB statement No. 5, and (2) require auditors to perform their audits of ICFR using the same materiality measures used to plan and perform the audit of the annual financial statements.

Testing

We refer to the original words of section 404 of the Sarbanes-Oxley act, which reads as follows:-

> ....with respect to the internal control assessment required by subsection (a) (i.e the assessment by management), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the **assessment made by the management** (my emphasis) of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board (i.e. the PCAOB). Any such attestation shall not be the subject of a separate engagement.

Based on the above, the question became as to how "each registered public accounting firm" would be able to gather enough evidence to be able to make their attestations on managements' assessments. AS 2 was issued by the PCAOB and became the de facto standard for both the auditing firms, and public company managements, in guiding their respective testing approaches and methodologies. Two problems arose:-

- both public company managements' and their auditors' interpreted AS 2 to require that all /the majority of "key" controls had to be tested. As soon as that interpretation is reached, one cascades into multiple questions as to how many key controls should be tested, where should they be tested, how frequently, can the tests be rotational, who is allowed to do the testing, and the depth of testing (i.e. assessing each control for its own risk of ineffectiveness!)

- the ICFR audit work often became a separate exercise from any audit work related to the auditor's opinion on the financial statements.

While we understand that the proposed new standard incorporates a more "top down," approach to ICFR testing, we doubt that the proposed changes will translate into a signifcant reduction of both internal resource effort and external auditor effort, because it appears that

- the focus remains centered on audit firms having to test all/the majority of "key" controls – which will probably result in managements testing controls in the same manner.

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- In particular, paragraph 51 of the new proposal could have the unintended consequence of adding yet a new level of complexity to testing. Paragraph 51 indicates that every control selected for testing should be first assessed for the risk that it might be ineffective and after having done that, then adjust the amount of evidence to be acquired in testing based on that risk assessment. *We believe that the PCAOB should make the fundamental decision that audit firms should report only on management's assessment and not have to report on ICFR. In doing so, auditors would have to not duplicate the testing conducted by management in its assessment of the effectiveness of its controls.*

- the separateness of the "two audits" also will probably remain. In our opinion, there is still confusion as to the interaction of substantive testing of a company's financial statements on the resultant extent of required ICFR testing. *We believe that if an audit firm concludes that the year end balance sheet of a company is not mis-stated, via its substantive testing, then surely that is a strong indication that the control environment is not ineffective. The more emphasis that can be given to an integrated audit, including the ability to draw inferences regarding controls based upon account balance accuracy, the less cost.*

We believe our position is more than justified by

- the excessive cost of complying with Sarbox Section 404, relative to the small benefit perceived by ourselves and every corporation with which we have discussed the matter, and

- the unaccountable failure of the AS 2 – and the new proposal - to recognize the validity and usefulness of statistically valid sample testing and the significant cost reductions associated with its use.

Equally importantly, we believe that Sarbox Section 404 and AS 2 were adopted in an environment in which the quality of financial statement audit assurance was much lower than it is today in the post-Sarbox era. Like every corporation that Rock-Tenn has discussed the matter with, the cost of Rock-Tenn's annual financial audit has increased dramatically since the Sarbanes-Oxley Act was enacted. In Rock-Tenn's case, the increase was due to both Sarbox work and audit work associated with the financial statements and was due to increases in audit hours, not by hourly rate increases. Unfortunately, we believe that the current proposals will do little to reduce them. However, given the dramatic increase in audit hours, together with the PCAOB's reviews of audit firms, and the resultant dramatic increase in the quality of audit assurance, Rock-Tenn believes that most of the rationale for the adoption of Sarbox Section 404 and AS 2 no longer applies, For these reasons we believe our proposals, which would significantly reduce duplicative control testing by auditors, are essential in order to match the cost of Sarbox compliance with its potential benefit.

Yours sincerely,

/s/ A. STEPHEN MEADOWS

A. Stephen Meadows
Chief Accounting Officer

cc: James A. Rubright, Chief Executive Officer
Steven C. Voorhees, Chief Financial Officer

From: Shaw, Andy [mailto:AShaw@rocksp.com]
Sent: Friday, February 09, 2007 4:22 PM
To: Comments
Subject: Docket 21

I respectfully submit this question / observation regarding materiality, the concept of material misstatements and quantification of material weaknesses.

The PCAOB proposed standard says that the ICFR audit and financial statement audit should be planned and performed using the same measure of materiality. The SEC proposed guidance to management says that both quantitative and qualitative factors are to be considered but is not explicit. Our external auditors have an existing metric used for materiality – a percentage of net income. If management does not use the same metric there is a possibility that the auditor's threshold may be lower and hence they might identify potential material weaknesses that management would not have identified during its assessment. There does not appear to be any prescribed mechanism to reconcile this potential gap in either the SEC or PCAOB proposals. What is the view of the SEC and PCAOB on this potential gap and how management and the external auditor must resolve it?

Thank you.

P. Andrew Shaw
Director Internal Audit / SOX
Rockwood Holdings, Inc.
100 Overlook Center
Princeton, NJ 08540
609-734-6423
Ashaw@rocksp.com

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From: srosenkranz@ScottStringfellow.com
Sent: Tuesday, January 02, 2007 10:17 AM
To: Comments
Subject: PROPOSED AUDITING STANDARD - Feedback

Dear Sir or Ma'am,

I am writing in response to Release No. 2006-007, published December 19, 2006. My concern pertains to your use of "Risk Assessments" in evaluating the effectiveness of internal controls. Speaking from a strictly information technology perspective, risk assessments are an involved and detailed undertaking comprised of both objective and subjective elements. They also vary significantly from the risk assessment I believe you are alluding to, which are subjective and operational in nature.

In my opinion, the differences between the two types or "risk assessments" must be captured and articulated before using them as the foundation for assessing whether or not a company's internal controls are effective. Based on my experience, auditors evaluating the effectiveness of information security controls as part of SOX Section 404 compliance are quick to assess a control as insufficient without identifying either the level of residual risk troubling them or how they derived that residual risk. This lack accountability in making such determinations is both frustrating and troubling. I believe that individuals performing evaluations should adhere to the same standards of due diligence and due care as the organization they are evaluating. Again this is my opinion, and I confess my perspective may be colored by the fact that I am the recipient of external audits and not the one performing them.

Finally, a variety of methodologies exist to perform information security-type risk assessments, and it might be prudent to articulate a general structure or approach which would be considered acceptable for companies to use so they are not deliberating the utility (or lack there of) of their process prior to auditors arriving to perform their evaluation and analysis.

Thank you for your attention in this matter and for working to make audits more efficient, effective and useful.

Regards,

Steve

Stephen R. Rosenkranz

CISSP, CBCP

SSI Security/Disaster Recovery Engineer

Information Systems Department

Phone: (804) 727-3438

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8006 Discovery Drive, Suite 300, Richmond, VA 23229

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From: srosenkranz@ScottStringfellow.com
Sent: Wednesday, January 31, 2007 5:00 PM
To: Public Affairs
Cc: Comments

January 31, 2007

Public Company Accounting Oversight Board

1666 K Street, NW

Washington, DC 20006-2803

Dear Sir or Ma'am:

On January 2, 2007, I submitted a comment to your comments@pcaob.org mailbox regarding the proposed auditing standard published in PCAOB Release No. 2006-007. Please note that the submission was made on my personal behalf and as such reflects my personal views and not the views of my employer. Please update my submission record and comment to reflect this.

Sincerely,

Stephen R. Rosenkranz

CISSP, CBCP

SSI Security/Disaster Recovery Engineer

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Attachment regarding Proposed Revisions to Auditing Standard #5 (AS 5):
"An Audit of Internal Controls Over Financial Reporting that is Integrated with an Audit of Financial Statements"

Walkthrough Requirements

AS 5 requires the performance of walkthroughs for each significant process, but changes the requirements such that an external auditor is no longer required to perform a walkthrough for each major class of transactions within each significant process. While this recalibration of walkthrough requirements noted in AS 5 may result in efficiencies, greater benefit could be derived with further allowances in several areas:

1. *Supervision of Walkthroughs*: AS 5 allows for the external auditor to utilize the direct assistance of others when performing the required walkthroughs, provided the external auditor properly supervises the work performed. It would be helpful if the guidance confirmed that an appropriate means for achieving the 'standard of supervision' could be that the auditor defined specific walkthrough procedures and deliverable. The walkthrough procedures could then be executed by company resources and the specified deliverable provided to the auditor. This arrangement would be more efficient than an arrangement where the auditor supervises the company resources as if they worked for the auditor.

2. *Auditor Judgment for Performing Walkthroughs*: AS 5 does not allow the external auditor to apply judgment (e.g., giving consideration to such factors as prior year control evaluation, auditor knowledge of area, degree of process change) in determining which significant processes a walkthrough must be performed. Walkthroughs are very time consuming and costly. For significant processes that are extensively audited annually and thus the auditor is very knowledgeable, the benefits of a walkthrough are not derived. Further, in those areas that have lower relative inherent risk and do not change significantly year over year (e.g., Payroll Expense) very little value from a walkthrough is gained. It would be helpful if the guidance provided greater flexibility for the auditor to apply judgment in determining the area for which a walkthrough is performed and the frequency of a walkthrough.

3. *Reliance on Walkthrough for Controls Evaluation*: AS 5 indicates that walkthroughs alone are sufficient evidence for the auditor to conclude on the operating effectiveness of key financial reporting controls. However, regardless of the inherent risk or materiality in certain areas, paragraph B9 requires substantive procedures (above the performance of a walkthrough) in order to opine on the financial statements. Similar to the points noted above related to the application of auditor judgment in determining what area and how frequently to perform a walkthrough, it would be helpful if the guidance allowed the auditor to use judgment and rely on the results of a walkthrough (specifically for low inherent risk controls such as Fixed Assets) as sufficient evidence to opine on the financial statements.

Company-Level Controls

AS 5 guides the auditor to test those company-level controls that are important to the auditor's conclusion about whether the company has effective internal controls over financial reporting. The auditor's evaluation of company-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on controls at the process, transaction, or application levels. While this guidance of using a top-down approach to the audit of internal controls over financial reporting may result in efficiencies, greater clarity would be helpful in several areas:

1. *Definition of Company-Level Controls*: In paragraph 18 of AS 5, a description of what is meant by a company-level control is provided. Further, in paragraph 43 of AS 5, the

guidance suggests that the auditor should give consideration to which company-level controls to test as company-level controls operate at varying levels of precision. It would be helpful if the guidance provided specific examples of company-level controls that operate at varying levels of precision that by themselves would sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected in a timely basis. It is often difficult to identify 'key' company-level controls that have a direct, clear linkage to mitigating risk associated financial misstatement. As such, auditors have placed little reliance on company-level controls in the past. If the guidance were expanded to include specific examples of company-level controls at the process level, transaction level, and application level that might adequately prevent or detect on a timely basis misstatements, this would provide clarity and result in the ability for auditors to place greater reliance on company-level controls as intended.

2. *Evidence to Demonstrate Operating Effectiveness of Company-Level Controls*: AS 5 allows greater reliance by auditors on company-level controls. In conjunction with greater clarity on the definition of company-level controls (at the process, transaction, and application level) that operate at the appropriate degree of precision for the auditor to place reliance, it would be helpful if the guidance commented on the nature, extent, and timing of 'key' company-level control evidence that would be sufficient for the auditor to place reliance upon. For example, for the following process level, company control, is the suggested audit evidence sufficient?
   - Key process level, company control: On a monthly basis, the Funding and Investments department performs a trend analysis of interest income and expense to validate that the income/expense levels are appropriate and in accordance with management expectations. This monthly trend analysis includes a review of several specific data elements month over month (e.g., investment balance, debt outstanding, interest rate.)
   - Suggested control evidence: For two months from different quarters obtain the following: (1) procedures for performing and reviewing trend analysis with notation on specific data elements reviewed and managements tolerable variance, (2) a copy of management's trend analysis and review, (3) evidence of management's review & approval, and (4) evidence of research and resolution for any identified data anomalies.

Submitted by William M. Diefenderfer, Sallie Mae, Audit Committee Chairman. 703-759-0822

San Jose
Water
Company

374 West Santa Clara St.
San Jose, CA 95196-0001
Phone 408 279-7800
Fax 408 279-7934

Ms. Laura Phillips
Deputy Chief Auditor
Office of the Secretary, PCAOB
1666 K Street, N.W.,
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021

February 16, 2007

Dear Laura,

San Jose Water Company is in full support of the new proposal on the subject of switching from rule-based to principles-based accounting; putting more focus on risk and materiality, and help management make their evaluation process more efficient and cost-effective.

Our company's annual revenue is under $200M; however, we have to spend approximately half a million dollars per year just to comply with SOX, not including the 2+ dedicated in-house staff working on SOX, as well as the significant time I spend on the topic. On top of that, every single one of our staff has to work longer and harder because of the extra burden of SOX compliance. Because our industry is heavily regulated, we cannot pass on the extra cost to our customer without prior approval, and the approval process is vigorous and takes place once every 3 years.

The current SOX approach of documentation and testing do not allow procedures and processes to be properly evaluated for their overall effectiveness. At smaller companies, segregation of duties is often more difficult to accomplish due to limited staff and resources, so excessive documentation and testing is burdensome for smaller firms. We believe the most important control is the "tone at the top," and we fully support the streamlining and simplifying the whole process of SOX for small companies.

Based on the above explanation, we believe that PCAOB should coordinate with the SEC's efforts and rewrite audit guidelines for auditing firms to provide the use of better judgments and appropriate audit procedures in auditing smaller companies. We also believe that auditors should be able to rely on the work of others (such as company's internal auditor, as well as 3rd party testers), and make the audit more scalable for smaller and less complex companies. Our audit fee has increased significantly after SOX due to the increased scope of work, and some of the focus is unnecessary and inefficient.

Thank you very much for your attention regarding this matter.

Sincerely,

Angela Yip

Angela Yip

Sappi Ltd Group response to PCAOB

Proposed Auditing Standard – an Audit of Internal Controls Over Financial Reporting That is Integrated with an Audit of Financial Statements and related Other Proposals

Questions

A. Focusing the Audit on the Matters Most Important to Internal Control
1. Directing the Auditor's Attention Towards the Most Important Controls

1. Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?
In our opinion this is only partly achieved. Where the previous guidance was fairly prescriptive about the way in which significant locations are identified first the current guidance provides significant latitude in determining which locations should be visited. We appreciate that this latitude is an inevitable consequence of a risk based approach and will never result in a 'clear description' as to how it should be applied.

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

3. Will the top-down approach better focus the auditor's attention on the most important controls?
Yes. Notwithstanding our comments in one above, we believe that a top-down approach will better focus attention on the most important 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?
Yes

2. Emphasizing the Importance of Risk Assessment

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?
Yes. For 'super key' (our terminology) controls - covering high risk areas - full evidence is required. For lower risk areas - prior year evidence plus roll forward type procedures are possible / walkthrough testing evidence suitable. Rotational testing not yet allowed. This is unfortunate and we would support this further change.

6. Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?
Yes - especially suitable for Sappi SOX controls many of which only require a small sample to be tested. For applicable controls the evidence will essentially be the same

as if we were testing the control - so the impact on "use of others work" should be minimal).

3. Revising the Definitions of Significant Deficiency and Material Weakness

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?
Yes

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?
Yes

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?
Yes. *Too much emphasis was placed on the aggregation of low-level deficiencies with the previous guidance (as prepared by the 9 audit firms).*

4. Revising the Strong Indicators of a Material Weakness

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?
Yes. While this does place a greater emphasis on audit judgment there are a number of circumstances that can be contemplated where a strong indicator should not automatically lead to conclusions about deficiencies.

6. Clarifying the Role of Interim Materiality in the Audit

11.Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?
No

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?
Yes. We do not believe that the removal should have an impact on the scope of the audit.

B. Eliminating Unnecessary Procedures

1. Removing the Requirement to Evaluate Management's Process

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

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?
Yes. Management's processes are part of the overall system of internal control. Auditors will still have access to control descriptions, evaluations and process flow documentation. Reviewing this documentation will facilitate their conclusion although they do not have to review the process in itself.

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?
Yes.

2. Permitting Consideration of Knowledge Obtained During Previous Audits

16. Does the proposed standard appropriately incorporate the value of cumulative knowledge?
Almost. We are of the opinion that a well considered system of rotational testing is risk based in itself and would have led to further efficiencies.

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?
There should have been no material changes in people or processes and very few is any significant findings during the previous year's testing. Management's own testing plans might provide further assurance enabling this approach to be taken.

3. Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage

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?
Yes. We believe that this is one of the most important aspects of the changed guidance although it might have been useful to supplement with a degree of rotational testing. It is also not always practical to perform a detailed risk assessment and identify major classes of transactions at a central level. Quantitative evaluations are inherently easier. Notwithstanding the challenge, we believe that the changed guidance is appropriate

4. Removing Barriers to Using the Work of Others

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?
Yes

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?
No

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

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

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?
Yes

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

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?
Weren't sure what was meant here

5. Recalibrating the Walkthrough Requirements

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

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?
Yes

C. Scaling the Audit for Smaller Companies

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?

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

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?

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

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?

D. Simplifying the Requirements
III. Proposed Rule 3525 – Audit Committee Pre-approval of Services Related to Internal control

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?

VI. Effective Date

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?
The Board should permit auditors to apply the guidance with immediate effect for the following reasons:

- *Represents the boards current thinking*
- *Failure to do so allows for continued audit inefficiencies in certain areas.*
- *We have worked with our auditors to identify areas where their testing can be reduced assuming that the guidance remains in its current form. In this way the disruption should be limited.*

SCHNEIDER DOWNS

INSIGHT ▪ INNOVATION ▪ EXPERIENCE

February 26, 2007

Attn: Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

File Number: PCAOB Rulemaking Docket No. 021
Proposed Auditing Standard – ***An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements***

Dear PCAOB,

Schneider Downs thanks the PCAOB for the opportunity to comment on the proposed auditing standard ***An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements***. We respectfully acknowledge the PCAOB's proactive efforts in addressing many of the concerns raised by both business and the accounting profession since the implementation of the Sarbanes-Oxley Act. The proposed standard provides significantly clearer guidance regarding the expectations placed on management and the external audit profession. We found that many ambiguities of the existing rule that were cause for debate and interpretation have been addressed, if not eliminated. The intent of the revised standard is welcomed in both the business and accounting communities.

In review of the proposed standard, we put forth the following observations for your consideration, which we believe will further clarify areas where greater definitive guidance would be beneficial.

When assessing the proposed standard, two points where greater clarification/insight would be welcomed:

1. With respect to section – **B. Eliminating Unnecessary Procedures, 4. Removing Barriers to Using the Work of Others** page 24 makes the following statement – "In addition, the proposed standard would remind the auditor that the responsibility to report on the financial statements or management's assessment of internal controls rests solely with the auditor and that the auditor must obtain sufficient competent evidence to support this or her opinion." However, the proposal makes direct reference in section – **B. Eliminating Unnecessary Procedures, 1. Removing the Requirement to Evaluate Management's Process** page 14

that the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process, effectively removing the evaluation requirement. We believe that section 4 needs to be amended.

2. Regarding restatement resulting in a material weakness, a point that has not been explicitly covered is in situations where a company places reliance on the opinion/guidance provided by a recognized third party specialist/expert. Having done proper due diligence in selection of the third party and not having the internal expertise to conclude on a matter without third party assistance, it would appear reasonable and prudent to follow the guidance provided. However, if a company experiences a restatement under these conditions, in such a situation, where appropriate evidence of due diligence in selecting the third party specialist/expert is available, a company would appear to have proper internal controls over financial reporting and the resulting restatement would not appear to be representative of a failed internal control(s) resulting in a material weakness. Guidance on this matter in the proposed auditing standard would be welcomed.

We thank you for considering these observations.

Sincerely,

Schneider Downs & Co., Inc.

Schneider Downs & Co., Inc.

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February 16, 2007

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

VIA ELECTRONIC MAIL

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir/Madam:

I appreciate this opportunity to comment on the proposed PCAOB Auditing Standard No. 5 (AS 5), which would supersede AS 2. I am responding to Question 9 in PCAOB Release 2006-007 (Release). Specifically, my comments pertain to the use of the term "reasonable possibility" in the proposed redefinitions of "significant deficiency" and "material weakness."

Recommended Revisions to Proposed AS 5

1. Revise Paragraph A8 to delete the term "reasonable possibility" in the definition of "material weakness" and insert the appropriate number, as follows:

   A **material weakness** is a control deficiency, or combination of control deficiencies, such that there is at least a *[insert number between 0.0 and 1.0 here]* probability that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.

2. Delete the note to Paragraph A8.

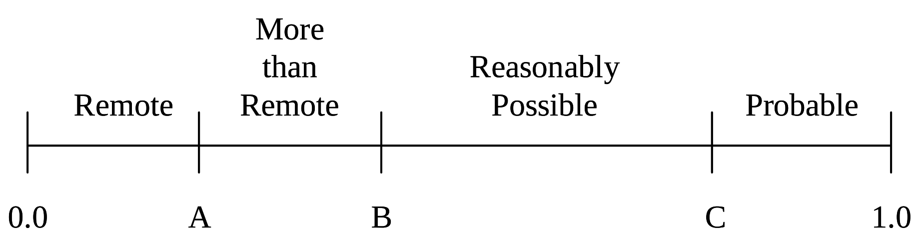
3. Revise Paragraph A12 to delete the term "reasonable possibility" in the definition of "significant deficiency" and insert the appropriate number, as follows:

   A **significant deficiency** is a control deficiency, or combination of control deficiencies, such that there is at least a *[insert number between 0.0 and 1.0 here]* probability that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected.

4. Delete the note to Paragraph 73 of proposed AS 5.

Analysis

In the Release, the PCAOB has stated that it is adopting terminology from Statement of Financial Accounting Standards No. 5 (SFAS 5), which employs the qualitative terms “more than remote”, “reasonably likely [or possible]” and “probable.” The points A, B and C in the diagram below denote unspecified probabilities that must, of necessity, demarcate the ranges of uncertainty used to apply SFAS 5:



Before proceeding further, it is important to note that Points A, B and C do not change. In other words, the points are unaffected by the facts and circumstances of a particular transaction; similarly, no publication of the PCAOB that I am aware of provides any indication that the PCAOB believes that the points should vary across audit engagements for the purpose of determining whether a significant deficiency or material weakness exists.

Regardless of the FASB’s motives for promulgating SFAS 5 as it did, it is neither in the public interest, nor is it consistent with the PCAOB’s mission, to continue to follow the unnecessarily vague approach to dealing with uncertainty set forth in SFAS 5. The FASB did not disclose any information concerning the process by which “probable” and other qualitative terms for describing uncertainty were selected in the Basis for Conclusions section of SFAS 5; or whether quantitative probabilities were even considered. Arguably, many of the well-known problems in application of SFAS 5 have resulted from the absence of explicit points of demarcation—particularly Point C in the above diagram. The ambiguity and inevitable disagreement between auditors, preparers and users as to the appropriate demarcation Points B and C has had two effects: (1) substantial lack of comparability of financial statements, and (2) windfalls to auditors and preparers by allowing them to avoid being held to account for misleading financial statements.

With regard to auditing standards, investor protection is less than adequate by ambiguous specification of the point between “more than remote” and “reasonably possible” in AS 5 (i.e, Point B in the above diagram). Blurring the demarcation point with vague terminology adds judgment and cost to financial reporting while providing no discernible purpose that is consistent with the mission of the PCAOB. While I am sympathetic to a desire to avoid bright-line rules in principles-based standards, it is not always appropriate to do so. In respect to thresholds in the form of probabilities, the normative economic principles that address the use of judgment in decision making require that subjective probabilities be quantified. These principles have been widely applied for generations, taught in all accredited schools of business and accounting, and incorporated into more recent accounting standards. [1]

As applied to auditing, risk assessment is inherently quantitative and structured, even though an assessment of materiality may be more judgmental and dependent on facts and circumstances. Along these lines, the Board's contention that "evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made *without* [emphasis supplied] quantifying the probability of occurrence as a specific percentage or range"[2] runs counter to norms of rational decision making. For example:

> *Assume that Point B in the earlier diagram represents the probability 0.4. In the terms of proposed AS 5, this is the lower bound of "reasonably possible." Further assume that the auditor determines the materiality threshold for a misstatement of revenues to be $1,000,000. Therefore, $400,000 (0.4 x $1,000,000) represents the <u>maximum allowable expected misstatement</u> (given that a misstatement is at least reasonably possible) such that an ICFR weakness would not be disclosed as material.*

I am not sure how the Board can expect an auditor to obtain reasonable assurance for its opinion within the framework of AS 5 without undertaking a process substantially similar to the one described by the above example. Stated another way, as AS 2 was written, and as proposed AS 5 is currently written, it should be unacceptable for auditors to adopt different threshold probabilities for different clients, or even for different financial statement amounts[3] (although materiality or significance thresholds may reflect these factors). The unavoidable conclusion from the PCAOB's language in these auditing standards is that it should not be necessary, or required, for each auditor and client to come to separate conclusions on each engagement, and negotiate the threshold probability for "reasonably possible." Yet, the vague specification of Point B is an invitation for such negotiations to occur.

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[1] SFAS 144 on impairment of long-lived assets recognizes that probability-weighted cash flows may be used to test the recoverability of long-lived assets (¶17). SFAS 109 on income taxes specifies a probability threshold of 0.5 when measuring the deferred tax asset valuation allowance (¶17). Perhaps most germane is the auditing literature, wherein it is stated in AU Section 350 on sampling, "…the auditor should determine an acceptable audit risk and subjectively ***quantify*** [emphasis supplied] his or her judgment of the risk of material misstatement." (¶20).

[2] Note to ¶73 of proposed AS 5

[3] To illustrate a problem of static thresholds, consider the following extension of my numerical example: if a particular control over revenues had a probability of misstatement of 0.39, the control would never be reportable as a material weakness even if the resulting misstatement would be significantly greater than $1,000,000. Thus, thresholds *per se* in proposed AS 5 lack a foundation in principle.

In summary, the probability threshold in the definitions of "significant deficiency" and "material weakness" can be, and therefore should be, explicitly quantified. A change from qualitative terminology (i.e., "more than remote" in AS 2, or "reasonably possible" in proposed AS 5) would simplify auditing standards, increase reliability of ICFR audits, and reduce audit and compliance costs. Such a change would better protect the interests of investors and further the public interest through greater clarity and transparency of auditing and financial reporting. Especially since the PCAOB's position is that probability thresholds should not change with facts and circumstances, I know of no reason for intentionally blurring the lines with ambiguous language when precise thresholds are feasible.

About the Commentator

I am an emeritus professor of accounting of the Thunderbird School of Global Management and a former academic accounting fellow at the SEC, Office of the Chief Accountant. At present, I provide professional education, consulting and litigation support services. I also serve on the advisory board of the Association of Audit Committees, Inc.

If the PCAOB staff has any questions concerning this submission, please feel free to contact me at 602.228.4871, or via e-mail at tom.selling@grovesite.com.

Very truly yours,

Thomas I. Selling

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February 26, 2007

VIA E-Mail

Ms. Nancy M. Morris
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Re: SEC Release No. 33-8762; 34-54976 (File No. S7-24-06) and PCAOB Release No, 2006-007 (Rulemaking Docket Matter No. 021).

Semiconductor Equipment and Materials International (SEMI) and the Fabless Semiconductor Association (FSA) appreciate the opportunity to comment on the Proposed Changes to SEC rules ("Proposed Rules") and the Proposed Interpretive Guidance on the Management Assessment of Internal Control Over Financial Reporting in compliance with Section 404 of the Sarbanes-Oxley Act ("Proposed Guidance"). We commend the SEC's efforts to reel in the excessive costs that have characterized the implementation of Sarbanes-Oxley Section 404 ("SOX 404").

We also appreciate the opportunity to comment on the PCAOB's Proposed Auditing Standard – A*n Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements*, commonly referred to as Audit Standard No. 5 ("AS-5" or "the Proposed Standard"). We are also including comments on the Related Other Proposals in the same Release including the new *Standard on the Use of the Work of Others* and proposed changes to PCAOB rules and interim standards. We appreciate the Board's efforts to improve auditor efficiency in the SOX 404 process.

INTRODUCTION

SEMI is an international industry association representing more than 2,200 companies globally – approximately eight-hundred of which are headquartered in the United States and are involved in the semiconductor and flat panel display equipment and materials markets.[1] These markets are truly global, highly competitive and highly cyclical even by the norms of manufacturing generally.

The Fabless Semiconductor Association (FSA) is also an international industry association, which serves as the voice of the global fabless business model.[2] Members include fabless companies and their supply chain and service partners, representing more than 21 countries across the globe.

SEMI's members registered with the SEC make up an $18 billion dollar sector of the U.S. economy. Members of both organizations are highly exposed to the competitive consequences of any cost imposed by U.S. capital markets regulation that does not have a commensurate benefit to their customers or their shareholders. Some SEMI and FSA members are large companies with several billion dollars in annual revenue. However, most of our U.S. members are smaller and medium-size accelerated filers, the majority of which are now in their

[1] SEMI maintains offices in Austin, Beijing, Brussels, Hsinchu, Moscow, San Jose, Seoul, Shanghai, Singapore, Tokyo and Washington, D.C. We are committed to promoting transparent and high-quality financial reporting on a global basis. Among its many other functions, SEMI acts as a source of industry data and information, and facilitates open communication between the industry and investors, particularly the investment analysts who follow the industry and provide research to the investing public. *See generally*, www.semi.org.
[2] Incorporated in 1994, FSA positively impacts the growth and return on invested capital of the fabless semiconductor business model to enhance the environment for innovation. It provides a platform for meaningful global collaboration between fabless companies and their partners; identifies and articulates opportunities and challenges to enable solutions; and provides research, resources, publications and survey information. *See generally*, www.fsa.org.

third year of complying with SOX 404. It is well established that the cost-benefit imbalance of SOX 404 compliance has fallen disproportionately on these kinds of companies.

In addition, many SEMI members and FSA members are "non-accelerated filers" under the SEC rules. These companies continue to prepare for compliance with SOX 404 but are mindful of the Commission's pledge that "unless and until a framework for assessing internal control over financial reporting for smaller companies is developed that recognizes their characteristics and needs, smaller companies will get relief from Section 404."[3]

Therefore, FSA and SEMI represent a wide range of companies that bring significant collective experience with SOX 404 compliance as well as an acute awareness of its real benefits and excessive burdens. They also can attest to the impact of these excessive costs on their ability to compete with companies that are not subject to SOX.

GENERAL COMMENTS

Our member companies are committed to maintaining internal controls that provide reasonable assurance that the company has effective and efficient operations and reliable financial reports. The primary benefit of internal control over financial reporting ("ICFR") is to provide all financial statement users -- management, board, audit committee, shareholders and the investing public -- with a reasonable basis for reliance on the company's financial reports. We believe that this goal can be accomplished without a disproportionate outlay of resources. As SEMI noted in its 2005 comment letter on the proposed COSO guidance on internal control for smaller companies, and also quoted in its comment on the Draft Report of the SEC Advisory Committee on Smaller Public Companies:

> It is important to remember that investors benefit from cost-effective internal controls and are harmed by requirements that cause waste. Investors in our industry are especially sensitive to this point. Excessively costly Section 404 compliance diverts resources that could otherwise be invested in ways that create value and enhance innovation -- new product development, for example. This ultimately affects the ability of American companies to compete with overseas suppliers and to retain technological leadership. The stakes are especially high

[3] SEC Chairman Christopher Cox, Speech to the SEC Government-Business Forum on Small Business Capital Formation, September 29, 2006. Available at: http://www.sec.gov/news/speech/2006/spch092906cc.htm.

> when dealing with smaller companies since much of our innovative and competitive edge depends on them.[4]

Therefore we are participating in these rulemakings based on the stated commitments of the Commission and the Board that these rule changes will make a substantial difference in the cost-benefit balance of SOX 404 compliance. Our comments are candid and they are based on the worthy goals that regulators have set for solving the problem of excessive cost arising from the way the SEC and the PCAOB implemented SOX 404.

SEMI and FSA used surveys, email dialogues and conference calls to obtain direct feedback on the experience to date with SOX 404 as well as operational level evaluation of the SEC and PCAOB proposals from member companies. Most of these responses have come from personnel with overall responsibility for financial reporting, internal audit and related functions. From this feedback, we have found that compliance with Sarbanes-Oxley overall has improved their ICFR. New emphasis on audit committee responsibilities, management certifications under Section 302 as well as SOX 404(a)'s requirements for management to assess and report on ICFR have improved ICFR in a number of ways. These requirements have, for example:

- Improved the control environment;
- Increased management awareness of internal control;
- Reduced risk of fraud;
- Improved confidence in the integrity of the financial reporting process; and
- Increased the independence of finance and audit personnel.

A few of our members believe that the first external audit of ICFR helped to achieve some of these benefits. However, the majority believe that the bulk of these benefits would have been obtained without the full external audit of ICFR required by rules implementing SOX 404. Moreover, none of our members -- from the largest to the smallest -- believe that the full annual audit of ICFR as required by current rules can be justified on a cost-benefit basis. Furthermore, they are very doubtful whether the full external audit, under any rules, can be done cost-effectively.

[4] SEMI comment letter on the Draft Report of the SEC Advisory Committee on Smaller Public Companies (File No. 265-23), p. 5 (April 3, 2006) (quoting SEMI comment letter to COSO on Draft Guidance for Smaller Public Companies (Dec. 22, 2005)). Available at: http://www.sec.gov/rules/other/265-23/vdhadfield040306.pdf.

In other words, SOX 302 certification provides the majority of the benefit for ICFR. Some incremental improvement is achieved by management compliance with SOX 404(a). Furthermore, a smaller benefit comes -- at an excessive cost -- from the first external audit of ICFR design and effectiveness. However, each additional audit of ICFR is equally costly and cannot be cost-justified in any true financial sense. As one member put it, "the benefit is soft but the extra cost is hard."

Moreover, while our survey data shows significant cost reductions between Year 1 and Year 2 of SOX 404 compliance, indications are that the reductions from Year 2 to Year 3 will be *de minimus*. In addition, the year 1 to year 2 cost data shows that *internal* compliance cost declined at twice the rate of *external* auditor costs. We believe that management was able in Year 2 to perform work more efficiently after the year 1 experience. In addition, in Year 2 management did some of the work that was done by external auditors in Year 1 once they became aware of the high level of work that the external auditor would require before it considered the audit work complete.

However, the main point our survey data shows is how difficult it is to further reduce overall SOX 404 compliance cost without significantly changing the external audit. As noted, very little cost reduction is anticipated between Year 2 and Year 3 on the external audit side despite significant focus on the need to reduce its cost. The data is reinforced by written and oral comments of our members. Clearly, the external audit cost is growing as a percentage of the overall cost as managements become more efficient in fulfilling their ICFR responsibilities while the external auditors are not. Therefore, we believe that significant additional changes are needed in both the SEC rule proposals and the PCAOB audit standard proposals related to the auditor's role in ICFR reviews. Otherwise, SOX 404 implementation will not achieve the reasonable cost-benefit balance that Congress intended.

Furthermore, we are certain that no one will know how much of an impact these revised rules, standards and guidelines will have until they are implemented. Our survey data shows that companies expect the proposed rule changes to result in no more than 10% to 20% reductions in cost. In fact, a large percentage of survey responses expect no appreciable change in external audit costs at all. We interpret these expectations as reflecting significant experience with the inelasticity, or "stickiness," of the external auditors' requirements and costs.

For the same reasons that the cost of SOX 404 compliance under the original rules and guidance was a surprise to regulators, the complexity and novelty of this process of evaluation and mandatory reporting on ICFR renders every change an experiment. Therefore, whatever revisions are ultimately approved, the results will need to be monitored and both the Commission and the Board will need to shoulder the ongoing responsibility to work this problem of excessive cost until it is solved.

SPECIFIC COMMENTS

1. <u>Proposed SEC Guidance for Management Assessment and Rule Changes on Management Reports</u>

As noted above, SEMI has participated for a number of years in efforts to develop appropriate rules and guidance for management to develop, maintain and report on the effectiveness of ICFR. We see significant progress in the Commission's Proposed Guidance. We also believe the so-called non-exclusive safe harbor in the proposed amendments to SEC Rules 240.13a-15 and 240.15d-15 on management's filing obligations under SOX 404(a) will enhance the level of certainty as to whether a company has in fact performed a SOX-compliant evaluation of ICFR.

From a cost-benefit perspective, the Proposed Guidance raises the potential for two significant achievements. The first, which we think should be an explicit goal of the guidance, is to revive the concept of "reasonableness" within the <u>overall</u> SOX 404 compliance regime. The second is to provide a standard against which management's assessment can be judged separate from the PCAOB's audit standard.

a. Return to Reasonableness

The Proposed Guidance, set out in pages 18-49 of the Release, provides for a useful approach to management's ICFR evaluation. However, the "Introduction" section of the Release, which is not part of the Proposed Guidance, is equally significant in its tone and direction as to the requirement to implement SOX 404 is a cost-effective, reasonable way.

Therefore, we recommend that a large portion of the Release's "Introduction" section – pages 13-15, in particular -- be incorporated into the Proposed Guidance. This is important because the language in the Introduction places the requirement for "reasonable assurance" in the context of the securities laws, which clearly contemplate "the weighing of a number of relevant factors, including the costs of compliance."[5]

The Guidance should clearly state that management is responsible to determine the scope and depth of the assessment needed to provide reasonable assurance with "cost of compliance" as a key consideration. As with every other aspect of the management's evaluation and reporting process, the audit standard and any relevant PCAOB rules must be harmonized with the Guidance if it is to be effective.

Highlighting the Release's language on reasonableness in the SEC Guidance to which the SEC's rules refer would be an important piece of a larger revision of the SEC's and PCAOB's proposals. At the least, these changes should provide an additional barrier against the risk that audit standards or auditor's interpretations of terms will continue to drive excesses of documentation and testing. This language in the SEC Guidance could also bring reasonable, cost-beneficial assessment to the external auditor's ICFR review processes if more substantial changes to the SEC's auditor reporting requirements, discussed in Part 2 of our specific comments, below, are implemented.

b. An SEC Standard for Management's Assessment

The second major achievement that could come from the Proposed Guidance would be to provide a standard against which management's assessment can be judged separate from the PCAOB's audit standard. This is a critical unmet need under the current compliance regime, which has been driven by PCAOB Audit Standard No. 2 (AS-2). This need will continue to be critical under the proposed AS-5, even though it is a substantial improvement over AS-2.

While we generally prefer guidance and flexibility over rules and mandates there are situations where more specific and more mandatory procedures can produce a better result.

[5] SEC Release Nos. 33-8762; 34-54976, n. 38 (citing 15 U.S.C. 78m(b0(7). AND quoting conference committee report on amendments to the Foreign Corrupt Practices Act, Cong. Rec. H2116 (daily ed. April 20, 1988), from which the "reasonable assurance" language is drawn.

While we applaud the notion of a "safe harbor" for management's compliance with SOX 404(a), we do not see how this Proposed Guidance sets the boundaries of this safe harbor with the type of clarity typical of effective safe harbors in other aspects of the securities laws. Therefore, we believe it could be helpful if an outline of the Proposed Guidance were incorporated into the relevant SEC rules. The outline of the Proposed Guidance could provide a rule-based template within which management could document the steps they took and the judgments they made in evaluating and reporting on ICFR.

While many of our larger members have already developed their own frameworks for addressing their SOX 404(a) responsibilities, we support use of the SEC's Guidance as a prerequisite for the "safe harbor" if that is what is necessary to wall off the management assessment and report from auditor-imposed requirements.

Changes to the proposed PCAOB audit standard are also needed to make this possible. As explained in more detail in our comments on AS-5 below, so long as an external audit of the effectiveness of ICFR is required, an audit standard with a more stringent requirement for such an audit will almost certainly become the default standard for management's assessment. As one member's CFO stated it, "we need the auditor to sign off -- we can either do it their way ourselves or we can pay them to do it their way." This is the practical problem that the new SEC guidance and the new PCAOB audit standard must address.

2. <u>Proposed SEC Rule Changes on Auditor Reporting</u>

SEMI and FSA strongly support the elimination of one of the two external auditor reports on ICFR that have been required under current SEC and PCAOB rules. Clearly, substantial duplication of effort has arisen from the requirement that the auditor attest to both management's assessment of ICFR and to the effectiveness of ICFR.

We understand that careful consideration has gone into the SEC's decision to propose elimination of the auditor's role in assessing management's evaluation and the retention of the external audit of the effectiveness of ICFR. However, our evaluation of the proposals, based on the responses of seasoned and knowledgeable member company executives, leads us to conclude that the Commission's proposal eliminates the wrong auditor attestation.

We believe that the bulk of the excessive audit fees associated with SOX 404 compliance arises from the requirement that the auditor attest to the effectiveness of ICFR. Furthermore, while the language of SOX 103 muddies the issue, SOX 404(b) certainly is clear as to the requirement to "attest to, and report on, the assessment made by the management."[7] The Act is far from a clear mandate for the auditor to attest to the effectiveness of ICFR. In any case, we will not enter into a legal debate here since our point is practical.

The purpose of these revisions of the rules, standards and guidance for SOX 404 compliance is to significantly reduce the costs and enhance the benefits of the overall exercise. As noted above, SEMI and FSA member company executives with responsibility for ICFR and much experience with SOX 404 compliance have taken the time to review and consider the impact of these proposed changes. They do not believe that the external audit of the effectiveness of ICFR, even with these changes, can be cost-justified. There are good reasons to take these comments to heart.

First, the design and effectiveness of ICFR -- and internal control in general -- is a management responsibility. Furthermore, providing "reasonable assurance" based on the "level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs"[8] is inherently the role and responsibility of management, as steward of shareholder value. An external party such as an auditor providing its independent view, on an annual basis, as to the effectiveness of ICFR will almost certainly involve an amount of testing and detailed evaluation that is duplicative, costly and wasteful.

Second, the audit firm's driver for the necessary "level of detail and degree of assurance" of effectiveness is not the "satisfaction of prudent officials in the conduct of their own affairs." Instead, audit firms face liability risks that drive them to insist upon levels of detail and degrees of assurance that are almost guaranteed to be excessive.

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[7] SOX Section 404(b).
[8] SEC Release, p. 15 (quoting 15 U.S.C. Section 78(m)(b)(7)) (providing the definition of "reasonable assurance," to which SEC Section 404 implementing rule referred).

Third, the economics of SOX 404 audits gives audit firms an incentive to require more work, more documentation and more testing. The only counterweight to this pressure is their client companies, which bargain from a decidedly weak position with an oligarchic industry.

Fourth, it is true that PCAOB's standards can be improved so that the regulator requires less of an audit firm fulfilling its SOX 404 function; however, the PCAOB inspection process appears to be ill-equipped to identify or discipline an external auditor that conducts a SOX 404 audit in an inefficient, or even wasteful, manner. While the PCAOB could inspect audit firms in more innovative ways than they have in the past, documentation of the need for any level of audit work is primarily a matter of auditors' memos in the file. Auditors can always document the need for more work and get paid for doing it.

Therefore, we believe that the most significant change – perhaps the only change -- that can correct the SOX 404 cost-benefit imbalance will be to eliminate the external auditor's obligation to attest to the effectiveness of ICFR. While we are aware of the argument that an external auditor cannot comply with SOX unless it evaluates ICFR, we do not believe that an actual attestation is required. Given the importance of legal liability as a driver of excessive audit work, the elimination of the potential liability that arises from the external auditor's attestation of the effectiveness of internal controls has the greatest potential to rebalance the costs and benefits of SOX 404.

We are hopeful that the elimination of this attestation would help drive external auditors toward a reasonable level of assurance since they would have attested only to the fact that management had conducted its evaluation according to the requirements set forth by the Commission. The Commission's Proposed Guidance and new "safe harbor" approach should then be effective in limiting the need for auditors to duplicate work that management has already done.

Given the importance of this matter we would hope that the Commission and the PCAOB would <u>critically</u> evaluate the <u>incremental</u> benefit of an external audit of the effectiveness of ICFR and assess whether its cost is justified. We believe that: it is not justified under the existing standard; that it will not be justified under the proposed standards; and that it is not likely to be justified under any standard that requires an external auditor attestation of ICFR effectiveness.

3. Proposed PCAOB Standards and Rule Changes

a. Overview on PCAOB Proposals

As noted above, we believe that both the SEC and the PCAOB have assumed the responsibility for addressing the excessive costs of SOX 404 and that the root of the problem is the external audit of the effectiveness of ICFR. However, given the complexity of this issue, we also wish to provide our comments and recommendations on ways to improve AS-5 on the assumption that it will be developed further as a standard for an external audit of the effectiveness of ICFR. We also offer comments on related PCAOB auditing proposals.

We appreciate the PCAOB's serious attempt to develop a proper standard for an audit of ICFR under SOX 404. We especially appreciate the emphasis in AS-5 on scaling audits of smaller companies. SEMI has been involved in the effort to make SOX 404 work for smaller companies through both the COSO's efforts and the SEC's Advisory Committee on Smaller Public Companies.[9] Indeed we are pleased to see many of the types of recommendations we made for adapting the COSO framework to smaller companies contained in paragraphs 9 – 12 of AS-5.

In general, AS-5 is an improved standard when compared to AS-2. We appreciate its focus on many of the major areas that have led to excessive cost in the past. Indeed, everyone agrees with the PCAOB that the new standard should at least promote a top-down, risk-based approach, eliminate unnecessary audit procedures, permit consideration of knowledge obtained in prior audits, encourage the auditor to rely on the work of others and refine the walkthrough requirements. In addition, it is essential that the new standard provide for audits of smaller public companies that are appropriate to the scale of those companies.

With these goals as a guide, we offer suggestions for ways to improve AS-5 in our specific comments below. However, in general, informed from the perspective of our members who have had to comply with SOX 404, we respectfully suggest that the Board has

[9] *Supra*, note 3.

underestimated the task at hand. Righting the cost-benefit imbalance of SOX 404 that has arisen from the auditor's role in particular will require a much different standard than the one proposed.

Were AS-5 the first audit standard under SOX 404, it might result in significant progress toward the PCAOB's current goals. Unfortunately, excessive audit costs under the Board's standards are a problem that has defied various attempts at promoting better implementation of the PCAOB's audit requirements. Aside from the formal Implementation Guidance of May 2005, and its November 2005 Report on Initial Implementation of AS-2, the PCAOB has issued 55 Staff Q&A's, many of which have dealt with AS-2 implementation guidance. The fact that audit fees have not responded to this guidance and pressure to reduce wasteful work to date, leaves us skeptical that a standard such as AS-5 can bring this about.

The Proposed Standard needs to state with greater specificity the limits of an auditor's discretion and responsibilities before it can hope to make substantial progress toward the goals the Board has described. Moreover, these limits must be so fully aligned with the guidance or rules prescribed for management by the SEC that they eliminate any need for comparison.

So long as the auditors must attest to the effectiveness of ICFR, audit requirements will trump limits in SEC filing requirements. Despite the SEC's proposed guidance to management as to how they should perform their assessment of ICFR, it is very likely that in practice management's assessment of ICFR will have to be conformed to whatever rules are in AS-5. Therefore, the Proposed Standard should explicitly state that the external auditors should perform their assessments of ICFR using the same guidance and framework used by management. Language in AS-5 and other audit guidance that suggests otherwise should be deleted.

A second major flaw in AS-5 is in the unstated assumption that auditors should not trust management to make sound judgments regarding the effectiveness of ICFR. An audit based on this assumption will never be cost effective for shareholders. The Proposed Standard does not appear to recognize that managers have many strong incentives to maintain effective ICFR and responsibly assess ICFR under SOX 404(a). Moreover, as noted above, other high-profile provisions of SOX, such as SOX 302, make many SOX 404(a) requirements additive, if not duplicative, of management's other duties and liability-creating actions.

While SOX 404 is the accounting professions principal activity around ICFR, it is merely the most expensive aspect of the issuers' extensive and ongoing responsibility to design, operate, assess and report on ICFR. The Board's new ICFR audit standard should therefore be more directive in limiting the auditor's work regarding many aspects of the work already done by management in assessing the effectiveness of ICFR. We offer the following specific recommendations on the assumption – which we hope is incorrect – that the Commission and the Board will continue to require an external audit of the effectiveness of ICFR.

b. Specific Recommendations for Improving AS-5 as a Standard for the Full Audit of the Effectiveness of ICFR.

1. <u>The Standard should emphasize the same standard of "reasonableness" in ICFR audits as management is required to follow in its assessment.</u>

AS-5 should prominently incorporate the language of the SEC Release regarding the overarching application of "reasonableness" in each aspect of SOX 404 compliance. See SEC Release, pp. 13-15. At a minimum, the auditor should not apply a more stringent standard of reasonableness than management is required to use in its assessment under SEC rules and guidance. The Board's proposed amendment to Interim Standard AU sec. 230, *Due Professional Care in the Performance of Work,* contains a more stringent standard. It says: "[A]lthough not absolute assurance, ***reasonable assurance is a high level of assurance***." [emphasis supplied].[10]

"Reasonable assurance" is a key concept in the SEC's guidance and it is defined there quite differently than in this PCAOB rule.[11] According to the SEC Release, its definition of "reasonable assurance" is the "level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."[12] A "high level" of assurance could clearly be contrasted with the SEC definition to cause an auditor to conclude that the auditor's standard for ICFR is higher than management's. In any case, a different way of defining such a central term introduces ambiguity and adds nothing useful. Therefore, either the language quoted above

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[10] PCAOB Release 2006-007, Amendments, p. A4-2 (Dec. 19, 2006).
[11] *Supra,* Note 8.
[12] SEC Release, p. 15 (quoting 15 U.S.C. Section 78(m)(b)(7)) (providing the definition of "reasonable assurance," to which SEC Section 404 implementing rule referred).

should be removed from proposed AU sec. 230, or AS-5 should explicitly incorporate the SEC definition for purposes of an audit of ICFR instead of AU sec. 230. This is just one example of the need to edit the auditing guidance to ensure that management and the auditor are operating from a common set of definitions and principles. The Proposed Standard and all other auditing rules should be reviewed and amended to conform to the SEC's more cost-effective notion of reasonableness.

2. The auditing standard should require the auditor to begin the determination of audit scope with the management's assessment.

Management is responsible for determining the scope and depth of its ICFR assessment, with "cost of compliance" as a key consideration.[13] Currently, because of the lack of guidance in this area, management has built its SOX 404 approach on the auditors' scoping and testing requirements. These requirements have come from either the PCAOB standards or frameworks developed by others in anticipation of the way the audit firms view their requirements. It would clearly be more cost effective for the audit process to begin with management's scope and considerations of risk. In practice, this approach to scoping could result in a process in which both management and the auditors agree in advance on the proposed scope. AS-5 should, therefore, direct the auditor to begin the scoping process by understanding the risk-based judgments management makes in determining the breadth and depth of its assessment.

3. The risk-based approach to ICFR audits should encourage well-known techniques for limiting cost and effort in areas where mitigating controls or prior knowledge lower the risk of a material deficiency.

While the new standard emphasizes a risk-based approach to auditing, it fails to state that a cost effective audit entails the assumption of risks. These risks include the near certainty that there will be elements of ICFR that management, in good faith, has failed to correctly identify as ineffective. In other words, risk-based audits entail accepting certain risks that material matters will escape both the management's and the auditor's review. Standards on

[13] *Id*., "the concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the cost of compliance." Conference Committee Report on amendments to the Foreign Corrupt Practices Act, Cong. Rec. H2116 (daily ed. April 20, 1988).

ICFR audits should clearly embrace such a concept so that the risk threshold used by the external auditor in their assessment of ICFR is not set at a level that requires excessive work. Reasonable assurance for prudent officials in the conduct of their own affairs means accepting a reasonable level of risk. Given the economics, the liability and the general caution that have driven auditors' reading of AS-2, AS-5 will bring about risk-based ICFR audits only if it is clearer and more mandatory regarding the assumption of such risks.

For example, despite its focus on risk-based audits, AS-5 explicitly excludes rotational testing in an area where it could be most effective. Especially in more mature companies, it is not unusual for a situation in a subsequent year to be the same as in a prior year. Such situations exist where, for example, key processes have not changed from the prior year, no material weaknesses or significant deficiencies were noted in the prior year, management's assessments of the significant processes uncover no problems, and inquiry reveals that the processes are the same as in the prior year. This is a case where the auditor should be allowed, or even mandated to test those processes on a rotational basis. AS-5 only takes a half-step in this direction by permitting auditors to take into account knowledge gained in prior years as a basis for a lower level of testing. Far more reliance on a prior year's audit and management's current year work should be permitted or mandated.

AS-5 must also be improved in the area of walkthroughs if it is to promote risk-based audits. The Board has properly focused on walkthroughs as a source of excessive cost. While it is an improvement over AS-2, AS-5 still requires walkthroughs of each significant process. Again the use of rotational testing can increase audit efficiency. Requiring repeated walkthroughs in every significant process year after year is wasteful. It fails to recognize that risks diminish when there have been no changes to controls tested in the previous audit and it is inconsistent with a risk-based approach. Therefore, AS-5 should expand on the meaning of "the use of prior knowledge" to include wide latitude to perform walkthroughs on a rotational basis.

4. The new Standard on the Use of the Work of Others must be more directive.

The Proposed Standard on the use of work of others is a definite improvement over the previous guidance. However, given the incentives of the external auditor, and the many reasons to discount the use of others' work under the new standard, it is very likely that much acceptable work of others will be duplicated by the auditor. In particular, the standard's provisions on evaluation of the competence and objectivity of others could easily exclude much of their work. Furthermore, it is likely that the auditor would waste significant time merely evaluating the competence and objectivity of others prior to any decision to actually use their work, even in low risk areas.

The new standard has two full pages of considerations and processes for evaluating the competence and objectivity of others for the auditor to apply. A cost-effective standard on the use of the work of others should result in an increase in the use of their work. It also should be easy to apply. With these goals in mind, we recommend that the new standard be simplified. It should explicitly say that the auditor should rely on the work of management, internal auditors or outsourced auditors unless there is an indication that the work of others presents a significant risk of ICFR failure in a financial reporting process. In particular, the auditor should be limited to spot checking the quality of the work done by others. In other words, it should be presumed that work done by others pursuant to management's assessment and reporting obligations under SOX 404(a) is useable. Otherwise, the subjective evaluation of the competence or objectivity of others under this standard will be wasteful.

5. The PCAOB inspection process should involve sanctions for failure to perform ICFR audits efficiently.

Several of our accelerated filer members have noted that financial statement and ICFR audits are not being integrated. In fact, they are being performed by two separate audit teams from the same firm. This duplication of effort leads to excessive costs and is in direct contravention of the statutory language of SOX 404. We appreciate the fact that the Board intends its inspections to focus on audit efficiency. However, it seems that the most serious sanctions against a firm arise from doing too little auditing, not too much. Therefore, there is a need for countervailing incentives to conduct audits efficiently. Thus far auditors have either not adequately planned for integrated audits or have made the choice to protect against other risks and accept the risk that comes from performing an audit inefficiently. Given the very real pressures for auditors to ignore efficiency and the issuers' meager bargaining leverage, the PCAOB inspection process is a key to promoting audit efficiency. Therefore, the PCAOB should devise some aspect of its inspection process to provide more concrete incentives for the audit firms to conduct ICFR audits efficiently than currently exist.

6. Efforts at "scalability" for smaller companies under AS-5 are not likely to result in cost-effective audits.

We appreciate the effort the PCAOB has made to include guidance as to how assessments of ICFR of smaller companies will vary from audits of larger, more complex companies; however, we are concerned that auditors will not always consider these factors when auditing smaller companies. Liability risks tend to drive external auditors to insist upon levels of detail and degrees of assurance that are excessive. Smaller companies with limited staff and less segregation of duties will heighten auditor liability concerns. Therefore, we believe that in practice, audits of smaller companies will not be scaled and compliance costs for smaller companies will continue to be disproportionately high under AS-5. The Proposed Standard could mitigate this concern by explicitly endorsing the level of $700 million market capitalization or $250 million in revenue[14] as indicative of a smaller public company and mandate that the audit of a smaller company should vary from that of a larger company in the six ways cited in paragraph 12 of the Proposed Standard.[15]

CONCLUSION

Much work has been done to address the problems arising from the implementation of SOX 404. More work is needed. It is critical now that the SEC and the PCAOB rise to the challenge. The goals they have set require more than rules and standards that, in theory, should promote more efficient SOX 404 compliance. The Board and the Commission must force wasteful excess out of the SOX 404 compliance process. We hope our suggestions are helpful.

We would be pleased to discuss these and any related matters. Please feel free to contact Ken Schramko of SEMI's staff or Lisa Tafoya of the FSA's staff to discuss these matters.

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[14] See *Final Report of the Advisory Committee on Smaller Public Companies*, Part II. Scaling Securities Regulation for Smaller Companies, pp. 14-22 (April 23, 2006).
[15] PCAOB Release 2006-007, Standard, p. A1-8 thru 10 (Dec. 19, 2006).

Sincerely,

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Comments on Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements

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Submitted Electronically on February 26, 2007

The Silicon Valley Leadership Group (Leadership Group) appreciates the opportunity to comment on the PCAOB's recent Release Number 2006-007, "An Audit of Internal Control Over Financial Reporting that is Integrated with a Audit of Financial Statements" ("PCAOB Release").

Please find attached the Leadership Group's Section 404 Reform Recommendations, focused principally on Section 404 (b). Our comments in respect to the PCAOB Release will be focused primarily on the issues we raised in our adopted position.

The Leadership Group has separately offered comments on the companion Release Numbers 33-8762 and 34-54975 of the Securities and Exchange Commission (the "SEC"), "Management's Report on Internal Control Over Financial Reporting" (the "SEC Release"), which follows.

Given our concerns with the burdensome and duplicative expense associated with regulatory implementation of Section 404 (b) of Sarbanes-Oxley, we are pleased that the PCAOB has determined to replace current Accounting Standard No. 2 with an entirely new standard for internal control audits, and has also reframed the new standard for such audits at least as nominally "integrated with", rather than "in conjunction with", the annual audit of the issuer's financial reports.

We believe this is wholly consistent with the original Congressional intent of Sarbanes-Oxley that the audit of financial controls not be the subject of a "separate" audit engagement but rather be truly integrated with the financial statement audit. We believe, however, that the PCAOB could go further in offering specific guidance on how to ensure effective "integration" of the Section 404 and financial statement audits. We offer responses to the questions in this release to suggest how the PCAOB should provide additional guidance.

It is also essential that the confusion between the accounting profession and the PCAOB regarding Section 404 (b) implementation not be replaced or even exacerbated by inconsistencies between the PCAOB Release and the SEC Release in relation to key terms of reference for Section 404(b) implementation.

Below are our responses to Questions 1-27 posed in the Release.

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

A top down approach is the most effective and efficient approach to assess the quality of a company's internal controls over financial reporting. However, the proposed standard does not provide the level of specificity required by auditors and their client companies to ensure that a consistent, defined standard is applied to all public companies. We believe the audit standard should provide examples of best practices in entity levels controls, which are common to most public companies. The standard should then prescribe the effect of a strong, moderate or weak control environment should have on follow on test work. For instance, if a Compensation sub-committee of the Board of Directors approves an employee incentive program from the outset and then approves or rejects the results of the program, what impact should that have on testing of management's detailed controls over the program, as compared to an employee incentive program with no Board of Director Oversight?

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

The Standard should be enhanced to provide more details on how an auditor should implement the top down approach, particularly as it pertains to assessing the entity level controls and risk of fraud. Again, if the Standard provided insight into deemed best corporate governance practices, an auditor can assess whether the client company has adopted such best practices and thus make a quantitative judgment regarding risk of fraud.

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

It could, but only if the Standard provides a better definition of corporate governance best practices which minimize the risk of fraud.

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?

Not in its current form. The Standard should provide a better definition of corporate governance best practices which minimize the risk of fraud.

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?

No. The standard should provide some specific examples. For example, the standard could provide that for lower risk processes, allowable evidence could include: self assessments and management reviews (e.g., evidence of balance sheet review), whereas areas that are deemed to be higher risk (e.g., revenue cut-off, or complex tax or stock option calculations) would require more specific objective evidence.

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

Yes, and the standard should specifically allow the auditor to rely on walkthroughs performed in previous years – even for higher risk processes. The auditor could do an inquiry and consider the following factors: the process and people performing the process haven't changed, no additional risk factors have been introduced into the process, the process is low risk and/or the auditor will be perform substantive audit procedures of process anyway as part of the audit.

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?

No, the term 'significant' as a replacement of 'more than remote' is not helpful to companies or their auditors, as this middle tier of control deficiency unnecessarily increases the level of judgment and debate surrounding categorization of deficiencies. We propose that the middle tier known as significant deficiencies be eliminated and that all deficiencies be assessed in terms of 'control deficiencies' or 'material weaknesses'. The notion of a middle ground is the subject of unproductive debate.

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?

No, it would appear to the casual observer that most material weaknesses materialize immediately subsequent to either an announcement of a company's restatement of its financials, or due to uncovering an accounting issue during the substantive audit. It does not appear that test work related to the internal control environment uncovers material weaknesses. The standard should focus auditors on the top ten material weakness areas such as quality and sufficiency of accounting staff, income taxes, revenue recognition, derivatives/fair value accounting, compensation, etc.

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?

Yes, it is reasonable to expect that the use of a term that has been historically used in the accounting vernacular will decrease the assessment effort.

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?

The assessment of deficiencies in an internal control environment is predicated on the professional judgment of both the Company's management and its auditors, the two parties most familiar with the facts and circumstances. Therefore, we agree that is makes sense that no particular deficiencies be prescribed as either significant or as a strong indicator or a material weakness. The company's management and its auditor are the only parties in a position to make this assessment and we should rely on their judgment, subject to regulatory oversight.

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

Move to a performance-based system of conducting external SOX audits on a rotating basis for those companies who have achieved an annual audit with no material weaknesses. While we agree that detailed internal controls documentation is essential for all complex and high volume transaction processes, we encourage more widespread use of the integrated audit, whereby substantive audit procedures supplemented with summary controls documentation will suffice for certain non-complex and low volume transaction processes.

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 reference has previously been incorrectly interpreted by auditors to be a scoping reference. Codifying into the guidance itself that this relates solely to the assessment of deficiencies and not to provide additional scoping guidance should address the issue without having to remove the reference from the definitions.

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

This change is positive, as there should be one opinion on the effectiveness of a company's internal controls over financial reporting. It could reduce management's work by not requiring management to meet the same audit standards that their auditors are required to meet, but if management plans to have auditors rely on their work (less direct testing by the auditor) then this change won't reduce management's effort - as reduced management effort would mean increased effort by auditors. It could help companies that don't have the resources internally to conduct extensive "formal" internal testing requirements, by allowing their auditors to perform that work.

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

Yes - by directly testing the controls; but as pointed out in the guidance, if the auditor is going to rely on management work (work performed by others), then the auditor will still need to evaluate management's 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?

Yes, and investors need to understand if controls are effective and financials are not materially misstated.

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

Yes. We believe good examples were provided to allow reduced direct testing for processes deemed to be lower risk and that have tested effectively in previous years' audits.

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?

When the auditor has already performed a walkthrough of the process in the previous year and the process, and people performing the process, have not changed; where the testing has shown that the controls have repeatedly been effective; where no new risk factors have been introduced into the process; where the process is low risk, and/or the auditor will be performing substantive audit procedures for the process as part of the audit.

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?

This should help reduce the testing requirements for multi-location audits, but the proposed language could provide more specific examples (e.g., for testing processes that are the same in multi-locations, the auditor should not impose a separate requirement to achieve the maximum sample sizes in all locations unless there was a specific risk to that specific location).

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?

Yes.

(19., cont.)If different frameworks are necessary, how should the Board minimize the barriers to integration that might result?

N/A

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?

Yes.

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

It depends. In theory, if the company has a strong monitoring function (i.e., Internal Audit) that evaluated processes regularly and identifies control deficiencies, fraud or financial misstatements, then the auditors should be able to rely on that information to reduce their own direct evaluation of the processes. In practice, usually auditors will dive more deeply in their evaluation of areas that the company has identified weaknesses. This proposed language will probably not change the auditor's practice.

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

No. It's not necessary and the proposal to remove the principal evidence provision from AS No. 2 is an improvement. If the auditor concludes that they can rely on the work of others, then they should place reliance on the evidence produced by the work of others. The process to conclude that they should be able to rely on the work of others includes a process to evaluate that work, including examining the objectivity and competence of the people performing the work.

23. Does the proposed standard provide an appropriate framework for evaluating the competence and objectivity of the persons performing the testing?

For the most part, the proposed framework is appropriate. It is very positive that the framework as proposed does not arbitrarily limit the use of the work of others in specific areas but allows judgment to be used. It is also positive that the framework explicit states the areas that the auditor might use the work performed by others. This should expand the auditors' willingness to rely on the work of others where appropriate. What is noticeably absent from the framework presented, however, are illustrative examples as previously provided in the guidance of AS No. 2. Given the level of judgment permitted in this framework, a variety of illustrative examples will be critical to the successful dialogue between management and auditors.

(23., cont.) Will this framework be sufficient to protect against inappropriate use of the work of others?

Yes. The emphasis on the "Responsibilities of the Auditor" and the direct reminder that the responsibility rests <u>solely</u> with the auditor, in conjunction with the rest of the framework, will act sufficiently to protect against inappropriate use of the work of others.

(23., cont.) Will it be too restrictive?

It is difficult to determine at this time, but possibly.

24. Has the Board identified the right factors for assessing competence and objectivity?

Yes.

(24., cont.) Are there other factors the auditor should consider?

Not at this time.

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?

This is a positive factor as it will result in management evaluating if it is compensating individuals performing the work in a way that would compromise objectivity. Again, to avoid inaccurate interpretation of this element and lengthy unproductive debates, illustrative examples of the intent of this factor should be provided.

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

Yes, and even for significant processes, walkthroughs should not be required every year. If the auditor has already performed a walkthrough of the process in the previous year, the auditor should be specifically allowed (by the audit standard) to consider the following factors: whether the process, and the people performing the process, are stable and haven't changed, whether additional risk factors could be introduced into the process, whether the process is lower risk, and even if it's higher risk, whether the auditor substantive audit procedures will be sufficient to conclude that the process is effective and that it would not be reasonable possible that a material misstatement could occur.

27. Is it appropriate for the auditor to use others as direct assistance in performing walkthroughs?

Yes, but we believe it's appropriate for the people who are performing critical tasks to be responsible to participate in the walkthrough at least once so that the company and the auditor can conclude that the people performing the tasks understand their roles in performing critical controls.

(27., cont.) Should the proposed standard allow the auditor to more broadly use the work of others in performing walkthroughs?

Yes, and this would especially be appropriate if the auditor had already performed a walkthrough of the process in a previous year and if the people performing the walkthroughs are competent and independent.

Finally, we choose to address via narrative questions 28-32 of the PCAOB Release as to whether its new proposed standard appropriately describes how auditors should "scale" the audit for the size and complexity of the company; what other attributes or differences with respect to smaller companies the PCAOB should address; whether the discussion of complexity in the standard limits flexibility as to scaling; and whether the market capitalization and revenue thresholds in the standard are meaningful in terms of company size for the purpose scaling the audits of internal controls.

First, we are satisfied with the measures of company size used as benchmarks in the standard. As to the prior questions on scalability, we return to the central concern of the Leadership Group's position: the extraordinarily adverse financial and operational effect of the Section 404(b) regulatory framework on smaller public companies.

Although the SEC argues in its Release that its new "top-down, risk-based approach should enable smaller public companies in particular to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances," it is not clear that the companion PCAOB Release will, by its terms, result in establishing a scalable model for audits of internal controls.

The PCAOB Release asserts that the auditor should evaluate the "size and complexity" of the company when planning and performing such audits, and lists specific attributes where the audit of a smaller company "might vary from the audit of a larger and more complex company" (PCAOB Release, Paragraphs 9-12). But the list is hardly exhaustive; it does not include, for example, an acknowledgement of the more limited financial resources available in smaller companies to pay for any audit services not fully integrated with the audit of financial reports, or the degree of sophistication and robustness of the IT systems supporting the financial controls in smaller companies.

Moreover, the PCAOB also indicated that even the six areas of the internal controls audit affected by these attributes of smaller companies would merely provide "the foundation for planned guidance on auditing internal controls in smaller companies to <u>be issued next year</u>" (emphasis supplied). Thus, it appears there will not be any truly comprehensive PCAOB guidance on Section 404(b) audits in respect to smaller company financial control audits <u>until 2008 at the earliest.</u>

We therefore reiterate our view that, in light of the potential for continuing confusion and significant cost, smaller companies should be exempted from Section 404 (b) compliance, at least until both the SEC and the PCAOB promulgate specific and internally consistent guidance for both management and auditors in respect of internal control attestation. Smaller public companies cannot afford to "wait till next year" for standards that are fully thought through by the regulators.

In conclusion, we note that an alternate approach to relieve the duplicative, burdensome and costly impact of 404 (b) compliance requirements would be to remove the requirement for auditor attestation of the financial controls themselves and instead require solely an attestation of management's assessment of such controls. This is, of course, the opposite of the current proposal but offered in the same spirit. We believe this approach is worthy of serious consideration on the parts of both the SEC and the PCAOB because it would appear to have a more far-reaching and salutary impact on the issues of complexity and excessive costs. Furthermore, it may be the best way in a regulatory context to emphasize the primacy of management's responsibility over internal controls over financial reporting. We would be pleased to provide additional comment should the SEC and PCAOB choose to explore this alternative further.

Sincerely,

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Sarbanes-Oxley Section 404 Reform Recommendations

Adopted December, 2006

The Sarbanes-Oxley Act of 2002, commonly known as SOX, is a set of accounting and auditing rules applicable to publicly-traded US companies which has resulted in significant costs to those corporations – particularly for compliance with Section 404.

SOX compliance brings with it a heavy burden that strains resources that could otherwise be used for critical research and development or other corporate initiatives to improve company management, expand into new markets and increase investor value.

While we are heartened by recent developments at the Public Company Accounting Oversight Board (PCAOB) and the Securities and Exchange Commission (SEC) to address the challenges identified by the business community, we support significant regulatory and/or legislative relief from the burdens imposed by Section 404(b) by exemption of smaller public companies and other means.

The Leadership Group and its member companies categorically support the objectives of the Sarbanes-Oxley Act of 2002; namely, to achieve increased management accountability for establishing and maintaining disclosure controls and procedures and enhanced internal control over financial reporting and detection of fraud and malfeasance.

However, the Leadership Group does not support the application of Section 404(b) to smaller companies – that is, companies that do not meet the definition of an accelerated filer. Due to lower staffing levels and insufficient earnings, smaller and micro-cap companies can not support the burdensome administrative overhead required to successfully comply with Section 404(b).

We feel that Section 404(b) is damaging the competitiveness of U.S. capital markets as it has been applied. We are already noting a trend of an increasing number of private companies seeking initial public offerings on foreign stock markets to avoid the costly requirements of Section 404(b) compliance.

The member companies also feel that a lack of clarity and agreement between the auditors and their regulators regarding Section 404(b) has resulted in undue burdens on all public companies. We therefore recommend a thorough review of 404(b), implementation of clearer guidance, and greater conformance with pre-existing audit standards - within six (6) months - for accelerated filers.

In light of such confusion and significant costs, the Leadership Group recommends that smaller companies be exempt from SOX Section 404(b), and that the SEC and the PCAOB quickly move to establish clearer guidance regarding its implementation for accelerated filers. We hope this can be achieved largely by confirming that compliance with existed, well-established standards, such as AU section 319, constitutes compliance with Section 404(b).

Short of the above recommendations, there are alternative means to modify Section 404 and the applicable audit standard to effectively achieve the objectives of SOX internal control assessments than under current practice – to whit:

- Move to a performance-based system of ***conducting external SOX audits on a rotating basis*** (as described in the attached matrix) for those companies who have achieved an annual audit with no material weaknesses. While we agree that detailed internal controls documentation is essential for all complex and high volume transaction processes, we encourage ***more widespread use of the integrated audit***, whereby substantive audit procedures supplemented with summary controls documentation will suffice for certain non-complex and low volume transaction processes.

- ***Modify the timeframe for management testing*** of internal controls to span a longer period, ***e.g. three year cycle***, ***based on a risk assessment model***. With this approach, ***higher risk processes/controls are tested annually***, and lower risk processes/controls are tested on a rotating basis. A risk-based approach to testing permits more time and emphasis to be placed on higher risk areas and internal control enhancements. While this model will ***require close coordination between auditors and their clients,*** we do not believe it would result in any notable incremental effort over the amount currently expended to coordinate management and external auditor testing.

- ***Encourage regulators to develop more detailed guidance for auditors*** to counter-balance the incentive for audit firms to interpret SOX conservatively. While understandable, a healthy counter-balance to this conservatism is required to prevent bloated, ineffective audit regimes. ***The PCAOB needs to clarify and codify risks, definitions, and scope*** – both quantitative and qualitative. We also recommend that PCAOB and SEC guidance surrounding key definitions relied upon in Section 404 compliance, including "significant deficiency", "remote likelihood" and "material weakness", be revisited.

We intend to actively engage in reform efforts at the PCAOB and SEC. In addition, if a proposal to amend SOX is introduced in the new Congress, such as the COMPETE Act of the previous session, we would consider that an excellent starting place for the reforms sought here.

Status	Events & Triggers	Audit Type	
		External	Internal
Year 1	Clean Opinion.	Full Scope Audit.	Full Scope Audit.
Year 2		Full Scope Audit for 1/3 of Companies, Based on a Rotating Schedule; Attestation and Management Certifications to Correspond.	Rotation of key control testing based on risk assessment.*
Year 3		Full Scope Audit for 1/3 of Companies, Based on a Rotating Schedule; Attestation and Management Certifications to Correspond.	Rotation of key control testing based on risk assessment.
Year 4 +		Cycle continues.	
Any Year - Isolated Material Weakness	*Isolated Material Weakness:* Limited to a single functional area or financial statement line item. (e.g., tax process or A/R financial statement line item).	Limited Scope Audit.	Full examination audit of key controls related to process or financial statement line item where material deficiency occurred. Rotation of key control testing based on risk assessment.
Any Year - Pervasive Material Weakness	*Pervasive Material Weakness:* More than one material weakness or multiple significant deficiencies involving a pervasive break-down in controls (e.g., personnel hiring / staffing deficiencies or pervasive lack of appropriate reconciliations or management reviews).	Full Scope Audit.	Full Scope Audit.
Plus - 1 Year	Clean Opinion.	Full Scope Audit.	Full Scope Audit.
(repeat cycle above)			
Any Year - Material change in entity-wide controls over financial reporting	For example, major changes in key company personnel or an ERP implementation.	*Full or Limited Scope Audit,* based on risk assessment. If change or factors could have a pervasive impact on processes and/or financial statement accounts, then full examination is called for.	*Full or Limited Scope Audit,* based on risk assessment.

* Risk assessment to include quantitative and qualitative considerations. With this approach, higher risk processes/ controls are tested annually, and lower risk processes/controls are tested on a rotating basis. A risk-based approach to testing permits more time and emphasis to be placed on higher risk areas and internal control enhancements.

Comments on SEC File No. S7-24-06, Management's Report on Internal Control Over Financial Reporting

Submitted Electronically on February 26, 2007

The Silicon Valley Leadership Group appreciates the opportunity to submit comments in respect to the Securities and Exchange Commission's Release No. 33-8762 and 34-54976 regarding Management's Report on Internal Control Over Financial Reporting (File No.: S7-24-06, the "Release").

This Release is largely concerned with Section 404(a) of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), while the Leadership Group's attached Section 404 Reform Recommendations focus principally on Section 404 (b) requiring auditor attestation regarding financial controls; in particular the adverse impact on smaller public companies, and the competitiveness of U.S. capital markets, of its burdensome and costly requirements.

Our comments will therefore first address the change proposed in the Release to the Commission's current rule implementing Section 404(b). We commend the proposed modifications to Rules 1-02(a) and 2.02(f) of Regulation S-X, eliminating the separate auditor's attestation as to management's assessment of internal controls, which has created significant confusion, inconsistency and duplication of effort, all of which have been especially burdensome for smaller public companies.

We agree with the Commission's focus on a direct opinion on the effectiveness of internal controls. Moreover, we believe that the foundation and framework for such opinion is included in preexisting auditing requirements, specifically under AU Section 319, and hence, does not require duplication or supplementation, under Section 404(b) of the Sarbanes-Oxley Act or otherwise. As the Commission itself has stated, the "establishment and maintenance of internal controls has been required of public companies since enactment of the Foreign Corrupt Practices Act of 1977", which was implemented by AU Section 319.

Accordingly, in specific response to the Commissions question as to whether this proposed rule revision effectively communicates the auditor's responsibility or whether "another alternative would better convey the auditor's role with respect to management's assessment and the auditor's reporting obligations," we believe that further clarification is required. This will prevent unnecessary cost, duplication of effort and confusion on the part of auditors and companies in connection with the preparation and audit of financial statements and the assessment and reporting on internal controls. Fortunately, we believe the clarification is apparent and leverages current practices. The preexisting requirements of AU Section 319 mandate an auditor to assess a Company's internal controls in connection with its standard audit and audit opinion process.

It is our belief that these requirements are sufficient, in and of themselves, to support and satisfy the auditor attestation/opinion requirements of Section 404(b). Moreover, it is our belief that conformance of Section 404(b) with AU Section 319 will significantly achieve the Commission's current objectives to reduce confusion, work duplication and inconsistency. Accordingly, we respectfully suggest that the following alternative language would be more properly aligned with the clear legislative intent of Sarbanes-Oxley that the auditor's assessment of internal controls should be considered an integral part of the audit report "and not the subject of a separate engagement."

Specifically, we propose that the Commission simply confirm by rule that:

A. "Compliance with the requirements of AU section 319 constitutes compliance with Section 404(b);"
B. "The requirements of related Section 103 (a)(2)(A)(iii) of the Act are deemed satisfied by a description of the standard processes used by the relevant auditor to comply with AU section 319;" and
C. "Nothing in Section 404(b), or elsewhere in the Sarbanes-Oxley Act of 2002, shall be deemed to modify AU section 319 in any manner or to impose additional requirements or procedures with respect to the compliance therewith."

The Leadership Group's further comments and responses to the Commission's questions at pages 49-51 and 53-54 of the Release are limited to the provisions of the Release which address the concerns raised in our adopted position.

Our position relative to Section 404 (a) suggested modification of the timeframe for management's testing of internal controls to a three-year cycle based on a risk assessment model. We also urged clarification of the Commission's and PCAOB's guidance concerning the meaning of terms such as "significant deficiency," "remote likelihood" and "material weakness".

Accordingly, we are pleased that the Commission has provided specific guidance to management to adopt what our position termed a "top-down, risk-based approach" to determine whether internal controls adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner, and further that management's "evaluation should be based on its assessment of risk". We believe that such an assessment model would indeed allow for the rotational approach to testing controls that the Leadership Group has suggested.

We also support the effort by the Commission, as well as the PCAOB in its parallel Release No. 2006-07 (the "PCAOB Release") to clarify definitional issues and thereby address the lack of clarity and agreement between auditors and their regulators which is resulting in undue burdens on all public compliances.

We note that the Commission's definition of "smaller" companies in the Release with specific reference to the existing definition of "large accelerated filers" is a helpful clarifying step.

The Commission's useful new definition of material weakness provided at page 13 of the Release, however, begs the question whether the PCAOB "re-articulation" of its definition of the same term will be understood the same way. It is essential that the current lack of clarity between <u>auditors</u> and the PCAOB not be replaced and exacerbated by lack of consistency between the <u>Commission</u> and the PCAOB. We will address such apparent inconsistencies in our separate letter of comments on the PCAOB Release.

In terms of the specific questions raised at pages 53-54 of the Release concerning the Commission's interpretive guidance for management's assessment of the effectiveness of internal controls, we believe that such guidance should be:(i) voluntary in terms of issuer choice, since many have adopted their own processes while waiting five years for specific guidance from the Commission; (ii) implemented by rule, to provide maximum clarity going forward; and (iii) deemed a <u>non-exclusive</u> safe harbor for demonstrating compliance with Section 404(a).

This new specific guidance is clearly preferable to the current state of affairs, which the Commission itself acknowledges has led management to misapply the PCAOB's Auditing Standard No. 2 regarding audit firms' internal control attestation to the management assessment process. Auditing Standard No. 2 was never intended to serve this purpose, and has in fact been so ineffective in serving the purpose for which it was intended that the PCAOB Release abandons it altogether in favor of a wholly new formulation of standards for the auditor's attestation. This new standard is "integrated with" the audit of the company's financial reports: we are pleased that this recasting at least of the <u>title</u> of the Auditing Standard for Section 404 (b) is consistent with the core recommendations of the Leadership Group.

Finally, we address the Commission's question at pg. 53 of the Release as to whether it should "consider change to other definitions or rules". In light of our belief (now apparently shared by the PCAOB) that the nature of the internal controls audit under Section 404 (b) must be truly integrated with the financial report audit and no longer a separate opinion "in conjunction with" such audit, we return to our central concern: the extraordinarily adverse effect of the Section 404(b) regulatory framework on smaller public companies.

Although the Commission argues that its new "top-down, risk-based approach should enable smaller public companies in particular to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances," it is really not yet clear that the PCAOB Release will result in an equivalently scaleable approach to the auditing of internal controls.

The PCAOB Release does assert that the auditor should evaluate the "size and complexity" of the company when planning and performing such audits, and lists six specific attributes where the audit of a smaller company “might vary from the audit of a larger and more complex company” (PCAOB Release, Paragraphs 9-12). However, the PCAOB also indicated that these six attributes would provide the foundation for planned guidance on auditing internal controls in smaller companies “to be issued next year”. Thus, it appears there will not be any truly comprehensive PCAOB guidance on Section 404(b) in respect to smaller companies until 2008 at the earliest.

We therefore reiterate our earlier view that, in light of the potential for continuing confusion and significant cost, smaller companies should be exempted by the Commission from Section 404 (b) compliance, at least until both the Commission and the PCAOB promulgate specific and internally consistent guidance for both management and auditors in respect of internal control attestation. Smaller public companies cannot afford to “wait till next year”.

In conclusion, we note that an alternate approach to relieve the duplicative, burdensome and costly impact of 404 (b) compliance requirements would be to remove the requirement for auditor attestation of the financial controls themselves and instead require solely an attestation of management's assessment of such controls. This is, of course, the opposite of the current proposal but offered in the same spirit. We believe this approach is worthy of serious consideration on the parts of both the SEC and the PCAOB because it would appear to have a more far-reaching and salutary impact on the issues of complexity and excessive costs. Furthermore, it may be the best way in a regulatory context to emphasize the primacy of management's responsibility over internal controls over financial reporting. We would be pleased to provide additional comment should the SEC and PCAOB choose to explore this alternative further.

Sincerely,

Carl Guardino
President & CEO, Silicon Valley Leadership Group

SBA
Office of Advocacy
www.sba.gov/advo

Advocacy: the voice of small business in government

February 21, 2007

Via Electronic Mail

The Honorable Christopher Cox, Chairman
U.S. Securities and Exchange Commission
Attn: Nancy M. Morris, Secretary
100 F Street, NE
Washington, DC 20549
Electronic Address: rule-comments@sec.gov

The Honorable Mark W. Olson, Chairman
Attn: Office of the Secretary
Public Company Accounting Oversight Board
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Re: SEC File Number S-7-24-06; Management's Report on Internal Control Over Financial Reporting (71 Fed. Reg. 77,635); PCAOB Release No. 2006-007; Proposed Auditing Standard

Dear Chairmen Cox and Olson:

The Office of Advocacy (Advocacy) of the Small Business Administration (SBA) respectfully submits this comment letter on the U.S. Securities and Exchange Commission's (SEC) proposed interpretative guidance and proposed rule, *Management's Report on Internal Control Over Financial Reporting*,[1] and the Public Company Accounting Oversight Board's (PCAOB) proposed revised auditing standard, *An Audit of Internal Control Over Financial Reporting*.[2] Advocacy acknowledges the efforts undertaken by the SEC and the PCAOB to make the internal controls reporting requirements under Section 404 of the Sarbanes-Oxley Act (SOX)[3] more cost-effective and efficient for small public companies.

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[1] *Management's Report on Internal Control Over Financial Reporting; Proposed interpretation; Proposed Rule*, 71 *Fed. Reg.* 77,635 (Dec. 27, 2006).
[2] *Proposed Auditing Standard-An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Proposals*, Release No. 2006-007 (Public Company Accounting Oversight Board, Dec. 2006), *available at*: http://www.pcaobus.org/Rules/Docket_021/index.aspx.
[3] *Sarbanes-Oxley Act of 2002*, Pub. L. No. 107-204, 116 Stat. 745 (2002).

Advocacy hosted a roundtable on Friday, January 26, 2007, to solicit input from small business representatives on the new proposals by the SEC and the PCAOB. Advocacy applauds the many dedicated members of the SEC and the PCAOB who attended this roundtable and explained the proposals, answered questions, and listened to the concerns of the small business community. This comment letter discusses a few of the major problems raised by small businesses, in particular: 1) the need for further exemptions due to the recent receipt of the guidance and the revised auditing standard, 2) the request for clarifications of major provisions in these proposals, and 3) the issue of whether these proposals actually "fix" the problem of scalability and high costs in internal controls reporting for small public companies.

Based on small business comments, Advocacy believes that the Section 404 requirements may still impose large and disproportionate costs on small public companies after these proposals are finalized, which may restrict the ability of a new generation of small, innovative companies from seeking capital in the U.S. capital markets. Advocacy strongly recommends that the SEC continue to provide further exemptions for small public companies until such time as more cost-effective procedures for internal controls reporting can be developed.

I. The Office of Advocacy

Congress established the Office of Advocacy in 1976 by Pub. L. 94-305 to represent the views and the interests of small business within the federal government. Advocacy is an independent office within SBA, so the views expressed by Advocacy do not necessarily reflect the views of the SBA or the Administration. The Regulatory Flexibility Act (RFA),[4] as amended by the Small Business Regulatory Enforcement Fairness Act (SBREFA),[5] gives small entities a voice in the rulemaking process. For all rules that are expected to have a significant economic impact on a substantial number of small entities, federal agencies are required by the RFA to assess the impact of the proposed rule on small business and to consider less burdensome alternatives.[6] Advocacy regularly hosts small business roundtables to solicit feedback and information from small business representatives on regulatory proposals.

II. Background

In 2003, the SEC adopted rules implementing Section 404 of SOX, which required public companies to submit reports on their internal controls, or systems in place in a company to guard against fraudulent or mistaken transactions and to ensure the accuracy of annual financial reports.[7] Section 404(a) requires that management provide a report assessing the effectiveness of their internal controls. Section 404(b) requires an external auditor to

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[4] *Regulatory Flexibility Act of 1980*, Pub. L. No. 96-354, 94 Stat. 1164 (1980) (codified as amended at 5 U.S.C. § 601 et seq.).

[5] *Small Business Regulatory Enforcement Fairness Act*, Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C. § 601 et seq.).

[6] 5 U.S.C. § 603.

[7] *Sarbanes-Oxley Act of 2002*, Pub. L. 107-204, Title IV, 116 Stat. 789 (2002) (codified in 15 U.S.C. § 7262).

submit one report on whether the management's assessment is fairly stated and another report on whether the company's internal control is effective.[8] The Public Company Accounting Oversight Board (PCAOB), a non-profit corporation created by SOX to oversee the auditors of public companies, created Auditing Standard No. 2 (AS2) as a guide for auditors evaluating a company's internal controls reporting under Section 404(b).[9]

The SEC divided public companies into two categories, non-accelerated filers (small public companies with a market capitalization of below $75 million); and accelerated filers (companies with a market capitalization of above $75 million). The SEC estimates that there were over 4,000 small public companies that make up 44 percent of the listed public companies in 2005.[10]

In the absence of management guidance in 2004, accelerated filers complying with Section 404 had to utilize the complicated auditing standard AS2. These entities testified that AS2 was a one-size-fits-all standard that had onerous requirements and resulted in excess costs and redundancies. In April 2006, the SEC's Advisory Committee on Smaller Public Companies ("Advisory Committee") recommended that the SEC provide exemptions from the internal control requirements of Section 404 for smaller public companies, unless and until a cost effective framework was developed that recognizes the characteristics and needs of these companies.[11]

On December 15, 2006, the SEC extended the compliance deadlines to Section 404 for non-accelerated filers (small public companies).[12] In this same month, the SEC released their proposed interpretative guidance and proposed rule, and the PCAOB released their proposed revised auditing standard. The SEC's proposed interpretation sets forth a "top-down, risk-based" approach for management to complete Section 404(a), which is supposed to make this process more effective and efficient. The SEC's proposed rule states that management can fulfill Section 404(a) by following the interpretative guidance. The SEC is also proposing to change Section 404(b) by requiring only one auditor attestation report on the effectiveness of management's internal controls reporting.[13] The PCAOB's revised auditing standard also incorporates this "top-down, risk-based" approach.

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[8] SEC Advisory Committee on Smaller Public Companies, Final Report of the SEC Advisory Committee on Smaller Public Companies 31 (Apr. 23, 2006) (*Advisory Committee Report*), *available at*: http://www.sec.gov/info/smallbus/acspc.shtml.
[9] 15 U.S.C. § 7262.
[10] *Advisory Committee Report*, at E3. The data on this graph was from the Center for Research in Security Prices. It lists 4,171 public companies that had a market capitalization of up to $75 million in 2005.
[11] *Advisory Committee Report*, at 6.
[12] *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies*, 71 *Fed. Reg.* 76580 (Dec. 21, 2006).
[13] 71 *Fed. Reg.* 77,635 (Dec. 27, 2006).

III. Small Entities Have Expressed Serious Concerns with Both Proposals

Over 35 people participated in Advocacy's small business roundtable, including small business owners and representatives, trade association staff, congressional staffers, and personnel from the SEC and the PCAOB. Participants raised many concerns with the SEC's management guidance and the PCAOB's revised auditing standard, in particular: 1) the need for further exemptions due to the recent receipt of the guidance and the revised auditing standard, 2) the request for clarifications of major provisions in these proposals, and 3) the issue of whether these proposals actually "fix" the problem of scalability and high costs in internal controls reporting for small public companies.

1) Small Public Companies Need Further Exemptions Due to Recent Receipt of Management Guidance and Revised Auditing Standard

Small public companies expressed concern with the timing of these draft proposals. The SEC and the PCAOB just released these proposals in December 2006, but most small public companies are expected to complete a management report on internal controls reporting by the end of the year and submit an auditor's report attesting to these internal controls next year.[14] Participants at the roundtable strongly recommended that the SEC provide a further extension for small public companies, to provide management with extra time to understand and implement these complex Section 404 proposals. Small entities commented that they had already planned and budgeted for FY 2007 the prior year, and it would be difficult and costly to start a new internal control reporting process in the middle of spring 2007.

Participants at the roundtable explained that it will take a longer time for small public companies to create and implement an internal controls reporting process. Although small public companies regularly submit annual financial reports to the SEC, the internal controls reporting process is time intensive because it adds the new requirements of identifying processes, assessing risk levels, and documenting and testing the internal controls. Small companies are at a disadvantage in complying with Section 404 process because they have more informal processes, fewer personnel and accountants and have no experience complying with Section 404 of SOX. William Zaiser, the Chief Financial Officer at a small public company with a market capitalization of $64 million, hired an external consultant, and it still took four months to begin the internal controls reporting process. Zaiser stated that it would be very difficult if his company had to start the Section 404 process at this late date, because his company would have to hire extra staff or he would have to devote a large amount of his time on this project.[15] According to the Government Accounting Office survey of small business companies in 2005, 81 percent

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[14] 71 *Fed. Reg.* 76,580 (Dec. 21, 2006). Under the SEC's extensions, non-accelerated filers would submit a management assessment report with its annual report for the first fiscal year ending on or after December 2006. These entities would not be required to submit an auditor's attestation report until the following year, or the first fiscal year ending on or after December 15, 2007.

[15] Telephone interview with William J. Zaiser, Chief Financial Officer, MHI Hospitality Corporation, in Greenbelt, Md. (Feb. 13, 2007).

of the respondents hired a separate accounting firm or external consultants to assist them with Section 404 requirements, at an individual cost of $3000 to $1.4 million.[16]

2) Small Businesses Request Clarifications of Major Provisions in Proposals

a. The SEC and The PCAOB Must Resolve Differences Between the Management Guidance and Revised Auditing Standard

The Institute of Management Accountants (IMA) has commented that the SEC and the PCAOB have created two rule books for the same task of internal controls reporting, and this is a source of confusion and complexity.[17] Small businesses at the roundtable were concerned that the management guidance is "ambiguity disguised as flexibility," because the standard is so vague that it does not provide any practical guidance that the management of small public companies need on how to complete internal controls reporting under Section 404(a). The SEC guidance seeks to provide flexibility and scalability for small public companies, and therefore "does not prescribe a particular methodology for the identification of risks and controls."[18] In contrast, the PCAOB's revised accounting standard is very prescriptive, and contains detailed bullet points on how auditors must evaluate a management's internal control reporting process. The IMA has also commented that it has identified three very significant differences and/or inconsistencies between the two documents, on topics such as the control environment evaluation, identifying significant accounts and strong indicators of material weakness.[19]

Small business representatives have stated that they will be using the PCAOB's revised auditing standard as their de facto guidance, because they are afraid that following the SEC's vague and flexible management guidance will result in a negative audit by an auditor utilizing the more detailed and prescriptive revised auditing standard. Advocacy believes that the SEC and PCAOB must work together to resolve any differences or inconsistencies between the management guidance and the revised auditing standard. Participants have also recommended that additional information be provided in the management guidance, without being overly prescriptive. For example, the SEC guidance should provide examples and case studies of sample or successful audits of different types and sizes of companies.

b. The SEC and the PCAOB Must Address Management and Auditor Liability

Participants at the roundtable raised the issue of liability in the Section 404 process as an important factor that most impedes the ability of these proposals to provide a scalable and cost-effective audit.

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[16] GAO, *Report to the Committee on Small Business and Entrepreneurship, U.S. Senate, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, at 17. (April 2006) *(GAO Report) available at*: http://www.gao.gov/new.items/d06361.pdf.

[17] Comment letter from Paul A. Sharman, President and CEO, Institute of Management Accountants, to the SEC and the PCOAB (Feb. 13, 2007) (*IMA Comment Letter*), *available at*: http://www.sec.gov/comments/s7-24-06/lddevonish-mills5470.pdf.

[18] 71 *Fed. Reg.* 77,635 (Dec. 27, 2006).

[19] *IMA Comment Letter*, at 2.

Roundtable participants stated that the management of small public companies needs assurances that they will not be held liable for completing a scaled-down audit pursuant to the management guidance, because the incentive is for management to complete extra work to protect themselves and their company from liability. In particular, small businesses seek clarification of the provision which states that "the proposed amendments would be similar to a non-exclusive safe-harbor."[20] According to this proposed amendment, if management chooses to follow the management guidance, they will have complied with Section 404(a). Normally, a safe harbor affords some protection from liability or a penalty. Participants of the roundtable asked for further details of this safe harbor, such as how this safe harbor can be claimed and what type of liability protection this would afford.

Participants noted that auditors also need assurances from the PCAOB that they will not be penalized for auditing and approving a scaled management report in the inspections process. Auditors have every incentive to complete a larger audit, since they could charge extra fees and protect themselves from liability in PCOAB inspections. One participant at the roundtable stated that auditors are attributing a large percentage of their auditing fees to the potential liability and litigation exposure for these Section 404 audits. These new Section 404 requirements are likely to increase the potential liability of auditors, and increase the costs of these audits.

3) Small Public Companies Question Whether Proposals Will Actually Fix Problems of Scalability and High Costs

Many small business representatives at the roundtable commented that there needs to be a further exemption to test if these two proposals will actually result in scalability and cost savings for these small public companies. Laura Phillips, Deputy Chief Auditor at the PCAOB, told participants at the roundtable that the PCAOB is currently conducting a field test of accelerated filers with their revised auditing standards in 2007 to see if this standard results in cost savings, in preparation for the 404(b) audit of small public companies in 2008. Small businesses commented that a further exemption would allow for corrections in the standard, if the testing shows that the standard needs to be revised. One participant at the roundtable asked how the SEC and the PCAOB would measure the benchmarks or effectiveness of their proposals in providing scalability and cost savings to small public companies. This small business representative commented that "if the cost of the full audit continues to be disproportionately high for small companies, the incremental benefit of this full blown audit to investors should be separately evaluated using rigorous quantitative methods rather than vague notions of investor protection." While these proposals are helpful, Advocacy believes that the SEC and the PCAOB have overestimated the cost savings these proposals would create.

[20] 71 *Fed. Reg.* at 77,649 (Dec. 27, 2006).

IV. Section 404 Requirements Will Still Impose Large and Disproportionate Costs on Small Public Companies

Based on these comments made by small business representatives at the roundtable, Advocacy believes that the Section 404 requirements will still impose large and disproportionate costs on small public companies.

In June 2003, the SEC estimated that the average annual internal cost of compliance with Section 404 would be $91,000, and that the cost would be proportional relative to the size of the company.[21] Surveys of actual Sarbanes-Oxley Section 404 costs indicate that non-accelerated filers spent approximately $935,000 to comply with Section 404.[22] According to the SEC's Advisory Committee Report, costs in relation to revenue will be disproportionately borne by smaller public companies. To comply with Section 404 requirements, smaller public companies with a market capitalization under $100 million are expected to spend 2.55 percent of their revenue, while larger companies with a market capitalization of over $1 billion are expected to spend 0.16 percent of their revenue.[23] A study by W. Mark Crain found similar disproportionate costs borne by small entities, finding that very small firms with fewer than 20 employees annually spend 45 percent more per employee than larger firms to comply with federal regulations.[24]

Recent studies backed by Treasury Secretary Henry Paulson,[25] New York City Mayor Michael Bloomberg, and U.S. Senator Charles Schumer[26] provide evidence that the burdensome SOX requirements have already made the United States capital markets an increasingly unattractive environment to list shares, decreasing the number of initial public offerings (IPOs), and forcing companies to go private or to foreign stock exchanges. In a study by Foley & Lardner LLP, 81 percent of respondents felt that the SOX requirements were too strict, and 21 percent of respondents are considering going private as a result.[27] SOX requirements will likely impose major obstacles to small public companies seeking capital, perhaps to such an extent that their application to small issuers would prevent small businesses entirely from accessing U.S. capital markets.

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[21] *Advisory Committee Report*, at 29.

[22] FEI, *Survey on SOX Section 404 Implementation*, Exhibit A: Costs by Filing Status (March 2006).

[23] *Advisory Committee Report*, Page 33.

[24] *The Impact of Federal Regulations on Small Firms*, an Advocacy-funded study by W. Mark Crain, Sept. 2005 *available at*: http://www.sba.gov/advo/research/rs264tot.pdf.

[25] Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* (Nov. 30, 2006), *available at*: http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

[26] McKinsey & Co, *Sustaining New York's and the US Global Financial Services Leadership* (Jan. 22, 2007), *available at:* http://schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf.

[27] Thomas E. Hartman, Foley & Lardner LLP, *The Cost of Being Public In the Era of Sarbanes-Oxley* 1 (June 16, 2005), *available at:* http://www.fei.org/download/foley_6_16_2005.pdf.

V. Regulatory Flexibility Act Determinations

Advocacy commends the SEC and the PCAOB for developing these proposals in an effort to make Section 404 more cost-effective and efficient for small companies. Advocacy strongly recommends that the SEC continue to provide further exemptions for small public companies until such time as more cost-effective procedures for internal controls reporting can be developed.

Advocacy also recommends that the Securities and Exchange Commission complete a revised final regulatory flexibility analysis (FRFA) under Section 604 of the Regulatory Flexibility Act. The last regulatory analysis was completed in August 14, 2003, and this final regulatory flexibility analysis severely underestimates the cost of compliance with Section 404 of SOX. The SEC's 2003 FRFA states that small public companies will be "subject to an added reporting burden of approximately 398 hours and the portion of that burden that is reflected as the cost associated with outside professionals is approximately $35,286. We believe, however, that the annual average burden and costs for small issuers are much lower."[28] Current industry estimates place the Section 404 compliance burden at almost $1 million for small public companies.[29]

Advocacy also recommends that the SEC complete a required Small Business Compliance Guide for this rule. Under Section 212 of the Small Business Regulatory Enforcement Fairness Act (SBREFA), "for each rule or group of related rules for which an agency is required to prepare a final regulatory flexibility analysis…the agency shall publish one or more guides to assist small entities in complying with the rule."[30]

VI. Conclusion

The Office of Advocacy has worked closely with the SEC and the PCAOB since the Sarbanes-Oxley Act was enacted in 2002, and appreciates the continuing efforts of these entities to make the internal controls process cost-effective and efficient for small public companies. Small businesses provided input at our roundtable, and were concerned about the timing of the proposals, the need for further clarifications and the commented that these proposals will not fix the problems of scalability and high costs in internal controls reporting. Advocacy strongly recommends that the SEC provide further flexibility for small public companies.

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[28] *Management's Report on Internal Control Over Financial Reporting an Certification of Disclosure In Exchange Act Periodic Reports,* Exchange Act Release No. 3308238; 34047986; IC-26068 (Aug. 14, 2003), *available at:* http://www.sec.gov/rules/final/33-8238.htm.
[29] *See* note 22.
[30] *Small Business Regulatory Enforcement Fairness Act*, Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C. § 601 et seq.).

Advocacy is pleased to forward the comments and concerns of small businesses. Please feel free to contact me or Janis Reyes at (202) 619-0312 (Janis.Reyes@sba.gov) if you have any questions or require additional information.

Sincerely,

//signed//
Thomas M. Sullivan
Chief Counsel of Advocacy

//signed//
Janis C. Reyes
Assistant Chief Counsel

cc: Steven D. Aitken, Acting Administrator, Office of Information and Regulatory Affairs

SOCIETY OF CORPORATE COMPLIANCE AND ETHICS

February 21, 2007

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

RE: PCAOB Rulemaking Docket Matter No. 021

Dear Sir/Madam:

The purpose of this letter is to suggest revisions to the Proposed Auditing Standard – "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements" which is intended to supersede PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements."

At the outset we would note that we support the general theme of the changes proposed by the PCAOB. However, we would like to suggest several minor modifications intended to further promote appropriate control practices in organizations. All suggested changes to the document relate to Paragraph 79.

A. Auditor Evaluation of Audit Committee

Paragraph 79 relating to **Strong Indicators of Material Weaknesses** suggests that one of the indicators of a material weakness in internal control over financial reporting is "[i]neffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee." This section goes on to state in part that:

> "The aspects of the audit committee's effectiveness that are important may vary considerably with the circumstances. The auditor should focus on factors related to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting, such as the independence of the audit committee members from management, the clarity with which the audit committee's responsibilities are articulated (e.g., in the audit committee's charter), and how well the audit committee and management understand those responsibilities. The auditor might also consider the audit committee's involvement and interaction with key members of financial management, including the chief financial officer and chief accounting officer. The auditor also might evaluate whether the committee raises and pursues appropriate questions with management and the auditor, including questions that

indicate an understanding of the critical accounting policies and judgmental accounting estimates, and the committee's responsiveness to issues raised by the auditor."

The adoption of this standard will set a minimum threshold for auditor inquiry and evaluation and as a result also drive organizational behavior. While we believe that those factors specifically identified in the paragraph are appropriate, it is our view that the foregoing paragraph should be expanded to include additional factors which the auditor should consider when assessing the audit committee's effectiveness. Moreover, we think the PCAOB should expand the list of persons whose interaction and involvement with the audit committee should be evaluated by the auditor. These concerns are expressed in more detail below.

1. **Assessing Audit Committee Effectiveness.** We believe that any new standard should explicitly include at least two additional factors related to the evaluation of audit committee effectiveness.

   The first factor relates to the composition of the audit committee. The accuracy of an organization's financial reporting is dependent upon much more than the effectiveness of the finance and accounting functions. Many other functions may have information which directly impact the accuracy of financial reporting. Principal among these other functions are compliance, legal and operations. In order to function effectively, an audit committee must be composed of a diverse group of persons who have the breadth of relevant knowledge and experience to accurately oversee the organizations activities and assess the effectiveness of managements control activities. This expertise should include not only financial/accounting expertise (as is required by Sarbanes-Oxley), but relevant business, audit and compliance related expertise as well. Particularly in industries which are subject to extensive and complicated regulation, the vulnerability to fraud and internal control weaknesses that could result in a material misstatement of the organizations financial position depends substantially on the tone that the board and management set with respect to compliance as well as the effectiveness of controls designed to mitigate regulatory risks. Much of the conduct which precipitated the corporate scandals that spawned Sarbanes-Oxley as well as changes to the Organizational Sentencing Guidelines, were failures that might have been prevented if the organization's activities had included appropriately structured and effectively implemented compliance programs. These programs are more likely to exist in organizations where the audit committee has appropriate expertise. Consequently, we would suggest the addition of a factor that reads "the relevant expertise of the audit committee members (e.g. audit, compliance, industry expertise, etc.)".

   The second factor relates to the adequacy of the audit committee oversight. As noted above, inadequate oversight by the audit committee was a direct contributing factor to many of the corporate scandals. In order to function effectively, the audit committee must devote appropriate time and resources to its work, consistent with the size and complexity of the organization as well as the complexity of the regulatory environment(s) in which it operates. Consequently, we would suggest an additional factor that reads "whether the audit committee activities (including scope of responsibility and frequency and duration of meetings) provide adequate oversight given the regulatory environment and the size and complexity of the organization".

2. **List of Persons Who Interact with Audit Committee.** Paragraph 79 states in part that "[t]he auditor also might consider the audit committee's ...interaction with key members of management including the chief financial officer and chief accounting officer." While these two individuals are essential to the list of persons whose interaction the auditors must evaluate, there is other management in organizations who have direct responsibility for functions or processes that, while not purely financial, can clearly and directly result in failures (or the prevention thereof) that could lead to a material misstatement of the organizations financial reports. Because the proposed standard will set a minimum threshold for auditor inquiry, we believe the list of positions specifically enumerated should be expanded to include the "chief compliance officer, chief legal officer, and chief operating officer" in addition to the chief financial officer and chief accounting officer. Generally, we would expect the auditor's inquiry to extend beyond this group. However, we believe that these five positions should be a minimum standard.

B. Complex Entities in Highly Regulated Industries

The last section of Paragraph 79 reads as follows:

> "For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of an ineffective regulatory compliance function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting." (emphasis added)

We have two concerns regarding the forgoing language.

The first concern is use of the word function rather than "program." This sentence implies that the auditor should be focused on the effectiveness of the people who staff the compliance department (i.e., function) rather than on whether the program is effective. While an effective function is frequently, perhaps even typically, associated with an effective program, the two are not synonymous. For example, it is possible to have a very competent, professional compliance function which has developed a state of the art compliance program, but have that program periodically or regularly ignored by management and/or the board. Such was the case in many of the corporate scandals and more recently in organizations wrestling with stock option back-dating issues. Moreover, we believe that this provision as written, unintentionally sends the message that it is the compliance department (function) rather than management that is responsible for compliance. Clearly that is not the case. While it is the job of the compliance function to provide an organization with the tools, processes, procedures and other components necessary for an effective compliance program, it is the job of the board and management to ensure that the program is effectively implemented. Given the foregoing, we believe the word "function" should be replaced with the word "program".

We are also concerned that the use of the word "solely" may inappropriately de-emphasize the importance of the auditors work in this area. The consequences of non-compliance, particularly in entities operating in highly regulated industries, can be organizationally devastating. Cancellation of government or other contracts, exclusion from participation in government contracts, penalties and fines (or the real risk of any of the foregoing) can all have a material impact on the accuracy of an entity's financial reporting. Consequently we would suggest that this subparagraph be rewritten to read as follows:

> "For complex entities in highly regulated industries, an ineffective regulatory compliance <u>program</u>. This relates to those aspects of an ineffective regulatory compliance <u>program</u> in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting." (emphasis added)

Finally, we would note that we believe that the changes we have proposed would enhance the effectiveness of the audit process. Moreover, we believe that such provisions would promote the public policy initiatives – contained in Sarbanes-Oxley legislation, recent amendments to the Federal Organizational Sentencing Guidelines and elsewhere – designed to improve the culture of compliance in organizations and encourage the implementation of effective compliance programs.

We would welcome the opportunity to discuss these comments and proposals with the PCAOB or its representatives. If you have questions regarding these proposals, please contact me at 415-438-5579.

Sincerely,

Daniel R. Roach
President, Health Care Compliance Association
Co-Chair, Society of Corporate Compliance & Ethics

From: Fleischman, Edward [mailto:edward.fleischman@Linklaters.com]
Sent: Monday, February 26, 2007 3:11 PM
To: Comments
Cc: william.mostyn@bankofamerica.com; lydia.beebe@chevron.com; dsmith@governanceprofessionals.org; neila.radin@chase.com; skgeer@bellsouth.net
Subject: Society comments on proposals published in Release 2006-007

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via e-mail to: comments@pcaobus.org

February 26, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 21

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:
The Society of Corporate Secretaries & Governance Professionals is a professional association, founded in 1946, with over 4,000 members who serve more than 3,000 issuers. Responsibilities of our members include supporting the work of corporate boards of directors, their committees and executive management regarding corporate governance and disclosure. Our members ensure issuer compliance with the securities laws and regulations, corporate law, stock exchange listing requirements and the accounting rules, and have been on the front-line in implementing the structural changes necessitated by the Sarbanes-Oxley Act of 2002 and the related rules of the Securities and Exchange Commission, the Public Company Accounting Oversight Board (the "Board") and the exchanges. The majority of Society members are attorneys, although our members also include accountants and other non-attorney governance professionals.

* * * * * * * *

We commend the significant efforts by the Board to address issues previously raised by the Society and by others in the effort to balance improvements in the quality and efficiency of important corporate processes and controls against problems perceived and greater-than-expected costs incurred in the implementation of Auditing Standard No. 2. We join in the Board's view that "auditors should perform internal control audits as efficiently as possible for companies that are required by the SEC's rules to obtain an audit report on internal control", and we therefore commend the Board for undertaking an "evaluat[ion of] every significant aspect of the audit of internal control to determine whether the existing standard encourages auditors to perform procedures that are not necessary in order to achieve the intended benefits.". We generally support the measures proposed by the Board in its Release 2006-007 (the "Release"), as discussed below. Our comments include certain suggestions for additional flexibility without detracting from achievement of the goals articulated by the Board in the Release.

Generally, we support the Board's effort to design the proposals in the Release to focus the audit of internal control on those matters most important to internal control, to scale the audit for smaller companies subject to the audit requirement, and to eliminate procedures unnecessary for and simplify requirements relevant to the audit of internal control. Specifically, we support

1. incorporating into the standard proposed in the Release the top-down approach emphasized in the Board's May 16, 2005 guidance on applying Auditing Standard No.2, with a view to avoiding the auditors' reluctance to apply the prior guidance as somehow not consonant with Auditing Standard No. 2;
2. revising the definitions of the terms "significant deficiency" and "material weakness" to raise the threshold at which the likelihood of a misstatement is evaluated, to clarify that auditors are not required to search for deficiencies that, individually and in the aggregate, are less severe than material weaknesses, and to better establish the threshold of what is a significant deficiency; with a view to reducing the amount of effort, time and cost devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statements;
3. aligning the standards of materiality in audits of internal control with the materiality standards long recognized as applicable to audits of annual financial statements, with a view to ending the differences between the materiality measures used to plan and perform the two audits;
4. permitting auditors to take into account knowledge obtained during prior audits, with a view to reducing the nature, timing and extent of testing based on the auditors' cumulative knowledge related to individual controls;
5. providing direction and approval, within the unified framework of a separate auditing standard, for auditors to use the work of others in an audit of internal control, with a view to removing impediments to use of the work of others that stem from particular provisions of Auditing Standard No. 2;
6. eliminating the requirement that auditors evaluate management's process for annual assessment of the effectiveness of the issuer's internal controls, with a view to avoidance of repetitive testing and to terminating what has been perceived to be inappropriate dictation by auditors of how management should perform its own assessment; and
7. deferring as to guidance for management to the (proposed) interpretive guidance published by the SEC in parallel with the Board's publication of the Release.

As to the recalibrated walkthrough requirements, we support the Board's decisions that the number of required walkthroughs can be reduced (based on significant processes rather than on major classes of transactions within each significant process) and that auditors can be allowed to utilize the direct assistance of others when performing required walkthroughs. We would, however, continue to recommend that the Board consider additional flexibility in allowing auditors to perform periodic walkthroughs, or to perform walkthroughs on a rotating basis, to the extent that auditor has appropriate reason to believe that the control involved has not changed since the last walkthrough. We agree that walkthroughs should be required for any process for which there has been a significant change during the fiscal year, but we do not believe that testing should be required annually for those controls that are highly automated, have not changed from the prior year and have given rise to no significant deficiencies in the past three years. Similarly, we suggest for Board consideration that the frequency of required walkthroughs even of "major transactions" be limited to every second or every third year provided, again, that the control has not changed in any significant manner and has given rise to no significant deficiencies in the past three years. This treatment of walkthroughs would reduce external audit costs to a meaningful extent and, perhaps more important, would enable issuers and auditors alike to focus the more on those controls which carry a greater element of risk.

We also believe that the existing guidance issued by the Board continues to be relevant and should be accorded specific recognition in the structure of the currently proposed guidance and the Auditing Standards proposed in the Release. Incorporating the existing guidance within the proposed new Auditing Standards would remove any ambiguity about the status of the prior guidance and ensure that it is honored in the dual audit process. We also suggest the importance of specific reference, in the proposed new Auditing Standards, to the management guidance ultimately issued by the SEC.

In addition, we believe it important that the Board monitor implementation by auditors of the definitive Auditing Standards that will replace Auditing Standard No. 2. The Board has consistently stated in guidance it has provided with respect to the audit of internal controls that it will focus its inspections on whether the auditors efficiently achieved the objectives of an internal control audit; continuance of that policy and monitoring of its implementation appears to us to be vital on a going-forward basis, and we would suggest that an explicit statement to that effect in the Board's release adopting the definitive Auditing Standards would be extremely useful.

Finally, we believe that the Board, like the SEC, needs to act promptly to complete and adopt its definitive standards implementing Section 404 of the Sarbanes-Oxley Act, in order to afford issuers subject to the requirements of those standards the ability quickly to enter upon implementation of all necessary changes as part of their audit preparations for fiscal 2007.

We appreciate this opportunity to share our views with you, and would be happy to provide you with further information to the extent you would find it useful.

Respectfully submitted,
The Society of Corporate Secretaries and Governance Professionals

Edward H. Fleischman

By: Edward H. Fleischman, Member of the Drafting Committee

cc: Lydia Beebe, Society Chairman-Elect
William Mostyn, Society Chairman
David W. Smith, Society President
Neila Radin, Securities Law Committee Chair
Stacey K. Geer, Drafting Committee Chair

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SOUTHERN COMPANY
Energy to Serve Your World®

February 23, 2007

Mr. J. Gordon Seymour
Deputy General Counsel and Secretary
Public Company Accounting Oversight Board
1666 K Street N.W.
Washington, D.C. 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 021

FILED ELECTRONICALLY (comments@pcaobus.org)

Dear Mr. Seymour:

We appreciate the Public Company Accounting Oversight Board's ("PCAOB") effort to solicit feedback on the 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." Overall, we continue to support the intent and goals of Section 404 of the Sarbanes Oxley Act ("Act") and believe our Company continues to derive benefit from Section 404's requirements on management. However, we also believe that we are spending more time and resources on complying with Section 404 than is beneficial to our investors.

We believe that these proposed standards are very positive steps to increasingly efficient and cost effective internal control assessments. We especially applaud the revisions that, 1) replace the term "inconsequential" with "material," 2) replace the term "less than remote" with "reasonable possibility," and 3) expand the reliance on walkthroughs.

We observe in practice however, that disincentives for public accountants to embrace the risk based approach contained in the proposed auditing standards remain. Auditing Standard No. 2 resulted in an audit approach where every key control (even including some operational controls) was tested regardless of risk. This high degree of coverage afforded the public accountant significant protection from liability due to "missing something." Because public accountants are exposed to significant liability, they are reluctant to use judgment in any way that lessens coverage and associated audit evidence. As such, even though well constructed auditing standards such as these may exist which allow for practically applied judgments to increase efficiency, we believe that auditors will continue to exceed the intent of the proposed auditing standards in practice. They simply have no incentive to reduce testing that counter-balances their inherent goal of defending their audit opinions from liability. Further, the PCAOB's own inspections of the public accountants reinforce this behavior through commonly citing "lack of sufficient evidential matter."

We would also like to address the significant interaction that exists in practice between the guidance provided to management from the Securities and Exchange Commission ("SEC") and the auditing standards provided to public accountants by the PCAOB. While we think that the SEC's proposed interpretive guidance for management gives management the flexibility to build efficiency into the implementation of Sarbanes-Oxley Section 404, we believe the public accounting influence on management's assessment process negates this flexibility.

The SEC has acknowledged the possibility of a strong interaction between its own proposed interpretive guidance with the proposed guidance issued by the PCAOB. The SEC states the question as follows (page fifty of its proposed interpretive guidance): "Considering the PCAOB's proposed new auditing standards, <u>An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements</u> and <u>Considering and Using the Work of Others In an Audit</u>, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to solve the incompatibility?"

We believe that a strong interaction, as discussed above, does exist between the SEC guidance and the proposed PCAOB auditing standards. Further, we believe the SEC guidance for management is ultimately incompatible with the PCAOB's proposed new auditing standards. Management will continually seek to perform an ICFR assessment that is, foremost, effective and efficient. The public accountant will continue to perform an assessment that, foremost, creates quantities of evidence ample enough to defend its opinion and protect against litigation. Thus, from the public accounting perspective, more evidence equals less risk. Effectiveness and efficiency can only be sought after the public accounting firm's ability to defend its audit opinion is fully satisfied. The best evidence of the reality of this conflict is the need for entirely separate guidance for management and the public accountant regarding the performance of a review of the same process, that is, of internal control over financial reporting.

Given the interaction discussed above, we suggest that the solution most likely to overcome the inherent incompatibility between management's assessment process and the public accountant's assessment process is a standard that better balances the two differing perspectives. While we recognize that certain elements of the following recommendations are beyond the scope of the PCAOB's standard setting authority, it is essential that the PCAOB be mindful that any new auditing standard be fully compatible with any emerging legislative changes or SEC guidance. Ultimately, any new guidance should be based on and begin with the following actions:

- <u>**Eliminate the Section 404 (b) requirement for a public accountant opinion on ICFR.**</u> The current proposal provides no incentive for public accounting firms to limit the amount of controls documentation and testing they require in order to provide an opinion on ICFR. This results in a "more is better" tendency on the part of public accounting firms when gathering evidence of control effectiveness. More evidence obviously places the public accountant in a better position to defend their opinions. While the current proposal directs public accountants to the most important controls, there is no standard for management to rely on when debating with the public accountant on the appropriate balance of coverage. The net result is that when management presents a risk based evaluation of the number of controls to be documented and tested in its assessment of ICFR, any reductions will likely be perceived by the public accountant as imposing additional risk on the public accounting firm.

The public accountant response to a risk based management assessment that covers primarily the highest risk, most important controls, will likely be "if management won't test all internal controls over financial reporting, then we (the public accountant) will have to do more work. Thus, the most effective way to provide relief from the public accounting propensity to require more testing is to eliminate the public accountant's opinion on ICFR required by Section 404 (b). Subsequently, the public accountant would revert to the previously utilized auditing standard covering internal controls, that is, Statement of Auditing Standard No. 55, Consideration of Internal Control in a Financial Statement Audit (SAS 55). Accordingly, we advocate that the PCAOB bring forward into the new auditing standard the approach to evaluating internal controls similar to that contained in SAS 55. Adherence to SAS 55 by the public accountant, along with the certification of internal controls provided by management under Section 404 (a), would be sufficient to provide assurance of internal control effectiveness to the investing public.

- **Define the scope of the Section 404 (a) Management Assessment to eliminate or reduce compliance requirements for subsidiary registrants.** Due to the existence of corporations that contain multiple subsidiary SEC registrants, certain corporations find themselves having to certify multiple times within the same corporation. We believe that the multiple certifications required under current SEC rules are incompatible with the goal of efficiency stated by both the SEC and the PCAOB.

  To alleviate this inefficiency and redundancy, we suggest expanding the SEC Audit Committee exemption to encompass Section 404 (a) —effectively exempting or reducing compliance requirements for (subsidiary) registrants. Specifically, we recommend exemption for SEC registrants whose common stock is owned entirely by a registered holding company that also fully complies with Section 404 (a). Having management certify each subsidiary individually is an inherently redundant exercise with limited benefit to investors. A single management certification at the holding company level would provide sufficient assurance to investors that controls surrounding the financial reporting process are adequate to assure financial statements are properly stated.

Within the proposed auditing standard, the PCOAB provides guidance related to multi-location testing (Page 20, Section 3). We understand that the intent of the "multi-locations" guidance is to allow for "multiple- locations or business units" to be covered by a single assessment so structured as to provide adequate coverage of the multiple locations or business units. However, individual subsidiaries that are also "business units" have to provide individual certifications under current SEC rules. Thus, we consider the PCAOB guidance allowing multiple business units to be covered by a single assessment to be inconsistent with current SEC rules requiring individual certifications and therefore individual assessments at multiple subsidiaries.

To alleviate this inconsistency, we recommend that the PCAOB expand its guidance related to multiple locations or business units to clearly encompass the goal of having a single assessment for a corporation that has multiple subsidiaries. We feel that multiple subsidiary certifications will be confusing to investors given the variability associated with different levels of materiality at subsidiaries of various sizes within the same corporation.

- **Develop guidance that is compatible between the SEC and the PCAOB, thus enhancing the ability of the public accountant to rely on work performed by management that reflects SEC guidance.** Any incompatibility between the SEC guidance and the proposed PCAOB auditing standards ultimately lessens the ability of the public accountant to rely on work performed by management. This lessens the efficiency of the assessment and contributes to redundancy. The SEC guidance, taken alone, allows management to perform an internal control assessment with efficiency. When management alters their assessment to allow for utilization by the public accountant, the PCAOB guidance forces management to perform procedures and tests that exceed those levels suggested by the SEC's guidance, thus contributing to inefficiency.

We also have identified the following specific sections from the proposed standard that warrant further clarification:

- In paragraph 18, page A1-12, the following is cited as a company level control that must be tested—"Centralized processing and controls, including shared service environments." This bullet seems to infer that all shared services have elevated risks and must be tested. We view shared services as having superior control environments and therefore less risk than distributed processes. We suggest removing this category from the list of company level controls that the auditor must always test and leaving testing frequency of shared services and centralized controls to a risk-based determination.

- In paragraph 18, page A1-12, the following is cited as a company level control that must be tested—"Policies that address significant business control and risk management practices." This company level control is stated so broadly that it could be interpreted to include various insurance and loss minimization programs unrelated to internal control over financial reporting. We recommend this bullet be clarified to encompass only those "Policies that address significant business control and risk management practices that are material to internal control over financial reporting."

Lastly, we would like to add our endorsement of the response from the Edison Electric Institute ("EEI"). EEI is the association of United States shareholder-owned electric companies, whose members serve 97 percent of the ultimate customers in the shareholder owned segment of the industry.

We thank you for the opportunity to provide feedback on these proposed auditing standards. We look forward to your future standards to help achieve the goals of the Sarbanes-Oxley Act in a cost effective and efficient manner. If you would like to discuss our response, please contact me.

Sincerely,

/s/Thomas A. Fanning

**STATE BOARD OF ADMINISTRATION
OF FLORIDA**

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AS TREASURER**

**BILL McCOLLUM
ATTORNEY GENERAL
AS SECRETARY**

**COLEMAN STIPANOVICH
EXECUTIVE DIRECTOR**

VIA EMAIL

February 26, 2007

Office of the Secretary
Public Company Accounting Oversight Board (PCAOB)
1666 K Street, NW
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

The State Board of Administration (SBA) of Florida is writing to provide commentary on the Public Company Accounting Oversight Board's ("PCAOB") proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements And Other Related Proposals.* The SBA manages the Florida Retirement System (FRS), the fifth largest public pension plan in the United States with approximately 970,000 beneficiaries and retirees, and assets totaling approximately $136 billion. As a large institutional investor in global capital markets, the SBA has a significant interest in promoting accurate financial information in order for investors to make reasonably informed decisions and for the orderly functioning of the U.S. capital markets.

The SBA believes that Section 404 of the Sarbanes-Oxley Act of 2002 has been essential in restoring investor confidence and maintaining the overall integrity of our capital markets. We believe that effective internal controls, long required of public companies by the Foreign Corrupt Practices Act of 1977, are integral to high quality financial reports. Any publicly traded company, regardless of size, should have appropriate controls in place and management should be responsible for assessing those controls with meaningful review by external auditors. We continue to support Section 404 because we believe, as has been demonstrated empirically, that improved internal controls reduce the incidence of financial restatements and reduces equity risk.

The SBA views the Proposed Auditing Standard as flexibly structured, comprehensive, and timely for many of the issues that have arisen during the implementation of internal control auditing requirements imposed by Sarbanes-Oxley. As the proposal encompasses a top-down, risk-based approach, it should result in a reduction of the number of hours required to perform internal control audits without sacrificing effectiveness. To be clear, as long-term investors, we believe the Board should focus on quality and accuracy of financial statements above all else. While we support improving audit efficiency, the effectiveness of internal control audits should not be impaired in any way. The SBA strongly supports the proposal's adoption and implementation as a final standard. Below, we share our views on several of the key aspects of the proposal and note a few areas that could be clarified and/or improved in order to maintain its effectiveness.

ROLE OF THE AUDIT COMMITTEE

The competence of a board's audit committee is central to the development of high quality and transparent financial statements.[1] The proposal lists examples of strong indicators of material weakness, one of which is the, "ineffective oversight of the company's external financial reporting and internal controls over financial reporting by the company's audit committee." In our view, a weak audit committee is highly likely to foster an ineffective control environment, and as such, the audit committee as a topic should be an integral component of this auditing standard. While the proposal does not place responsibility for performing a separate evaluation of the audit committee upon the external auditor, neither does it adequately define and describe the circumstances for external auditors to evaluate the audit committee's oversight. The SBA urges the Board to provide additional clarity in the final standard for external auditors to use when assessing the effectiveness of a board's audit committee—specifically including examples of both effective as well as ineffective characteristics of oversight. As well, a meaningful evaluation of the audit committee members' competence and knowledge of accounting matters should be included as part of this evaluation.[2] We suggest a note or other clarification that external auditors should evaluate any circumstances they feel could impact an audit committee member's independence, and not limit such an evaluation to only using the current stock exchange listing standards for determining independence.

AUDITS OF SMALLER COMPANIES

The SBA supports the proposal's guidance on scaling the audit for smaller companies. Because smaller public companies may have less developed corporate governance frameworks and financial restatements are more frequently encountered by their shareowners, an audit of the internal control environment of these companies is certainly as important as an audit of the internal controls of larger firms. We respectfully request that the final standard clearly state that a scaled audit for a smaller company does not exempt the auditor from any of the principles set forth for planning the audit, testing controls, evaluating identified deficiencies, and reporting on internal control. We urge the Board to oppose any potential revisions to the Proposed Auditing Standard that would permit the scaling of the audit based simply on absolute or relative size thresholds (for example, a company's market capitalization or total revenues). Consistent with our general views on most corporate governance matters, we do not believe there is any justification for such bifurcation of auditing standards.

MATERIALITY IN THE AUDIT

We generally support the proposal's guidance on materiality and agree with the proposed clarification that the auditor should plan and perform the audit of internal control using the same qualitative, principles-based materiality measures to plan and perform the audit of the annual financial statements. However, we urge the Board to keep the current proposed guidance and

---

[1] See "Audit Committee Financial Literacy: A Work in Progress" by Douglas J. Coates, M. Laurentius Marais, Roman L. Weil, 2005. The authors found that firms with improving financial literacy (as measured by accounting certification, experience, etc.) of audit committees experienced annualized abnormal, excess returns of 4.6 percent per year above those firms which did not improve audit committee financial literacy.

[2] According to Huron Consulting, approximately 11 percent of all audit committee members in the United States are accountants. There are similar nuances related to the interpretation of the "financial expert" designation applied to audit committee directors.

avoid any revisions to the Proposal that would establish a rules-based numerical formula for assessing materiality in the audit of internal control (for example, a minimum percentage of net income). We believe that investors are best served by a qualitative principles-based approach to determining materiality.

FRAUD DETECTION AND USE OF OTHER QUALITATIVE MEASURES
The SBA urges the Board to provide additional guidance on fraud detection and the evaluation of risk, including coverage of non-traditional issues that can have a significant impact on a company's financial statements and how auditors can approach risk identification. We believe the inclusion of these other metrics can be highly effective for incorporating a stronger fraud detection component as part of the audit of internal controls. External auditors should triangulate accounting and financial information by evaluating fundamental industry benchmarks (for example, analyzing absolute and relative profit margins to identify elevated risks of fraud), reviewing a company's corporate governance (for example, analyzing incentive compensation plans and procedures used by a board's compensation committee), and assessing current market research (for example, research reports of major investment banks and ratings agencies). We believe the inclusion of such an orientation would further improve the effectiveness of internal control audits, with only de minimis cost implications.

The SBA commends the PCAOB's efforts to promote and enhance accurate financial information for the investment community and supports the full and cost effective implementation of the Proposed Auditing Standard. We also appreciate having the opportunity to provide input. If we can provide any further information or you have any questions, please contact Michael McCauley, Director of Corporate Governance, at (850) 413-1252 or me.

Sincerely,

Coleman Stipanovich
Executive Director

cc: Honorable Christopher Cox, Chairman, Securities and Exchange Commission

STATE STREET.

Edward J. Resch
Executive Vice President and
Chief Financial Officer

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Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Ms. Laura Philips
Office of the Secretary, PCAOB
1666 K Street N.W.
Washington, D.C. 20006-2803

Comments on File No. S7-24-06 and PCAOB Rule-Mailing Docket Matter No. 021

February 26, 2007

Dear Ms. Morris and Ms. Philips:

State Street Corporation (STT) is pleased to share with you our views derived from our experience with the requirements of Section 404 of the Sarbanes - Oxley Act of 2002 (the "Act") and related regulations, standards and guidance issued by the Securities Exchange Commission ("SEC") and the Public Company Accounting Oversight Board ("PCAOB").

We are appreciative of the SEC and PCAOB's proposed standards (superseding Auditing Standard No. 2) that focuses the auditor and management on the matters most important to ensuring the effectiveness of internal control over financial reporting. We believe that this aspect of the proposed guidance provides needed clarity to both registered public accounting firms and public companies. In summary, we support the following PCAOB proposed standard clarifications that:

- Clarifies the role of materiality in an audit;
- Removes the requirement to evaluate management's assessment process;
- Permits prior audit knowledge to be utilized in the audit;
- Provides more realistic guidance for smaller, less complex organizations;
- Refocuses the multi location testing requirements on risk;
- Recalibrates the walkthrough requirements;
- Proposes a revised standard on using the work of others;

Additionally, we concur with the two principles articulated within the SEC's proposed interpretation (File No. S7-24-06) that focuses management on a "top-down", "risk-based" approach to evaluating and evidencing the adequacy of internal controls over financial reporting. We are also encouraged by the SEC's acknowledgement of the importance of the organizational control environment and the focus of testing on key controls that mitigate the risk of material

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misstatement. Both principles will properly align management and the auditor's assessment efforts to better protect the investor community.

We also commend the SEC and PCAOB for encouraging the auditor to rely on the work of others. We believe that if the standard is to be effective in reducing the excessive cost and testing burden on corporations, the standard should direct the auditor to place reliance on the work done by others except in cases where the auditor demonstrates that the quality of work does not meet the standards for reasonable reliance.

We appreciate the PCAOB and SEC's guidance clarifications and updated proposals, however, we continue to see complexities with the practical implementation of the updated guidance. Although we support the repeal of management's assessment we do not believe that it will result in significantly decreasing the work of management and the auditor. We however, do believe that the independent attestation of internal control is the primary factor that results in excessive work and implementation challenges by registrants. We also see a conflict between the PCAOB's requirement of an independent attestation and the Sarbanes-Oxley Act in that we see no reference to a requirement of independent auditor attestation in Section 404. We propose that the PCAOB rules conform to the Sarbanes Oxley Act of 2002, eliminate the requirement of a stand alone opinion of internal control, and focus on consistently implementing the requirements of AU Section 319 in the requirements of a financial statement audit.

If the PCAOB continues to require a stand alone opinion on internal control, the updated guidance, which incorporates the use of judgment, will conflict with the registered public accounting firm's procedural requirements for a stand alone opinion on internal control. In practice, the registered public accounting firm procedure requires the attainment of a 95% confidence interval, thus dictating specific testing levels. The standards for an independent attestation of internal controls are uniform in the profession and enforce similar testing levels for service organizations reports on internal control. Should the PCAOB continue to require an opinion, we believe that this revised standard will create more confusion and result in the same testing levels as currently implemented rather than the reduction in testing the PCAOB is indicating in its exposure draft.

We believe that AU Section 319 provides adequate guidance to the auditor on tests of internal control in a financial statement audit and the flexibility to modify testing procedures based on the entities size, complexity and automation. For an auditor to opine on the financial statements, they are inherently required to attest to the adequacy of internal control. With prior guidance, the auditor had the ability to combine the nature and extent of substantive and control procedures to determine a level of comfort with the financial statements as a whole. For example, in a highly complex, automated organization, the auditor was required to rely more heavily on controls and less on substantive procedures. In a smaller, less complex organization, the auditor had the ability to place a heavier reliance on the substantive procedures and less reliance on control procedures. The stand alone opinion does not offer the auditor this flexibility and will result in a conflict between the independent attestation requirement and the proposed standard.

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Through Section 404, we believe that management should continue to be accountable for assessing the design and operation of internal control over financial reporting. Management should utilize the two clarifying principles presented by the SEC in the most recent proposed interpretation to focus their assessment on areas of risk that could lead to material misstatement. Management should also be permitted to leverage various organizational assessment practices to render their consolidated conclusion on the adequacy of internal controls over financial reporting and have the ability to utilize a testing rotation plan that is risk based.

PCAOB Rule 3525:

We oppose Rule 3525 that "requires auditors to take certain steps as part of seeking audit committee pre-approval of internal control related non-audit services." We believe that it is the responsibility of management to request required public accounting services. Title II, SEC.202, of the Act requires that all auditing and non-auditing services be pre-approved by the audit committee. The Act does not require the firm to approach the Audit Committee. We believe that Rule 3525 and similar rules requiring the registered public accounting firm to approach the Audit Committee places the firm in the role of management which could result in impairing a firm's independence. Existing rules and regulations require the registered public accounting firm to assess the independence and ensure that the firm does not provide services that would breach independence requirements.

General Computer Controls:

We agree that General Computer Controls are important considerations in highly complex and automated organizations. However, we believe that additional guidance is required to reconcile the most recent SEC interpretation and General Computer Control requirements. There appear to be numerous sources of authoritative guidance and frameworks for General Computer Controls and we request that the SEC provide specific direction.

Also, we request that additional guidance be provided to reconcile the SEC's two principles and the requirements of General Computer Control testing. PCAOB FAQ #35 issued in November of 2004 indicates that General Computer Controls alone cannot yield a material weakness within the financial statements and that the specific General Computer Control deficiency must be evaluated in conjunction with the application control to determine significance. Given the SEC and PCAOB's focus on risk of material misstatement, we believe that an organization should be able to omit certain General Computer Controls if management believed that key control environment and transactional controls mitigated any risk at the General Computer Control or Application Control level. The guidance should be amended to bridge the gap between the updated pronouncement and the General Computer Control requirements.

Acquisitions:

We understand that when a registrant completes an acquisition late in a quarter or annual reporting period, the registrant has the option of including or excluding the acquisition from the scope of the report and documenting the omission as a scope limitation in management's assessment. We recommend that the PCAOB and SEC's guidance be clarified or modified to allow organizations to

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consider materiality (as of the current reporting period) as a factor in determining whether the acquisition should be included in management's report. We recommend that the guidance be further expanded to permit an organization to omit immaterial acquisitions without the requirement of a scope limitation.

Changes to Technical Interpretations:

The proposed guidance notes that restatement of previously issued financial statements to reflect the correction of material misstatement is a strong indicator that a material weakness in ICFR exists. We believe that changes in industry or registered public accounting firm interpretations of GAAP should not be considered to be a material weakness.

We thank you for the opportunity to provide our comments to you and look forward to your response and final release.

Sincerely,

/s/ Edward J. Resch
Edward J. Resch
Executive Vice President and Chief Financial Officer

From: Phillips, Laura
Sent: Wednesday, January 10, 2007 5:15 PM
To: Comments
Subject: Rulemaking Docket Matter No. 21

-----Original Message-----
From: Thorsten-Trygve Stegmann [mailto:TrygveSt@gmx.de]
Sent: Tuesday, January 02, 2007 6:06 AM
To: Phillips, Laura
Subject: proposed new AS No.2 "significant deficiency"

Dear Mrs. Phillips,

during my study of the proposal of the new auditing standard no.2 I had slight difficulties with the change in the definition of “significant deficiencies” as the header itself indicates a certain importance but by using the word “significant” again in the definition and defying it as less than material … (see page 10 & 11, question 7) mitigates the overall definition itself. I believe this will broaden the gap between material weakness and significant deficiency too much. It can not be the objective to put too much emphasize on the material weakness as you run into the danger of loosing the stated “benefits” (page 2) as companies could loose their focus on the process controls. It is not impossible to cover all process controls by the top down approach, therefore a underestimated process control not covered by a management control and defined as a significant deficiency could have an unwanted impact on the financial reporting.

Kind regards

Thorsten Stegmann

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From: Richard Steinberg <rms@steinberggovernance.com>
To: Phillips, Laura
Sent: Mon Feb 26 13:02:39 2007
Subject: Comments On Proposed Audit Standard on Internal Control

Laura,

It was good talking with you earlier today. As promised, I've take a few minutes to summarize the comments I provided in the phone call.

§ In the proposed standard (A 1), in paragraph 1, the wording speaks to an audit of management's assessment of the effectiveness of internal control over financial reporting. The wording in the introductory paragraph of the illustrative auditor's report also speaks to management's assessment. The opinion paragraph of the illustrative auditor's report, however, speaks to the effectiveness of the internal control system itself.

I suggest conforming the wording to promote consistency. This could be done either by referring in the opinion paragraph to the fairness of management's assertion, or instead referring in the introductory paragraph (as well as in paragraph 1 of the proposal) to the internal control system itself. I believe the latter approach is likely to provide greater clarity to readers.

§ The proposal in number of paragraphs uses the term "control objective." I believe use of this term is unnecessary, and reduces rather than enhances understanding of the requirements.

The COSO internal control report refers to objectives of financial reporting, beginning with the reliability of financial statements, supported by principles of fair presentation and the five standard financial statement assertions. These are the objectives of reliable financial reporting. Effective internal control requires that risks to achievement of these objectives be identified, and that the risks be appropriately managed with relevant internal controls in place and operating effectively.

Use of the term "control objective" confuses the matter by inserting an additional concept. Also, the term might suggest that controls have some, perhaps predetermined, inherent objectives of their own. The term is not needed, and the proposal would be better without its use.

§ In at least one place in the proposal (page 31), the role of the audit committee is noted to be part of both the control environment and monitoring components of internal control. Looking back at the COSO report, I believe the audit committee is addressed only as part of the control environment. On that basis, I suggest that reference to the audit committee be related only to the control environment component.

I hope this is useful to you and your staff in refining the document. By the way, I believe the proposal is an improvement over AS 2, and is well crafted.

If you'd like to discuss further, please let me know.

Stay well,

Rick Steinberg

SUPERVALU INC.

SUPERVALU

11840 Valley View Road
Eden Prairie, MN 55344
952 828 4000

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February 22, 2007

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

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: PCAOB Rulemaking Docket Matter No. 021
SEC File Number S7-24-06

Dear Board Members/Commissioners:

On December 19, 2006, the Public Company Accounting Oversight Board ("PCAOB") issued Release 2006-007 proposing changes to rules governing external auditor responsibilities (the "PCAOB's proposed standards") under the Sarbanes-Oxley Act of 2002, Section 404 ("SOX 404"). Also on December 19, 2006, the Securities and Exchange Commission ("SEC") proposed Release 33-8762 (the "SEC's proposed standards"), and together with the PCAOB's proposed standards, (the "proposed standards").

In the introduction to the proposed Release 2006-007, the PCAOB cited SEC Chairman Christopher Cox as a means of highlighting that a significant benefit of Release 2006-007 was to "repeal the unduly expensive and inefficient auditing standard under Section 404 of Sarbanes-Oxley." Although we believe that the proposed Auditing Standard No. 5, ("AS5"), along with *Considering and Using the Work of Others in an Audit*, are an improvement upon Auditing Standard No. 2, ("AS2"), we also believe that there are some additional changes that should be implemented in the proposal to allow companies to realize the additional benefits that the PCAOB intended to provide when it promulgated its new standards.

In our opinion, there is an element of discord between the PCAOB's proposed standards and the SEC's proposed standards. As a result of a company taking advantage of the flexibility provided by the SEC's proposed standards, it may adopt practices that vary from the PCAOB's. We do not believe that the PCAOB mandates meaningful change for the auditor as it does not align with the greater flexibility provided by the SEC's proposed standards for management. Therefore, the cost savings and efficiencies that the PCAOB intended for companies to realize by modifying its assessment of internal controls will likely be significantly eroded by the costs companies will incur both internally and externally as their external auditor performs their assessment to a different standard.

The following is an example of how the PCAOB's proposed standards differ from the additional flexibility that the SEC's proposed standards provide. PCAOB Page A1-20, paragraphs 50 and 55 relate to the testing of operating effectiveness. Paragraph 50 states, "Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, walkthroughs and re-performance of the control." Paragraph 55 states, "Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control. When combined with another test, such as observation, inspection or re-performance, however, inquiry might provide sufficient evidence about the effectiveness of a control." In the SEC's proposed standards regarding "Implementing Procedures to Evaluate Evidence of the Operation of ICFR", it states, "As the assessed risk increases, management will ordinarily adjust the nature of the evidence that is obtained. For example, management can vary the nature of evidence from ongoing monitoring by adjusting the extent of validation through periodic direct testing of the underlying controls and/or adjusting the objectivity of those performing the self-assessments." Additionally, "For lower risk areas, management may conclude that evidence from on-going monitoring is sufficient and that no direct testing is required."

Clearly, the PCAOB's proposed standards on testing are more stringent than what is required by the SEC. In order to maintain significant reliance on management's assessment for the external auditor and keep audit fees in line with expectations, we believe that a company would continue to follow the PCAOB requirements rather than initiate a process that would require additional and incremental assessment procedures by its external auditors. We recommend that the PCAOB and SEC proposed standards be aligned and provide similar flexibility for the external auditors to that provided to management by the SEC proposed standards. An example of this is in the evaluation of the design and operating effectiveness of controls as demonstrated above.

In our opinion, the guidance provided by the SEC and the PCAOB and the interpretation of such guidance by the external auditors could be made more effective through the implementation of the following additional changes:

1. The proposed standards emphasize the use of a top-down, risk-based approach, however they do not provide meaningful guidance for practical implementation. In our opinion, a comprehensive definition of a top-down, risk-based approach and a common methodology for management and external auditors to follow is required in both the PCAOB and SEC proposed standards if meaningful change is to occur.

2. The proposed standards appear to support a more focused effort on entity-level and company-level controls. For example, AS5 states that if company-level controls are strong and link directly to the process level controls or if they are significantly precise to detect material misstatements to the relevant assertions, the auditor will be able to reduce the testing of controls at the process level. Although, we believe that this effort is

positive, we believe this will be difficult for the external auditors to implement into practice without further guidance. We would like to see specific criteria and examples provided to external auditors of larger companies (including evidence requirements) for the following company-level controls:

a. Controls related to the control environment

b. Controls over management override

c. The company's risk assessment process

d. Controls to monitor financial operations

e. Controls to monitor other controls, including activities of the internal audit function.

We also recommend that the proposed SEC standards include this guidance around company-level controls.

3. We believe that the ability of external auditors to rely upon the work of others in an "integrated audit of the financial statements" is a positive change to the standard and will assist in the reduction of external audit fees. However, we also believe this represents a significant change for external auditors. We recommend that the PCAOB proposed standards provide specific criteria and examples to external auditors on how to meet the competency and objectivity standards for individuals outside of designated internal audit functions.

4. Benchmarking of automated controls can help reduce the level of effort and cost to assess the effectiveness of automated controls. We believe that the use of this strategy by the external auditors has been limited and inconsistent in practice. It seems more difficult for external auditors to apply this standard in more complex IT environments with "more than a few changes to applications". We believe that the external auditor should be able to place more reliance on a company's program change controls, specifically the testing done by the company through its program change process. To accomplish this objective, we recommend the following phrase be removed from paragraph B31 of the proposed PCAOB standard "and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e. tested the application control)".

5. We believe that rotational testing is appropriate in many areas including areas where risk is low and changes have not occurred. AS5 states that "the Board is not proposing to permit rotational testing as it is commonly understood." We believe that some auditing firms may be interpreting this to mean that they can not rotate the testing of controls. We recommend that the proposed PCAOB standards expressly permit rotational testing for lower risk areas where controls have not changed from the prior year. We also recommend that this concept of rotational testing be included in the proposed SEC standards.

6. We recommend that the proposed PCAOB's standards mandate an integrated audit of internal control over financial reporting and the financial statements rather than using the word "should".

In conclusion, although the proposed standards are a step in the right direction, we feel that the direction provided by the PCAOB and the SEC and the interpretation of such standards by the external auditors, will only generate the intended benefits to publicly-traded companies if additional alignment of the standards occurs and additional interpretive guidance is provided by the PCAOB and the SEC.

We thank you for considering our comments on this very important issue.

Respectfully submitted,

Sherry Smith

Sherry Smith

Senior Vice President, Finance

From: Ian Lamdin [mailto:ilamdin@symmetricom.com]
Sent: Wednesday, February 14, 2007 6:39 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 021

To whom it may concern:

I am concerned by your proposal to drop the requirement for external auditors to report on management's assessment of internal control, while keeping the external auditors' report on internal control. It seems you plan to drop the wrong report.

Firstly, investors want confidence that the attestations of the CEO and CFO are actually JUSTIFIED, and it is only the present external auditors' attestation on management's assessment that provides that confidence.

Secondly, the combination of a "clean" audit report on the financial statements and a "clean" attestation on management's assessment of internal control is tantamount to an assessment of internal control by the external auditors anyway, rendering their "Report on Internal Control" somewhat redundant. It nevertheless entails a significant amount of unnecessary and duplicative work being performed annually by the external auditors.

Thirdly, the proposal is in direct conflict with the legislation passed by Congress in 2002. Here's a cut'n'paste from SOX #404:

>>> b. Internal Control Evaluation and Reporting. With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement. <<<

It is evident that the attestation on "the assessment made by the management of the issuer" IS legally required, whereas (to my knowledge, anyway) the external auditors' attestation on internal control ISN'T.

Fourthly, the two reports that the new proposals require would be the same the two attestations from independent auditors that were, in the late 1990s, afforded to the shareholders of Enron only. So you are now proposing that the result of the legislation that was enacted to prevent another debacle like Enron - is that all companies will receive the same attestation reports as Enron! I'm sure your detractors in the press are salivating at prospect of drawing the investing public's attention to the irony of this situation!!

Respectfully submitted.

Ian D. Lamdin, CPA, CFE
Internal Audit Manager
Symmetricom, Inc.

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February 26, 2007

Via e-mail to:

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

RE: PCAOB Rulemaking Docket Matter No. 021

Dear Office of the Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals*.

Tatum LLC is the largest and fastest-growing executive services firm in the United States providing clients with, among other professional services, Sarbanes-Oxley compliance and consulting services. Tatum and The Controller Group, now a division of Tatum, like many other professional services firms, has been on the frontline with the Sarbanes-Oxley Act since it was passed in 2002. This experience has enabled us to see full well the challenges that companies have faced and are currently experiencing with initial compliance as well as ongoing monitoring.

Overall, we support the proposed changes and believe that the proposed auditing standard will continue to enhance the integrity of our capital markets and restore investor confidence. We appreciate the PCAOB's continued emphasis on a top-down, risk based approach as well as the flexibility on the auditor's use of professional judgment. In addition, we appreciate the specific guidance related to the auditor's consideration and use of the work of others and the requirement for the auditor to evaluate the size and complexity of the company when planning and performing the audit of internal control over financial reporting.

We understand the need to avoid guidance that is too strict or detailed and to allow for judgment and flexibility; however, we believe that more practical guidance is necessary in a number of areas to truly achieve the desired efficiencies. We offer the following observations for your consideration:

Overall Comments

We suggest more practical guidance and examples to demonstrate how the audit of internal control over financial reporting and an audit of financial statements should be integrated. Under the proposed standard, the auditor is encouraged to reduce the amount of testing over lower risk controls and reduce testing of controls in subsequent years. In addition, examples cited include the use of a walkthrough only or "testing controls through inquiry combined with observation or other procedures" (Paragraph 12). If less evidence is obtained by the auditor over the effectiveness of controls (even lower risk controls), auditors may be compelled to perform additional and/or excess substantive procedures to obtain comfort for the financial statement audit. We believe that true audit efficiency cannot be achieved without specific guidance on how the auditor should consider evidence obtained over the effectiveness of the internal controls over financial reporting, either through their own testing or the work of others, when determining the amount of evidence needed for the financial statement audit. We believe that the example of simply using a walkthrough (even if supplemented by observation) in subsequent years may be challenging for auditors to implement without a corresponding increase in substantive procedures, especially if the guidance implies that only one walkthrough is necessary. This is largely due to the fact that inquiry and observation can really only establish control operation at a point in time; while in order to leverage reliance on the control for financial statement audit purposes, auditors need satisfaction that the control operated throughout the audit period.

We also suggest that the PCAOB guidance and guidance issued by the Securities and Exchange Commission (SEC) be more closely aligned with respect to specific activities such as scoping and testing. For example, in our comments to the SEC related to their proposed guidance for management, we note that there is no mention of identifying significant accounts and major classes of transactions and relating them (and controls) to relevant financial statement assertions (AS5 paragraphs 28 and 29, 32-34). This could lead to a difference in scope definition and large differences in the evaluations being performed by management and the external auditors. This difference may result in disagreements or unnecessary testing of accounts and/or locations/business units and could further lead to deficiencies, including significant deficiencies and material weaknesses, identified by external auditors rather than management. In addition, if the scope, activities and testing are not somewhat aligned, companies will lose the opportunity to capitalize on the benefits of auditor reliance and their ability to leverage the work performed in conducting management's assessment to reduce the amount of work performed by the auditor.

Responses Specific to Certain Questions

Questions 1 and 4

While the top-down approach and company level controls are described well, we have experienced reluctance on the part of many auditors to employ such approaches and believe that more practical guidance is necessary

Question 6 and 17

The performance of a walkthrough only may be sufficient to substantiate that there were no changes to controls or processes since the previous audit and to test the design and operating effectiveness of certain low risk and/or IT controls; however, as previously noted, the reduction in direct testing may create the need for the performance of additional substantive audit tests in order to satisfy financial statement audit objectives. There may be little or no value in this trade-off.

Question 11

We believe that further clarifications and examples related to materiality determination and application to determining the scope of the audit of internal control is warranted to avoid unnecessary testing and disagreements between management and the auditors. This guidance should be closely aligned with guidance provided to management by the SEC.

Question 13 and 14

Removal of the auditors report on management's assessment will yield efficiencies for some clients; however, in our experience, in many cases audit teams were performing the evaluation of management's assessment and their controls testing simultaneously, especially in those cases where there was extensive auditor reliance on the work performed by internal audit or by us, as the company's service provider. Elimination of this provision will likely lead to less influence by auditors on management's assessment process which will be welcomed relief for many companies.

Question 18

More practical guidance is needed to clarify the scope for multi-location engagements before efficiencies can be gained. Other factors that will heavily influence this relate to comments made earlier related to integration of the ICFR audit and the financial statement audit. Many auditing tools and assumptions are based on coverage and relationship between control risk and remaining risk.

Question 19 and 22

The guidance related to using the work of others may be misunderstood and requires further clarification, especially as it relates to (1) elimination of the "principal evidence provision" (2) reliance on ICFR work performed in connection with management's assessment and (3) direct assistance that the auditor requests, and thus supervises and reviews. Please see further comments below related to paragraph 13 of AS5.

Question 26

Requiring a walkthrough only for all significant processes versus major classes of transaction is not likely to reduce the number and detail of the walkthroughs performed. We have observed that under AS 2 auditors typically only walkthrough those portions or controls within the process that are substantially different and only walkthrough once those controls that are similar or identical across the major classes of transactions. Because the processes that are substantially different generally present significantly different risks, we believe that auditor will still be required to perform a walkthrough.

Question 27

While we support the use of others as direct assistance in performing walkthroughs, we acknowledge that it does create a risk that the process may not be fully understood by the auditors if they have not had the benefit of walking through it themselves. This could, in turn, impair their ability to effectively audit the process.

Questions 28 - 30

While progress has certainly been made in providing guidance on "scaling" the audit for smaller companies, we believe that more can be done in this area related to specific applicability/non-applicability of certain controls and application of the COSO guidance for smaller businesses. We still witness to a large extent a "one size fits all" approach to ICFR from a number of audit firms. In addition, we suggest more practical guidance related to the extent and formalization of Disclosure Control Procedures and certain entity-level control procedures as well as segregation of duties in smaller companies.

Comments related to specific paragraphs of Proposed AS5

Paragraph 12

In our overall comments above, we addressed concerns related to reliance on a walkthrough. In addition, clarification may be required regarding those "absences" of documentation that may be acceptable. For example, if the control requires account reconciliations to be prepared and located in a specific place (electronic or hard copy) and the reconciliation cannot be located, it would be difficult to obtain the necessary assurance from inquiry and observation, especially as it relates to the timeliness of the account reconciliation.

Paragraph 13 and 63

With respect to using the work of others, as previously noted in our response to questions 19 and 22 above, we encourage additional points of clarification regarding the work performed by others (absent specific auditor request for direct assistance, thus supervised, reviewed and approved by others such as internal audit, management or a

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service provider) and work performed by others at the specific request of auditors (thus required to be supervised, reviewed, evaluated and tested by auditors). We believe clarification is necessary to avoid confusion regarding auditor influence on management's assessment procedures.

In addition, Paragraph 10 in Appendix 2 of the proposed standard states that "To use the work of others to reduce the nature, timing, or extent of the work the auditor would have otherwise performed, the auditor should –

a. Evaluate the nature of the subject matter tested by others;
b. Evaluate the competence and objectivity of the individuals who performed the work; and
c. Test some of the work performed by others to evaluate the quality and effectiveness of their work."

We believe that the auditor may find limitations in their ability to use the work of management when taking into consideration the interpretive guidance proposed by the SEC in Release Nos. 33-8762 and 34-54976. Under the SEC's proposed guidance, management's evidence to support their evaluation may come from a combination of on-going monitoring activities and direct testing of controls. In addition, management may determine that it is not necessary to maintain copies of the evidence that it evaluates and in smaller companies where management relies on the daily interaction with its controls, management may have limited documentation for their evaluation. We believe that specific guidance should be included as to how the auditor should consider the work of others when management has obtained their evidence through on-going monitoring activities and limited or no documentation is maintained as permitted by the SEC guidance.

In addition, we suggest additional guidance or suggestion related to using the work of others in the performance of roll-forward procedures.

Paragraph 24

We suggest adding that when identifying significant accounts and disclosures, the auditor also consider management's evaluation and risk assessment. We have seen situations where the auditor's determination of significant accounts and disclosures does not consider all relevant facts and circumstances, including qualitative factors considered by management.

Paragraph 31

The statement that the auditor may base his or her work on assertions that differ from those in this standard may lead to confusion. What other assertions may be applicable that would still provide for the focus on controls over financial reporting?

Paragraph 44

We believe that a closer link needs to be made with the SEC's guidance for management with respect to selecting controls to test.

Paragraph 53

Please provide additional clarification related to the comment in the "Note:" that any individual control does not necessarily have to operate without any deviation to be considered effective. If the failure could (or does) result in a misstatement or is an indicator that further failures could lead to a material misstatement it could not be considered effective – this would be determined in the evaluation of the deficiency. In addition, current audit tools for sampling rely on inputs that include the expected number of errors. Sample sizes increase substantially if an error is encountered when not expected or if an error is expected. Perhaps this comment is better addressed relating to evaluating deficiencies to avoid the potential for increased sample sizes.

Paragraphs 78 and 79

These indicators are not consistent with SEC guidance for management. This could lead to disagreements between management and auditors. In addition, with respect to the last bullet of paragraph 79 – we suggest more practical guidance and examples related to compliance with laws and regulations that could have a material effect on the reliability of financial reporting in order to avoid the over-expansion of the audit scope.

Comments related to Appendix B

B9

This paragraph may be too broad and may be misinterpreted to imply an increase in substantive procedures which could lead to over-auditing. Low risk areas with controls evaluated as effective should have limited substantive testing.

B12

As previously noted, we suggest multi-location guidance be further linked to SEC guidance for management to avoid large scope differences between management and the auditors.

Use of Service Organizations

All of this guidance needs to be more closely linked and related to guidance for management from the SEC. Currently, the proposed standard implies that only auditors need to perform these procedures and the only reference to relying on management's procedures is in paragraph B28 as an "additional procedure." This could lead to misinterpretation and duplication of work by auditors when they could be relying on work performed in conducting management's assessment or performed by management as a monitoring control (e.g., only engaging service providers with SAS 70s, review of the annual SAS 70, etc.).

We appreciate the efforts being made by the PCAOB to ensure audit quality and efficiency. Again, we appreciate the opportunity to comment on the proposed standard and would welcome the opportunity to meet with you to clarify our comments.

Sincerely,

Kathy Schrock

Kathy Schrock
Partner and National Solution Leader – Sarbanes-Oxley
Tatum LLC

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February 26, 2007

The Honorable Christopher Cox, Chairman
U.S. Securities and Exchange Commission
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Washington, DC 20549-1090
Electronic Address: rule-comments@sec.gov

The Honorable Mark W. Olson, Chairman
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803
Electronic Address: comments@pcaobus.org

**Re: SEC File Number S-7-24-06; Management's Report on Internal Control Over Financial Reporting (71 Fed. Reg. 77,635);
PCAOB Release No. 2006-007; Proposed Auditing Standard**

Dear Chairman Cox and Chairman Olson:

The Telecommunications Industry Association (TIA) appreciates the opportunity to comment on the proposed regulations promulgated by the Securities and Exchange Commission (SEC) [1] and the Public Company Accounting Oversight Board (PCAOB). TIA commends the agencies for addressing the important issue of the Sarbanes-Oxley Act[2] (SOX Act) compliance. Our members are particularly concerned with the impact of Section 404 on small- and medium-size businesses (SMEs). While the goal of Section 404, protecting investors from financial accounting manipulations, is meaningful, it has resulted in a negative, unintended burden on the small business community.

TIA represents more than 600 companies that provide information and communications technology products and services for the global marketplace through its core competencies in standards development, domestic and international advocacy, as well as market development and trade promotion programs. The association facilitates the convergence of new communications networks while working for a competitive and innovative market environment. TIA has a broad membership with interests in various policy issues affecting their business. Eighty percent of TIA's members are comprised of small-

[1] *Management's Report on Internal Control Over Financial Reporting; Proposed interpretation; Proposed Rule, 71 Fed. Reg. 77,635 (Dec. 27, 2006)* [hereinafter *Management's Report*].
[2] *Sarbanes-Oxley Act of 2002,* Pub. L. No. 107-204, 116 Stat. 745 (2202).

or medium-sized businesses, and TIA appreciates this opportunity to comment on the effects of SOX Section 404 on these entities.

Representing 99.7 percent of all employer firms and employing half of all private sector employees, small businesses are vital to the United States economy.[3] The U.S. economy depends on these companies to create jobs and spur innovation, particularly since 41 percent of high-tech workers are employed by SMEs.[4] Unfortunately, this essential sector of the U.S. economy is being harmed by the effects of SOX Section 404.

Since the enactment of the SOX Act, TIA has been concerned with its disproportionate effects on small- and medium-sized public companies. Although not the objective of the SOX Act, compliance with Section 404 triggers extensive administrative costs and auditing fees that particularly impact SMEs. Based on data from Foley & Lardner's 2004 and 2005 studies on the impact of the SOX Act, audit fees increased an average of 84% for Standard and Poor's (S&P) small-cap companies and 92% for S&P mid-cap companies, while only increasing 55% for S&P 500 companies.[5] Based on data from the same study, the average cost of being public in FY 2004 for companies with annual revenue of under $1 billion, increased by $851,00 (33%) over 2003.[6] These costs can be attributed in large part to accounting and auditing fees, lost productivity, and legal fees associated with SOX compliance.[7]

The costly burden of Section 404 of the SOX Act is driving small companies out of public markets. It is simply too difficult for these companies to comply with the requirements of Section 404 and operate as a public company. As a result, these companies are choosing not to go public or to delist as a public company.[8] Further, some of these companies are turning to foreign exchange to list, injuring U.S. competitiveness in a global market.

TIA hopes that the SEC and PCAOB use this rulemaking to remedy the significantly different impact that the SOX Act has on smaller and larger companies, and the unexpected burden that is falling on smaller companies. There is a need for regulatory clarity regarding this issue, which is why TIA supports the provisions in both the SEC and PCAOB proposed rules addressing scalability.[9] It is important that management and auditors have the freedom to consider both the size and complexity of a company when identifying a material weakness, which is a deficiency, or combination of deficiencies in Internal Control Financial Reporting (ICFR) such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's ICFR.[10] Recognizing that smaller companies have fewer business lines, less complex business processes and reporting systems, and fewer levels of management, will allow both management and auditors to focus only on material weaknesses, while reducing the time and money exerted by small companies on SOX compliance.

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[3] Advocacy Small Business Statistics and Research *at* http://app1.sba.gov/faqs/faqindex.cfm?areaID=24 (last visited Feb. 7, 2007).
[4] *Id.*
[5] Foley and Lardner, LLP, "The Cost of Being Public in the Era of Sarbanes-Oxley," June 16, 2005.
[6] *Id.*
[7] *Id.*
[8] Neal Wolkoff, "American's regulations are scaring the Sox off small caps," Financial Times, Aug. 1, 2006.
[9] Add cite to appropriate section of each proposed reg
[10] Management's Report, *supra* note 1, at 13.

Additionally, TIA supports a minimum one-year extension of the exemption for non-accelerated filers, unless and until a cost/benefit analysis of the regulations has been completed. This can be achieved through full-field testing of the proposed regulations on accelerated filers before they become mandatory for non-accelerated filers. Extending the exemption for non-accelerated filers will allow these companies to properly prepare for compliance and reduce the likelihood of a material weakness on their first audit. Further, the SEC and PCAOB can use this time to evaluate the effects of the regulations on larger companies before imposing them on smaller companies, for whom the regulations are significantly more burdensome.

TIA strongly believes that it is important to balance the interest in protecting investors' interest, with the need to foster the U.S. capital market and small- and medium-size public companies, in particular. We believe this can be accomplished through the scaled approach to Section 404 where the requirements and related costs are appropriate to the company's size.

We would like to thank you on behalf of our members for this opportunity to submit comments regarding implementation of the Sarbanes-Oxley Act and your agencies' proposed regulations. If you have any questions about this submission, or if there are other ways we can assist you, please do not hesitate to contact us.

Sincerely,

Grant Seiffert
TIA President

Texas Society of Certified Public Accountants

February 26, 2007

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

RE: Docket Matter No. 021

To Whom It May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of certified public accountants in Texas, as well as the public interest. The TSCPA has established a Professional Standards Committee (PSC) to represent those interests on accounting and auditing matters. The committee has been authorized by the Texas Society of CPAs' Board of Directors to submit comments on matters of interest to the committee membership. The views expressed in this letter have not been approved by the Texas Society of CPAs' Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policy of the Texas Society of CPAs.

We appreciate the opportunity to provide input into your deliberations on Docket Matter No. 021.

Our letter provides comments on each of the questions included in the Exposure Draft of this proposed Auditing Standard.

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

We believe the proposed standard does a good job in describing the top-down approach to auditing internal control. Emphasizing that the auditor starts with the financial statement level and company-level controls and works down to controls over significant accounts and significant processes is most appropriate. We feel that this approach will help the auditor in the planning process and allow him or her to allocate scarce audit resources to those areas most likely to cause concerns about the risk of material misstatements due to errors or fraud.

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

We believe appropriate emphasis is placed on the importance of identifying and testing controls designed to prevent or detect fraud. The listing of several company-level controls and items that the auditor should assess in evaluating the control environment should prove quite helpful. One concern we have is that an auditor might interpret the listed items as an all-inclusive list. To avoid such an interpretation, we believe the proposed standard should state that the list of controls and areas of concern do not constitute an all-inclusive list. Further, the auditor should be reminded to exercise professional judgment in addressing risk factors that might be unique to a particular client. The PSC also believes that specific emphasis should be added to the proposed standard encouraging the auditor to assess the audit entity's "tone at the top." The tone at the top tends to have a substantial impact on the behavior of entity personnel and serves as an important component in the prevention and/or detection of fraud.

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

We believe this approach represents an improvement over the previous guidance. The top-down approach allows the auditor to focus on those controls that are most significant in the prevention of material misstatements. This approach should serve to make the audit process more efficient since the auditor is required to opine on both the entity's financial statements and the effectiveness of its internal 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?**

We believe the standard adequately articulates the appropriate consideration of company-level controls and their effect on the auditor's work. The standard does a good job of addressing which controls should be tested by the auditor. The only concern we have is that the proposed standard is written as if all the components will be addressed in every situation. Since there will always be clients or unique situations that the standard cannot predict, auditors should be reminded that when the guidance in the standard does not address a particular situation, reliance should be placed on the auditor's professional judgment.

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

We believe the proposed standard incorporates risk assessment with the auditor's tests of internal controls, as well as the impact that such assessment has on the evidence to be gathered. Again, we feel the standard should make it clear that the discussion of the nature, timing, and extent is meant to be illustrative and is not intended to address evidence-gathering issues and unique situations that may arise during an audit engagement. The proposed standard would benefit from specific illustrations of the relationship between the level of risk and the necessary evidence.

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

We believe a walkthrough should be sufficient to test the design and operating effectiveness of some of the lower risk controls. However, the auditor should be reminded to exercise professional judgment in determining whether such walkthroughs would be sufficient. The sufficiency of a walkthrough should depend on the overall audit risk and how risky the process being assessed happens to be. If a process is considered to be a low-risk process, then a walkthrough should be sufficient in most situations. The standard should emphasize that walkthroughs are highly dependent on the risk profile of the audit client and the nature of the process being considered.

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7. Is the proposed definition of "significant" sufficiently descriptive to be applied in practice?

The new definition states that "(a) **significant misstatement** is a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting." In our opinion, this definition provides better guidance than "more than inconsequential" as found in the existing standard. However, we believe reasonable professionals will likely have disparate views of what is "important enough." This is due to the confusion that we believe exists with the terms "reasonable possibility" and "less than material." There needs to be further clarification of these terms.

Does it appropriately describe the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency?

We do not believe the definition appropriately describes the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency. We were unable to find the description referred to in this question within paragraphs 70 – 79 of the proposed standard which deals with this new definition. Thus, if the guidance does exist, it appears to be misplaced.

8. Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or the auditor?

We believe it is extremely difficult to assess the potential impact of a control weakness if it is only potential. The fact that the control weakness has never had any material impact argues against its potential materiality, but other evidence could indicate a high probability that it is material. We believe in most instances, such an issue would result in considerable discussions involving the auditor, management, and the audit committee. A final conclusion regarding such issues involves the exercise of professional judgment, and the aforementioned parties are the correct group to be exercising that judgment.

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 believe the proposed standard should include a definitive statement to the effect that the failure to identify a material misstatement does not negate the auditor's responsibility to identify any existing material weaknesses.

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 the proposed changes should reduce the effort. In our opinion, the existing guidance was already clear regarding the intent of the standard. The revisions in the proposed standard should help to make the language of the standard agree with the guidance.

10. Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present?

Since the overall assessment is a matter of professional judgment, such decisions should be left to the auditor.

Will this change improve practice by allowing the use of greater judgment?

We believe the change will improve practice. Leaving the auditor free to exercise his or her professional judgment is the best approach. Trying to micromanage the audit is an inappropriate course of action.

Will this change lead to inconsistency in the evaluation of deficiencies?

There is always the potential that the exercise of professional judgment will vary somewhat among audit professionals. However, we believe that given the larger framework and other available guidance, the differences will be at the margins where significant judgment is required, not in the majority of situations. We believe there will be far less inconsistency in the evaluation of deficiencies.

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

We believe the proposed standard makes it clear that the goal is to avoid detail tests of every control and that the focus should be on those areas that have the highest risk and are most likely to lead to material misstatements. However, there needs to be enhanced guidance on the scope of the audit of internal control where entities with multiple locations are involved. We still lack the necessary guidance in this area, especially as it regards an integrated audit.

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?

We believe the reference to interim should remain, but this entire area is in need of clarification due to the confusion that exists in practice. It is still important to evaluate whether the controls are effective throughout the year and not just at year end. The sections of the proposed standard that discuss audit scope and evaluation are sufficient to overcome any tendency to set audit scope too low. However, it should be pointed out that materiality is not the same for interim and annual financial statements, and appropriate adjustments should be made when interim vs. annual financial statements are being considered.

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

We do not believe there will be any reduction in audit work as a result of removing the requirement for an evaluation of management's process.

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

Whether you call it an "assessment" or an "understanding," we believe the auditor needs to know what management has done in order to determine the nature, timing, and extent of his or her audit engagement tests.

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?

In essence, we believe that both opinions are not really needed.

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

The value of cumulative knowledge is appropriately incorporated in the proposed standard.

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?

We believe walkthrough procedures would prove reliable in areas where there is little risk of capturing and properly recording, as well as in processes with low materiality to the financial statements. The auditor should only be testing key controls for relevant assertions in significant accounts which by definition mean they are material and have a high risk of material misstatement. Therefore, relying on only a walkthrough in such areas would seldom, if ever, produce sufficient evidence.

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?

We question whether the proposed standard's approach for determining the scope of testing in a multi-location engagement will result in more efficient multi-location audits. We believe this proposed standard is much too vague in providing adequate guidance for an integrated audit. The auditing literature lacks adequate guidance in this area in general, and this proposed standard does not appear to correct this guidance deficiency. This answer tends to reiterate the concern we expressed earlier in our response to Question 11. Until greater guidance is provided on scope determination in multi-location engagements, practitioners will continue to be inefficient in the audits of multi-location entities.

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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?

We believe a single framework for using the work of others for both an integrated audit and an audit of only financial statements is appropriate. An integrated audit and an audit of only financial statements both rely on the general standards of GAAS and the same standards for the gathering of audit evidence. This is true whether testing controls for the purpose of an audit of internal control or testing controls, account balances, and disclosures for an audit of the financial statements. The key factors used by the auditor in determining reliance are the same – the nature of the subject matter tested and the competence and objectivity of the persons performing the tests. Thus, we do not believe different frameworks are necessary.

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?

We believe the proposed definition adequately captures the correct scope of activities. Relevant activities encompass two types of tests: (1) tests of the design and operating effectiveness of internal controls over financial reporting; or (2) tests that provide evidence about potential misstatements of the financial statements.

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

We do believe that such an understanding has the potential to provide benefit to the auditor in improving audit quality. While the proposed standard does not change the requirements that an auditor must meet, the use of work performed by others may provide the auditor with additional insight due to specialized knowledge and expertise possessed by the other individuals. The auditor can always benefit from information developed by those individuals performing relevant activities.

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 do not believe the principal evidence provision found in AS No. 2 was necessary. If the auditor can obtain sufficient appropriate evidence through the work of others, the principal evidence provision of AS No. 2 only increases the direct work required by the auditor with no enhancement of the quality of the results achieved. If auditors are expected to exercise professional judgment, the standards should support this expectation.

23. Does the proposed standard provide an appropriate framework for evaluating the competence and objectivity of the persons performing the testing?

We agree the auditor should consider traits such as the education, professional experience, certification, supervision, and work product quality in evaluating an individual's competence. Traits such as independence from the area under review, the organizational placement of those responsible for the work of others, and policies concerning compensation arrangements should be considered when assessing an individual's objectivity. We do suggest the development of specific guidance on testing the competence, objectivity, and work product of the persons performing the testing.

Will this framework be sufficient to protect against inappropriate use of the work of others?

We believe the standards are objective and measurable, and the framework is appropriate. Facts and circumstances supported by professional judgment should always dictate the extent of reliance that can be placed on the work of others.

Will it be too restrictive?

We do not believe it will be too restrictive. These factors are no different than those auditors apply to their own personnel in gauging competence, objectivity, and quality of work.

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

We find the criteria provided in the proposed standard to be objective, measurable, and sufficient for its intended purposes.

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 this eliminates the potential of an individual's compensation being tied to achieving a particular result, either positive or negative, in the final outcome of the testing. It also seems to eliminate the potential challenge to the result of the testing based on a factor which could indicate a vested interest in achieving a particular result. Compensation is always a factor, but not necessarily a major factor. Of greater importance is how independent the person is, to whom he or she reports in the organization, and his or her professional qualifications.

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

We believe the split between significant process and major classes within each significant process is more form than substance. In the example presented in the proposed standard, why wouldn't an auditor do a walkthrough of Internet sales? It is obviously a different process than retail sales with different controls and risks. How would one know if he or she didn't gain an understanding of both processes? In most circumstances, how would it be possible to gain an understanding without performing a walkthrough?

27. Is it appropriate for the auditor to use others as direct assistance in performing walkthroughs?

We believe the answer to this question rests on the significance of the transaction cycle. We feel the auditor generates a greater degree of comfort if he or she does the walkthrough when a significant transaction cycle with high risk implications is involved. The understanding obtained in such circumstances is too important to delegate to other individuals. As always, the significance of the transaction cycle is a matter of professional judgment to be exercised by the auditor.

Should the proposed standard allow the auditor to more broadly use the work of others in performing walkthroughs?

We do not support allowing the auditor to more broadly use the work of others in performing walkthroughs. As noted in the first part of this question, we find that the critical nature of the process to the audit should be the controlling factor in determining who performs the walkthrough. To allow for a broad consideration of who should perform the walkthrough would lead to an inconsistent and inappropriate approach to the walkthrough process on the part of auditors. This understanding is too important to relegate to a broad and flexible set of guidelines.

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?

While the proposed standard presents a strong theoretical description of the issue of scaling the audit for the size and complexity of the company, it does not provide much practical guidance. We believe the proposed standard tends to lack useful guidance in this area and is deficient in helping audit practitioners make informed judgments that will result in efficient and effective audits. Practitioners need practical guidance upon which to base the exercise of professional judgment. To merely include a dialogue that does not lend itself to practical application results in confusion and a variety of approaches that do not meet the intent of the standard.

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

We believe the proposed standard was adequate in this area.

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?

We have no additional suggestions in this area.

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

We don't believe it does.

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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 believe they are meaningful to size, but not necessarily to complexity. It is important to note that a diversified or decentralized large company can have business locations or business segments that are managed and controlled more like a small business.

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?

We are not aware of any other information.

34. How can the Board structure the effective date so as to best minimize disruption to the 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?

We believe that since this is an audit standard, public accounting firms need at least one year to modify their internal processes and change their firm-wide methodology to comply with the proposed standard. If approved by the SEC in mid-2007, it should be effective for the audits of companies with years ending after December 15, 2008. We do believe earlier application should be encouraged.

We appreciate the opportunity to provide input into the standard setting process.

Sincerely,

Sandra K. Johnigan

Sandra K. Johnigan, CPA, CFE
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Re: SEC File Number S7-24-06
PCAOB Rulemaking Docket Matter No. 021

Dear Gentlemen,

We would like to thank the Commission and the Board for the opportunity to comment on the Securities and Exchange Commission's (SEC) proposed interpretive guidance for management regarding its evaluation of internal control over financial reporting (ICFR) and the Public Company Accounting Oversight Board's (PCAOB) proposed auditing standard on auditing internal controls. We expect that this proposed interpretive guidance and auditing standard will enhance the efficiency of management's and the external auditors' assessments of a company's ICFR. Our hope is that the SEC and PCAOB will continue to assess the requirements of ICFR into the future and provide additional guidance as deemed necessary.

We are pleased with the direction of the proposed guidance and believe that a risk-based approach to the evaluation of internal controls over financial reporting for both management and the auditors will enhance the efficiency of management's assessment and auditors' audit of internal controls, while reducing some of the unnecessary costs associated with the current process. As a company in the business of risk assessment, we find it appropriate that a company's resources should be focused on an assessment of the financial reporting functions and processes with the most risk. We also commend the Commission and the Board for the coordinated effort in producing complementary guidance for management and auditors and recommend that this coordinated approach be extended to the development of future guidance.

As stated above, we are pleased with the direction of the Board and the Commission and the high level guidance offered. In an effort to add to the efficiency in the proposed guidance without sacrificing effectiveness, we offer the following suggestions:

- The Commission should consider allowing the rotation of management's assessment of significant controls over financial reporting where there are complementary controls or mitigating factors in place and a history of successful assessment. The Commission's proposed interpretative guidance recognizes that there are inherent mitigating factors and entity-level controls in some of the internal controls and allows for on-going monitoring instead of testing in some cases, however, we believe that this should be extended to include the rotation of the testing of significant internal controls. Once a baseline is established and a company has a history of success in assessing a control, that control should be assessed when there is a change in the process and absent a change, it should be evaluated for operating effectiveness on a rotational basis (e.g., no less frequently than every 3 years) with other controls having a history of operating effectively.

- Similar to our suggestion on the rotation of control testing for management, we recommend that the Board reconsider the necessary evidence criteria for significant, including high risk, controls. If an auditor concludes that a Company's internal controls are appropriately designed and the auditor has a successful history in auditing the Company's internal controls with high risk, there should be an opportunity for the auditor to perform reduced testing and lessen the need for substantial evidence every year. We believe that the individual controls should be reviewed based on risk, the Company's risk mitigation, the Company's assessment of the control, the auditor's assessment of the Company's personnel and processes and the auditor's history of testing the control, rather than a presumption that there are controls with such a high degree of risk that the necessary evidence could not be reduced.

- We recommend that the Commission either eliminate "program development" from the Role of General Information Technology Controls discussion or provide additional clarification. Program development broadly includes all of the pre-implementation project management, design, development and testing, all of which have no impact on the financial statements as these functions typically occur in a non-production environment. If a Company has appropriate controls in place for testing new programs or program changes prior to placing the new program or changes into production, testing in the development phase would be unnecessary and redundant. We believe that the references to program development could be eliminated or, if it is retained, clarification should be provided for better context of its intended application.

In summary, we are pleased with the direction of the Commission's interpretive guidance for management's assessment of ICFR and the Board's proposed auditing standard. We commend you for taking a collaborative approach to developing this guidance and for using a risk-based approach. Where there are opportunities to do so, we recommend that a similar approach be used in developing guidance in the future.

Thank you for your consideration.

Sincerely,

D. Keith Bell

cc: Jay S. Benet

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Re: SEC File Number S7-24-06
<u>PCAOB Rulemaking Docket Matter No. 021</u>

Ladies and Gentlemen:

The U.S. Chamber of Commerce is the largest business federation in the world, representing the interests of some three million companies of every size and industry. We have been an advocate for the issuance of specific guidance by the U.S. Securities and Exchange Commission (the "SEC") for issuers under Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX") and for revisions to Auditing Standard No. 2 ("AS2") as promulgated by the Public Company Accounting Oversight Board (the "PCAOB"). In that regard, we very much appreciate the opportunity to provide comments in response to the SEC's proposed interpretive guidance and rule amendments with respect to SOX 404 (the "SEC Guidance") and the PCAOB's proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* that would supersede AS2 (we refer to the new proposed auditing standard as "AS5") as well as the other proposals included in the PCAOB's Rulemaking Docket (the "PCAOB Release").

The Chamber has been very supportive of most provisions of SOX and, with respect to Section 404, strongly advocates for good systems of internal control in public companies. We believe that SOX has had positive effects in causing boards, management and external auditors to be more thorough and attentive in fulfilling their responsibilities. However, a large cross-section of our membership has expressed concerns about the implementation of Section 404 through AS2. The most common general concern expressed by our members is that the implementation of Section 404 has had a negative effect on the competitiveness of U.S. companies and the U.S. capital markets and created burdens on these companies and their management well beyond what Congress intended and what is necessary to remedy acknowledged abuses. While SOX 404 was conceived fundamentally as a disclosure requirement to provide more information about internal controls, under AS2 it has evolved into a substantive requirement for specific levels of internal controls that goes far beyond the Congressional mandate.

Overview

We commend the efforts of the SEC and the PCAOB to provide additional issuer guidance regarding internal controls and to promulgate more detailed standards for auditors that will replace AS2. As companies have attempted to comply with SOX 404, they have been forced to reconcile the increased costs associated with such compliance with critical ongoing expenditures for research, development, investment and employment. We believe that the proposals represent a legitimate and significant attempt to address the widespread concerns of the business community and the difficulties that public companies have faced on the ground. We concur with your public statements that the proposals are, for the most part, principles-based.

However, we believe that some of the core issues with SOX 404 and AS2 have not been sufficiently addressed, particularly the ambiguity of the internal control requirements and the application of the rules to smaller public companies. If these issues remain unaddressed, the damage to our capital markets is likely to continue to be severe – the negative effects currently suffered by public companies will continue, smaller issuers will face barriers to entering the public market and foreign companies that may have hoped to list here in the future will be dissuaded from doing so.

We set forth below our specific comments on the proposed guidance and rules. Whatever the final form of the SEC Guidance and AS5 that are enacted, we believe it is important to note that their true impact on public companies and their auditors ultimately will depend largely on questions of implementation. The manner in which the SEC enforces SOX 404 and interprets its guidance and the way in which the PCAOB implements its new audit standard in its reviews will determine whether these rules and standards will provide the desired assurance to market participants regarding internal controls while affording companies the certainty and flexibility necessary to conduct their business activities and remain competitive. As a result, we anticipate that continued scrutiny by the SEC and the PCAOB of implementations of the guidance and standards by their staffs will be required and suggest that both engage in post-adoption cost-benefit analysis of the guidance and standards. Once it is enacted, AS5 should be applied consistently throughout the PCAOB's inspections process so that ongoing expectations for companies and their auditors are clear. The PCAOB should endeavor to issue timely inspection reports and periodically identify for companies and independent auditors any specific trends that it has noted in its inspections. Additionally, the PCAOB should consider how its inspection process could develop a stronger, more direct understanding of management's assessment process instead of relying solely on the auditor's summarization of this process. These post-adoption steps will permit the SEC and the PCAOB to assess implementation issues and the content of the guidance with respect to audits of internal control in smaller companies that the PCAOB indicates in its Release will be forthcoming next year.

Discussion

Specificity of Rules and Guidance

Interaction between SOX 404 and AS5. We recognize the efforts of both the SEC and the PCAOB in attempting to provide practical guidance for companies and auditors that will allow them to comply with the internal control requirements with certainty and in a cost-effective manner. As we have noted in the past, in the absence of direct guidance for issuers, management has been forced to rely on AS2 in its evaluation of internal controls. This has had the effect of de-emphasizing the importance of management's own assessment of its internal controls, despite the fact that the PCAOB was never intended to be a regulator of issuers. Also, the focus on the auditor's assessment has had the effect of inhibiting the exchange of ideas between management and independent auditors, turning a formerly collaborative relationship into one that is increasingly adversarial.

As proposed, AS5 sets forth the requirements applicable to an audit of internal controls with a high degree of specificity. The SEC Guidance is written quite differently and, in an appropriate attempt to provide companies with necessary flexibility, it is inherently more vague about the specific procedures that companies need to follow in order to establish and evaluate internal controls.

While we understand the sources of this disparity, we are concerned that the relative specificity of AS5 may have the unintended consequence of increasing the focus on the auditor's assessment as opposed to management's assessment of internal controls. We believe that this risk can be avoided through increased coordination of the requirements of SOX 404 and AS5. There are areas of natural overlap between SOX 404 and AS5, and we encourage the SEC and the PCAOB to work closely together in order to weave together the specific provisions of AS5 with the more general guidance set forth in the interpretive release on SOX 404.

Use of Illustrative Examples and Feedback. The SEC Guidance would be more helpful if it provided more illustrative examples of how the guidance should be implemented. In particular, companies that are striving to maintain a comprehensive yet cost-effective internal control environment would appreciate examples of insufficient compliance measures as well as overly conservative implementation. While we understand that there is no single road map to effective compliance, examples that are illustrative, rather than dispositive, would go a long way towards assuring companies that they are on the right path. We also urge the SEC to consider means of providing prospective advice and guidance to companies so that they can receive feedback on their internal control efforts as they are being implemented rather than after the fact.

Defined Terms

The SEC should consider providing more specific language and/or examples in order to clarify various defined terms that are used in its Guidance and the PCAOB should revisit its definitions to address continuing problems.

Material Weakness. The definition of "material weakness" is central to SOX 404 analysis and one that continues to be unnecessarily vague. For example, at what point do actual quantitative errors give rise to a presumption of a material weakness? Do a series of errors that are immaterial by themselves indicate a material weakness when viewed collectively? What is the role of bad faith or deception in determining whether a material weakness exists?

The PCAOB has reworded its standard for material weakness from "more than a remote likelihood" in AS2 to "reasonable possibility" in AS5. However, AS5 suggests that these standards are equivalent, asserting "that some auditors and issuers have misunderstood the term 'more than remote.'" We believe that this "misunderstanding" gave rise to many of the problems that arose under AS2 and, as a result, the PCAOB should provide a stronger statement of what the new standard means and its relationship to the old standard. This will prevent companies and their auditors from falling back on prior analyses and permit them to reevaluate material weakness through the application of the new "reasonable possibility" standard to the internal control environment.

We believe the PCAOB's use of the term "combination of control deficiencies" in the definition of material weakness should be clarified. The term could be read to require the aggregation of various discrete control deficiencies to determine the existence of a material weakness, despite the fact that the individual control deficiencies may be completely unrelated to one another. The PCAOB should make it clear that the determination of a material weakness requires an evaluation of control deficiencies that are related to each other or to a significant account.

At its most basic level, the "material weakness" analysis involves proving a negative – companies have to certify and demonstrate to their auditors that no material weakness exists, as opposed to affirmatively establishing and demonstrating the effectiveness of internal controls. As long as this is the case, the "strong indicators" of a material weakness need to be made more specific, with more illustrative examples, so that they may serve as a practical guide to companies that are evaluating their internal controls. A results-oriented, "top-down" approach to identifying a material weakness may be more desirable than the "bottom-up" approach, which tends to view a material weakness as an aggregation of control deficiencies.

Companies need to be able to consult with their external auditors and other advisors about their internal controls without fear that mere consultation will later be construed as evidence that a material weakness existed. In our view, the key control consideration is that companies should be able to identify issues that require attention; how they choose to seek guidance to address such issues should not usually be viewed as indicative of a material weakness. The SEC and the PCAOB should clearly state this and assure companies that they are encouraged to seek all appropriate advice in order to maintain an appropriate set of internal controls.

<u>Significant Deficiency.</u> We suggest that the PCAOB consider whether the term "significant deficiency" has any continuing usefulness in light of the changes in AS5. In AS2, an evaluation of the existence of "significant deficiencies" was a component of the process by which a "material weakness" was determined to exist. In AS5, the PCAOB focuses instead on the concept of "control deficiency" in the

determination of material weakness and appears to recognize that "significant deficiency" no longer has any definitional connection to the material weakness determination. Nevertheless, AS5 calls for continued evaluation of significant deficiencies, essentially as a way station towards a potential determination of material deficiencies in future years. As a result, we believe that, instead of eliminating a procedure, AS5 has created another set of procedures and conclusions on significant deficiencies, in addition to the inquiries that are required for material weaknesses. The PCAOB should further clarify these definitions and their applications in AS5 so that their use in AS5 results in streamlined procedures for companies and their auditors instead of unnecessary duplication and confusion.

Materiality. We continue to believe that the SEC Guidance and AS5 should further clarify the definition of "material." We recognize that materiality is a difficult concept that is at the core of financial statement and other public disclosure, but in the context of the testing contemplated by AS5, it is important to guide companies and their auditors with as much precision as possible, including through the use of illustrative examples.

Interplay Between the SEC Guidance and Auditing Standard No. 4

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* ("AS4"), sets forth guidelines that must be followed in order for a company to emerge from being characterized as having a material weakness, if it wishes to engage its auditors in providing such a report. We suggest that, just as AS2 required rethinking, the PCAOB, along with the SEC in its Guidance, should consider clarifying the procedures required by AS4. While a single road map may be impractical, it would be useful for companies to have benchmarks to guide them as to when management will be able to give clean SOX 404 certifications after a material weakness has been identified and auditors can provide proper reporting.

Information Technology

Our members have told us in the past that it has been particularly difficult to determine the application of SOX 404 and AS2 to information technology ("IT") systems. The new AS5 sets forth some more specific points for auditors to consider in evaluating the effectiveness of IT systems, especially as they apply to smaller companies. The requirements of AS5 are not easy to reconcile with the discussion of

IT systems in the SEC Guidance, which focuses in a more general way on the identification of IT systems and controls that are relevant to financial reporting. It would be helpful for the SEC and the PCAOB to more closely align their activities so that companies and their auditors are working with a well-defined set of criteria for both identifying and evaluating IT controls. These could include specific guidance on instances where qualitative factors would override quantitative factors in determining significant accounts and where strong company-level controls link directly to process-level controls, thereby reducing testing at the process-level.

Based on experiences of our members with the implementation of AS2, we have two specific recommendations on IT controls that we encourage you to consider:

- Today, even in well controlled, low-risk applications, auditors believe that they need to audit "through the computer" as well as "around the computer" using more traditional auditing procedures. If a company has well-controlled input/output controls and a well-controlled accounting close process, we do not believe that auditors should also need to audit IT processes through a client's data processing systems. Whether to audit through or around IT systems should be a judgment call by auditors, rather than today's practice which auditors believe requires both.

- While companies traditionally lock down IT systems to preclude system changes late in the fiscal year, we have observed that as a result of SOX 404 and AS2, this lockdown date is occurring earlier in the year, often during the third quarter of the fiscal year. This can be extremely inefficient, costly and, from an IT management perspective, unnecessary. We recommend that guidance be developed that addresses IT system changes that occur late in the year and permits companies to implement these changes while allowing them to satisfy their internal control reporting responsibilities.

Proposed Safe Harbor

In connection with the new guidance on SOX 404, the SEC has proposed amendments to the rules under the Securities Exchange Act of 1934 (the "Exchange Act") that would provide for a non-exclusive "safe harbor" for companies that perform an evaluation of their internal controls in accordance with the SEC Guidance. While we appreciate the SEC's efforts to add certainty to the compliance process, we believe that, as currently proposed, the safe harbor is not structured so as to provide companies with an appropriate level of certainty.

As we noted above, the SEC Guidance is vague as to the specific procedures that companies should follow to establish and evaluate their internal controls. While this may be necessary in order to give companies the flexibility to adapt their procedures to their particular circumstances, the effect is that the proposed safe harbor is not specific enough to provide meaningful protection for companies that wish to comply. Any safe harbor should set forth reasonable, well-defined criteria for compliance. In crafting these criteria, the SEC should not set the bar unreasonably high by requiring "best practices" for internal controls that only the largest companies with the most extensive resources can afford. Rather, the safe harbor guidelines should be specific and achievable enough to be a practical guide to compliance for all public companies.

The SEC's rules contain a number of safe harbors that have been successful because they set forth well-defined and easy-to-understand criteria for compliance. For example, Rule 144A under the Securities Act of 1933 (the "Securities Act") clarifies a nebulous intersection of Sections 4(1) and 4(2) of the Securities Act by providing a safe harbor from registration for resales of privately placed securities to qualified institutional buyers. Regulation D under the Securities Act contains safe harbors from registration for certain private placements of securities that comply with detailed procedural requirements. In each case, the safe harbor serves to minimize the uncertainty inherent in broad statutory language by specifying criteria to be met and procedures to be followed in order to comply. In contrast, the SOX 404 guidance gives companies wide latitude in determining the procedures that they will employ, which makes it difficult to know how to qualify for the protection of the safe harbor or to establish that the safe harbor criteria have been satisfied when challenged by a regulator or a private litigant.

While the business community will welcome an appropriately structured safe harbor for SOX 404 compliance, we believe that the proposed safe harbor does little to reduce the uncertainty that has been inherent in the compliance process to date. Also, in order to provide the greatest level of certainty for companies that wish to comply, any safe harbor that is enacted should be incorporated in its entirety as an amendment to the Exchange Act rules. It is not sufficient for the rule to direct companies to the interpretive guidance to determine whether they comply with the safe harbor.

Fraud Controls

The SEC and the PCAOB should not lose sight of the fundamental issue of fraud controls, which SOX 404 addresses only indirectly at best. While SOX 404 and AS2 have led companies and auditors to renew their focus on effective internal controls, it must be acknowledged that fraud can, and does, occur even in companies with excellent internal controls and strong audits.

The SEC should take the lead in communicating to the public about the nature and limits of an audit and the internal control certification process. This may take the form of education campaigns, but should also include the filing of *amicus* briefs in appropriate cases and clear guidance through the activities of the SEC's Division of Enforcement. Many market participants mistakenly believe that SOX 404 and AS2 function as insurance against fraud and other business risks. This is not the case, and the SEC must ensure that investors are aware that fraud can occur even in a strong internal control environment. The limitations on the ability of internal controls to prevent fraud and the responsibility of auditors to detect fraud should be clearly described.

Walkthrough Requirements

We are encouraged by the PCAOB's recalibration of walkthrough requirements for auditors. However, we think that these requirements should be further refined and clarified. We suggest that the PCAOB state clearly that, in low-risk control areas, a walkthrough may be a sufficient process by itself. Further, AS5 should state that auditors do not need to perform repeat annual walkthroughs in areas where there has been no change in procedures from prior periods.

Financial Statement Footnotes

We observe that most of the existing and proposed guidance is effectively directed at companies' primary financial statements, while relatively little attention has been paid to the SOX procedures that affect disclosure in the notes to the financial statements. We understand that a significant amount of audit attention is aimed at controls over footnote disclosures, some of which may be unnecessary, and there is virtually no guidance as to how to proceed. We urge the SEC and the PCAOB to pay greater attention to guidance on footnote disclosure controls going forward.

Restatements

The SEC Guidance and AS5 proposals do not sufficiently account for the changing nature of financial statement restatements and their relationship with internal controls. The environment for, and meaning of, restatements has changed in recent years. In the past, restatements were relatively rare and resulted from material accounting errors – these restatements usually indicated that the company had serious financial problems. However, the number of restatements has increased significantly. The General Accounting Office has concluded that, between July 2002 and September 2005, there were 1,390 restatements by public companies – more than one per business day. Recent restatements frequently have been driven by reinterpretation of existing accounting treatments rather than correction of accounting errors or fraudulent activities. As a result, many if not most restatements are immaterial, yet they continue to give rise to the impression that companies have made accounting mistakes when in fact they complied at all times with applicable accounting guidance.

It is important for the SEC and the PCAOB to reinforce the idea that a restatement is not a decisive indicator that a material weakness exists. As we have noted in the past, accounting is not an exact science and disagreements about appropriate application of complex accounting standards are not evidence of failure. The pervasive view that a restatement is evidence of an internal control weakness conveys to market participants a false idea about the precision of the underlying financial statements, when in fact, in many cases, a restatement does not mean that the prior financial statements were inaccurate. We urge the SEC and PCAOB to make this clearer to the public.

Application of SOX 404 to Smaller Companies

We commend the SEC and the PCAOB for acknowledging the particular burdens that SOX 404 and AS2 have placed on smaller public companies. However, the proposed guidance and new auditing standard do not go far enough in defining the ways in which smaller companies may scale their activities so as to remain in compliance while reducing costs.

In its discussion of scaling the scope of the audit for smaller companies, AS5 introduces the term "complexity." We believe this presents an unnecessary new issue for evaluation. AS5 is clear that, in planning an audit of internal control, the auditor is to examine "the company's business, including its organization, operating characteristics and capital structure," among other areas. It must be acknowledged that, as the term "complexity" is commonly understood, there may be smaller companies that are highly "complex" as well as larger companies that are relatively less "complex." We urge the PCAOB to reconsider the use of this term – whatever is meant by the term "complexity," the relevant concepts for the evaluation are already included in the auditor's charge.

While we applaud the concept of "scalability," wishing for scalability does not make it so. Our members, particularly those that are smaller public companies or large companies with a number of small subsidiaries, are struggling to find an appropriate scope for their internal controls, and they need assurances from the SEC that they can do so without radically changing their operations or business objectives. Many companies have felt compelled by SOX 404 and AS2 to outsource much of their testing of internal controls to third parties, at significant cost, in order to satisfy the evaluation requirements of their independent auditors. Companies with fewer personnel and resources need to have guidelines for SOX 404 compliance that clearly define what is acceptable, even if that is less than optimal. We do not mean to imply that smaller companies should be subject to different standards or levels of assurance. However, a smaller company should be able to employ different procedures in order to reach the same level of assurance, which could include reliance on the direct involvement of internal audit and finance personnel in company activities.

For example, the SEC should clearly set forth how a small public company can appropriately tailor its span of control in a way that is different from a company that is hundreds of times larger – e.g. by establishing personal control, observation and oversight by senior management of the processes or assets in question. The SEC and the PCAOB should consider a more flexible approach to identifying and evaluating the effectiveness of "key" controls, which until now have been subject to relatively rigid, "one size fits all" scrutiny by independent auditors. We suggest that the PCAOB acknowledge in AS5 that a financial statement audit of a small company may involve sufficient testing of controls in certain areas such that additional procedures are not required for an internal control audit. The PCAOB has recognized that management override and mitigating actions and controls implemented in lieu of segregation of duties are areas that are especially important for smaller companies in internal control and in the evaluation of internal control. We believe that more specific guidance for auditors is necessary on this point – it is not enough simply to direct the auditor to evaluate this as a risk in a smaller company.

Our members are particularly concerned with documentation requirements. Auditors continue to focus on documentation as an indicator of internal controls despite that fact companies can have strong internal controls even without voluminous documentation. In the absence of clear and specific guidance, expensive and unnecessary over-documentation remains a real threat to all companies, and it imposes a particular burden on smaller companies. We encourage the SEC to evaluate specific lower-cost documentation solutions, determine whether they are acceptable for smaller companies and, if so, include them in its SOX 404 guidance. We also urge the SEC to closely examine the experience of large accelerated filers and accelerated filers in determining the nature and scope of compliance that will be required by non-accelerated filers.

Using the Work of Others

The PCAOB has made progress on removing barriers to using the work of others in its *Proposed Auditing Standard – Considering and Using the Work of Others in an Audit*. However, we are concerned that, in doing so, it has encouraged the creation of additional checklists instead of qualitative analysis. The proposal suggests a bias toward persons who are trained as accountants or have designated internal control functions. Many persons who exert highly effective internal control are neither trained accountants nor internal control professionals. The PCAOB should acknowledge this by permitting the use of their work by auditors. We also suggest that the PCAOB reevaluate whether the criteria established for objectivity truly address the likelihood of bias in a control environment.

Auditing Standard No. 3

As noted above, the nature and scope of the required documentation will continue to play a critical role in SOX 404 compliance. However, the PCAOB's Auditing Standard No. 3 ("AS3"), which governs audit documentation, remains intact and we understand that no revisions are currently proposed.

We urge the PCAOB to coordinate with the SEC and make necessary revisions to AS3 to provide detailed guidance to auditors regarding the documentation necessary to conduct an effective audit of internal controls. Without reconsideration of AS3, many of the benefits of the proposed guidance may not be realized. For example, AS5 does not eliminate consideration of low-risk audit procedures, despite the fact that Chief Accountant Hewitt has stated that companies do not need to spend time evaluating low-risk areas. Specific rules for audits of smaller companies should mirror the SEC's guidance on the scalability of internal controls, so that auditors do not impose impractical documentation requirements on such companies. While we do not suggest that the adoption of the new SEC guidance and AS5 should be delayed, we believe that AS3 should be reevaluated as well in the near future.

Conclusion

The U.S. Chamber of Commerce strongly supports the core ideas behind SOX 404 of increasing management accountability, strengthening internal control over financial reporting and facilitating accurate and fair disclosure for investors. We commend the SEC and the PCAOB for their efforts to provide greater certainty in the application of SOX 404 and the audit of internal controls.

However, even with the proposed SEC Guidance and new AS5, the internal control requirements remain ambiguous. The proposed safe harbor for SOX 404 will be of little use until the SEC determines and publicizes specific compliance criteria. The SEC and the PCAOB should more clearly address the relationship of a restatement to the adequacy of internal controls and the limits of SOX 404 and AS5 in identifying and preventing fraudulent conduct. Without more specific guidance on scalability, the blunt application of SOX 404 will continue to impose undue burdens on smaller companies and discourage their participation in the public markets.

We presume that, when the new guidance and standards are finalized, they will be effective beginning with the 2007 fiscal year. However, companies are likely to act on the proposed guidance and standards as if they were final to the extent that there are control procedures that need to be performed prior to year-end. While we encourage the SEC and the PCAOB to act as soon as possible in adopting the new guidance and standards, we also recommend that the SEC and the PCAOB take the necessary time to fully consider any comments that they receive, properly draft the final guidance and standards so as to minimize ambiguity, and align the requirements of the SEC Guidance and AS5 to the greatest extent possible. It is important for the SEC and the PCAOB to adopt clear and well-coordinated final guidance and standards before companies and their auditors are required to comply.

As an unintended result of the breadth and ambiguity of SOX 404, companies have incurred excessive and unnecessary compliance and audit costs that ultimately have damaged the interests of investors. These include the costs of independent auditors, external consultants, additional internal audit and compliance functions and the additional demands placed on the time and attention of management. Such costs have increased significantly despite the fact that companies already had strong economic incentives to implement effective internal controls even before SOX 404 was enacted. In some respects, the cost increases have resulted from the requirement that controls be judged to be either "effective" or "ineffective" – companies end up producing voluminous amounts of compliance paperwork in order to justify their determination of "effective" internal controls, when a more nuanced, qualitative evaluation could be both more useful and less expensive.

These additional costs reduce the cash available to a company to invest in its business, deter companies from accessing the U.S. capital markets and dilute the focus of management from creating value for company shareholders. The uncertain application of SOX 404 has led many companies to be overly conservative and spend large sums on internal controls, which can come at the expense of critical operating activities and inhibit business innovation and creativity. Such costs will continue to depend in part on the interpretation of SEC and PCAOB rules by independent accountants, which will not significantly reduce the current levels of time and expense involved in a public company audit in the absence of clear, specific guidance. We urge the SEC to consider all of these costs, and particularly the burdens that they impose on smaller public companies, in examining the full cost/benefit balance of SOX 404.

While the SEC and the PCAOB have made strides towards easing these burdens, the core issues with SOX 404 will remain until companies of all sizes have appropriate, specific guidance on how to comply. Thank you for your consideration, and we would be happy to discuss our comments with the relevant staff.

Sincerely,

David C. Chavern
Chief Operating Officer and
Senior Vice President

cc: Hon. Christopher Cox
Hon. Paul S. Atkins
Hon. Roel C. Campos
Hon. Kathleen L. Casey
Hon. Annette L. Nazareth
Hon. Mark W. Olson
Hon. Kayla J. Gillan
Hon. Daniel L. Goelzer
Hon. Bill Gradison
Hon. Charles D. Niemeier

GAO
Accountability * Integrity * Reliability

Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

February 26, 2007

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

Subject: PCAOB Release No. 2006-007—*Proposed Auditing Standard—An Audit of Internal Control over Financial Reporting That is Integrated with an Audit of Financial Statements, and Related Other Proposals*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) proposed standard for the audit of internal control over financial reporting that is integrated with the audit of financial statements.

We commend the PCAOB for undertaking this project. Overall, we generally support the proposed standard and believe that it resolves many of the issues in Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. We especially support the proposed provisions on

- incorporating a top-down, risk-based approach to increase auditors' ability to detect material weaknesses before they result in material misstatements
- scaling the audit approach to efficiently test controls at smaller, less-complex entities
- focusing the multi-location testing guidance on risk rather than on coverage
- clarifying the role of materiality in an audit of internal control over financial reporting

We have a serious concern regarding the proposed changes to the definitions of material weaknesses and significant deficiencies. Specifically, we believe that these definitions will not achieve the PCAOB's intended results and we have a concern about the potential confusion and extra costs associated with the PCAOB changing these definitions that are currently consistent with those used by the other U.S. auditing standards setting organizations—the GAO and AICPA. We are providing suggestions for how to resolve this issue.

In addition to the above issue, we have identified several matters for which we are offering comments. Our comments, which are detailed in the enclosure to this letter, address the following issues:

- proposed revisions to the definitions of material weakness and significant deficiency
- evaluating identified deficiencies
- permitting consideration of knowledge obtained during previous audits
- company-level controls
- information technology controls
- reporting
- scope limitations

Also, we believe that revising the auditing standard, while an important step, will not, in itself, be sufficient to improve the efficiency and effectiveness of audits of internal control over financial reporting or assure audit quality. In this regard, it will be imperative to align the auditing standard, the approach used in inspections of registered public accounting firms, and the public message conveyed by PCAOB members and key staff.

Finally, we believe it is critical that the standard be viewed in the proper context and that auditors not take the PCAOB's intended changes too far. Therefore, we urge the PCAOB to make concerted efforts to clarify its intent with respect to its issuance of this auditing standard.

We thank you for considering our comments on this very important issue and look forward to working with you to promote high-quality auditing in the United States.

David M. Walker
Comptroller General
of the United States

Enclosure

cc:
The Honorable Christopher Cox, Chairman
U.S. Securities and Exchange Commission

The Honorable Mark W. Olson, Chairman
U.S. Public Company Accounting Oversight Board

Harold Monk, Jr., Chair,
U.S. Auditing Standards Board

GAO Comments on PCAOB Release 2006-007

Proposed Revisions to the Definitions of Material Weakness and Significant Deficiency

We have the following concerns about the proposed changes to the definitions of material weaknesses and significant deficiencies: (1) the potential that the revised wording will not achieve the intended result and (2) the potential confusion and extra costs of changing definitions that are now consistent with those used by the other U.S. auditing standards setters—GAO and the AICPA. Rather than adopting the proposed changes to the definitions of material weaknesses and significant deficiencies, we recommend clarifying the AS No. 2 definitions by providing guidance and explanation for interpreting terms such as “probable,” “reasonably possible,” “remote,” and “more than inconsequential.” The following sections present our concerns in more detail.

PCAOB’s discussion paper states that the revisions to the definitions are meant to clarify but not change the definitions. Specifically, it states that contrary to the application of the definitions in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* (FAS No. 5), “some auditors and issuers have misunderstood the term ‘more than remote’ to mean something significantly less likely than a reasonable possibility. This, in turn, may have caused these issuers and auditors to evaluate the likelihood of a misstatement at a much lower threshold than the Board intended.” However, we believe that the revised wording “there is a reasonable possibility that a material misstatement” will result in auditors and issuers applying the everyday English meaning of the words, consequently creating too high of a threshold for identifying a material weakness.

The three U.S. auditing standard setters now have adopted consistent definitions of material weakness and significant deficiency, which we believe is the most beneficial to the entire community of auditors and users of auditors’ reports in the United States. Specifically, the AS No. 2 definitions were recently adopted by the AICPA’s Auditing Standards Board in its Statement on Auditing Standard (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, and by GAO in our *Government Auditing Standards*, *January 2007 Revision.* U.S. investors and taxpayers will be better served by having standard setters minimize competing efforts and instead assure consistency, where appropriate, with regard to core auditing standards. Inconsistencies in such core standards increase audit costs and lead to potential confusion. We believe that the definitions and terminology used to communicate internal control deficiencies represent core concepts for which the standards setters should work together to achieve agreement and consistency.

If the PCAOB believes that the AS No. 2 definitions of material weaknesses and significant deficiencies need revision, we recommend convening a group of the U.S. auditing standards setters and the International Auditing and Assurance Standards Board to develop definitions that can serve as the common core for use in the standards for audits of all types of entities. The U.S. Auditing Standards Coordinating Forum would be an ideal forum for convening such a group. We at GAO would welcome the opportunity to work with the PCAOB on such an effort.

Evaluating Identified Deficiencies

We support the proposed changes to the standard on evaluating identified deficiencies that make that standard less prescriptive, since such evaluations require professional judgment in assessing the facts and circumstance surrounding the deficiencies. We believe that the pervasiveness of a control deficiency is also an important consideration and recommend including it in the guidance on evaluating deficiencies.

In addition, we recommend rewording two of the strong indicators of material weaknesses in paragraph 79 of the proposed standard, as follows:

- Control systems that did not prevent or detect material misstatements so that it was later necessary to restate ~~Restatement of~~ previously issued financial statements to reflect the correction of a misstatement.

- Control systems that did not prevent or detect material misstatements that were identified by the auditors. ~~Identification by the auditor of a material misstatement in financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting.~~

We believe these changes are needed to properly communicate that the deficiency is the weakness in the control system; the restatement and the auditor identification of a material misstatement are results of the control deficiency.

Permitting Consideration of Knowledge Obtained During Previous Audits and Special Considerations for Subsequent Years' Audits

We agree with the broad principles expressed in paragraphs 65 through 69 of the proposed standard that deal with using knowledge obtained during past audits. However, we have two concerns with these paragraphs. Specifically, we believe that (1) the proposed standard should be more fully developed, and (2) the proposed standard should incorporate relevant standards and guidance included in SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained.*

First, we recommend moving pertinent guidance from the discussion paper in PCAOB Release 2006-007 to the proposed standard in order to more fully develop the standard and to help ensure consistent implementation. As written, we are concerned

GAO Comments on PCAOB Release 2006-007

that the standard is not sufficiently clear and specific. For instance, the proposed standard does not include the concept expressed in the last sentence on page 19 of the discussion paper that "Under the approach described by the proposed standard, some controls would be so important to the overall effectiveness of internal control over financial reporting or otherwise present such a high degree of risk that, even in subsequent years, the necessary evidence would not be reduced." Also omitted from the proposed standard is the concept in the first paragraph of page 19 of the discussion paper that "the proposed standard on auditing internal control would provide the auditor with the flexibility to decide to reduce testing in some areas based on that knowledge [gained from the prior years' audits] and its effect on the auditor's assessment of risk." We believe that these concepts, which are critically important when using knowledge gained in prior year audits, should be included in the body of the proposed standard.

Also, we support using information from prior year audits to help improve audit efficiency and effectiveness and agree with the approach included in paragraphs 40 through 44 of SAS No. 110, which allows greater flexibility than the definition of rotation testing in footnote 25 on page 18 of the PCAOB discussion paper. In addition, we place a number of requirements and conditions surrounding the use of "rotation testing" in federal government audits, as is detailed in Section 395G of the GAO/PCIE *Financial Audit Manual*.[1]

We encourage the Board to add specificity to the proposed standard relating to this issue.

Company-Level Controls

While we support the concepts related to evaluating and testing company-level controls in the proposed standard, we are concerned that the current presentation of the standard may result in auditors placing too much emphasis on company-level controls. For instance, paragraph 17 contains an unconditional requirement to test those "company-level controls that are important to the auditors' conclusion of the effectiveness of internal control over financial reporting." Since (1) auditors must fulfill the responsibilities of unconditional requirements in all cases in which the circumstances exist to which the requirement applies, and (2) failure to discharge such an unconditional requirement is a violation of the relevant standard and PCAOB Rule 3100, this will focus auditor attention on controls that are often difficult to assess and generally offer only a negative indicator of the effectiveness of controls. Specifically, ineffective company-level controls provide a strong indicator of pervasive problems. However, company-

[1] U.S. Government Accountability Office / President's Council on Integrity & Efficiency, *Financial Audit Manual* (GAO-01-765G July 2001), pgs. 395 G-1 through 395 G-4. http://www.gao.gov/special.pubs/gaopcie/.

level controls assessed as effective do not necessarily provide sufficient assurance about the effectiveness of controls throughout the entity by themselves.

Other statements in the standard may lead auditors to inappropriately conclude that they need not test beyond company-level controls. Examples of such statements include the following:

- "…if a company-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk." (Excerpt from the Proposed Auditing Standard, Paragraph 12, second bullet, last sentence)

- "The proposed standard omits the statement in paragraph 54 of AS No. 2 that '[t]esting company level controls alone is not sufficient for the purposes of expressing an opinion on the effectiveness of a company's internal control over financial reporting.' This statement has been interpreted to prohibit reliance on company level controls related to individual relevant assertions. The proposed standard would allow the auditor to determine that company-level controls are sufficient to address the risk of misstatement to a particular relevant assertion." (Excerpt from the Discussion Paper, page 6, footnote 10)

We recommend adding guidance to the standard limiting the circumstances under which it might be appropriate for auditors to reduce or eliminate testing of additional controls based on the effectiveness of a company-level control, such as when the risk of material misstatement is considered low and the relevant control relates to an immaterial account or assertion.

Finally, in paragraph 18, the proposed standard identifies eight specific company-level controls. Then, in paragraphs 19 through 23, the standard goes on to discuss in detail only two of the eight controls. This seems to suggest that these two controls are more important than the others, but we are unsure if this is the Board's intent. Therefore, we recommend revising the proposed standard to either include a discussion of each of the eight controls or explain why additional guidance is provided for only two controls.

Information Technology Controls

We recommend adding a caution in or immediately following paragraph 35 that the effectiveness of user controls —application controls that are performed by people interacting with IT systems—typically depend on the accuracy of the information produced by the IT systems. For example, the effectiveness of a user control consisting of supervisory review of an IT system exception report is dependent on (1) the effectiveness of the supervisor's review and (2) the accuracy of the exception

GAO Comments on PCAOB Release 2006-007

report, including relevant controls. Therefore, relevant IT controls would impact the effectiveness of these types of user controls.

Reporting

One of the stated objectives of the proposed standard is to eliminate unnecessary procedures, including the requirement to evaluate management's process. However, the report language included in paragraph 96 contains the following statement:

> "We also have audited management's assessment, included in the accompanying [*title of management's report*] that W Company maintained effective internal control over financial reporting as of December 31, 20x8…"

This language seems to contradict the elimination of the requirement to evaluate management's process. We recommend that PCAOB staff review this language to make sure that it is consistent with the Board's intent.

Scope Limitations

Paragraphs 83 and C3 of the proposed standard indicate that auditors should disclaim an opinion or withdraw from the engagement if there are restrictions on the engagement scope. We believe that when auditors are aware of one or more material weaknesses in an entity's internal control over financial reporting, they should be required to issue an adverse opinion even if the engagement scope is restricted. No matter how much additional testing the auditors perform, they will not be able to issue an unqualified opinion; because of the material weakness, the auditors must conclude that internal control over financial reporting is not effective. Thus, we suggest revising paragraphs 83 and C3 to indicate that auditors should express an adverse opinion when the scope of the audit is restricted but they are aware of material weaknesses. An exception to this requirement would provide for situations when auditors withdraw from an engagement and do not issue a report. In this situation, the auditors should also state that, due to the restrictions on the engagement scope, they did not examine all controls; therefore, additional material weaknesses may exist that have not been reported. We also suggest deleting the last part of paragraph 99 ("unless there is a restriction on the scope of the engagement") for consistency.

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Gregory J. Hayes
Vice President
Accounting and Finance

February 21, 2007

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

Dear Sir or Madam:

Re: PCAOB Rulemaking Docket Matter No. 021

We appreciate the opportunity to comment on the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

United Technologies Corporation (UTC), based in Hartford, Connecticut is a diversified company that provides a broad range of high technology products and support services to the building systems and aerospace industries. We are located in approximately 180 countries worldwide.

We appreciate the PCAOB's effort to provide clarification regarding the auditor's role in auditing internal control over financial reporting. We encourage the use of auditor judgment based on an assessment of risk and feel that this is appropriately addressed in the proposed standard. We also applaud the revision of the definitions of "significant deficiency" and "material weakness" as well as the elimination of the requirement for a separate evaluation of management's annual evaluation process. However, we believe additional emphasis and clarification is required with respect to audit rotation, (including risk assessment and related testing).

We recommend that the Board expressly permit rotation, as the term is commonly understood. We believe that the auditor should be encouraged to use professional judgment in determining the nature and scope of any audit testing based on current and cumulative audit knowledge. The draft standard does not allow for audit rotation. Rather it attempts to redefine the term as an increase or decrease of testing from year to year as opposed to the more commonly understood inclusion or exclusion of areas from testing on a year to year basis. Further the draft standard appears to propose a somewhat prescriptive testing approach based on the auditor's assessment of risk. For example, the standard implies with its example of rotation that all areas must be tested each year and that a walkthrough at a minimum is required for low risk areas. We are not sure that this was intended by the Board but are concerned that the example may be misinterpreted as requiring this testing.

* * * * *

Again, we appreciate the opportunity to comment on the exposure draft and would be happy to provide any additional clarification that you may desire.

Yours truly,

Gregory J. Hayes
Vice President, Accounting and Finance

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February 14, 2007

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Dear Sir/Madam:

The purpose of this letter is to provide commentary regarding PCAOB's AS 5 Exposure Draft (PCAOB Release 2006-007). At the outset, I want to state that I find many of the proposed changes in the AS 5 Exposure Draft to be beneficial—particularly the risk-based approach to control testing and the clarifications regarding the role of materiality in planning tests of controls. In particular, the materiality discussion in the AS 5 Exposure Draft should help remove some apparent inconsistencies for planning tests of controls in AS 2.

However, I have concerns related to two groups of issues: 1) the elimination of the auditor's attestation regarding management's control evaluation process coupled with a lack of guidance to auditors in reviewing management's testing process and 2) the proposed change in guidance to auditors who discover material misstatements during the audit. Both changes have been justified based on cost-benefit considerations. However, irrespective of whether these proposed changes save costs, I believe that the Sarbanes-Oxley (SOX) Act of 2002 will be weakened. I am fearful that the proposed changes may encourage a return to the aggressive financial reporting environment existing prior to SOX. In short, I believe that the negative impact on the reliability of financial statement information from these two changes will outweigh any potential cost savings that might accrue. For this reason, I do not believe that these two changes are in the public interest and I would strongly encourage the PCAOB to reconsider their position. In the following paragraphs, I enumerate my concerns and attempt to present arguments against these proposed changes.

Elimination of Attestation regarding the Adequacy of Management's Tests
The Sarbanes-Oxley Act (SOX) of 2002 requires management to perform an evaluation of disclosure controls on a quarterly basis and to evaluate all other controls having a material impact on financial statements on an annual basis. Currently, PCAOB Audit Standard 2 requires the auditor to perform an attestation on management's evaluation process that culminates in the expression of an opinion as to whether the auditor believes that management's evaluation process was adequate in scope and whether the auditor concludes that management's evaluation of the control system fairly presents.

The PCAOB, in the AS 5 Exposure Draft, has recently proposed the elimination of this attestation based on three arguments. The first argument, attributed to comments received from registrants (see page 15 of the AS 5 Exposure Draft) is that, "commentators have expressed concern that auditors were performing detailed testing, such as retesting items tested by management." A second, supporting argument (see page 15) is that, "auditors are inappropriately dictating how management should perform its evaluation." The third and main argument advanced by the PCAOB is that, eliminating the auditor's attestation regarding the adequacy of management's tests, will simplify the auditor's control report and eliminate unnecessary audit test work.

Regarding the first argument against attestation, I would agree that retesting management's work would appear to be excessive. However, one reason that this retesting problem may have occurred is that PCAOB's AS 2 currently provides extremely limited guidance to auditors in performing an attestation on the adequacy of management's tests. Rather, than abandoning the attestation entirely as proposed in the AS 5 Exposure Draft, I would encourage the PCAOB to provide auditors with better guidance in this area. Similarly, the alleged problem of the auditor's dictating to management how controls should be tested can be traced to the absence of guidance being provided to management by the SEC. Thus, AS 2 became (by default) the only guidance available to management. Fortunately, the SEC has responded to this problem by recently issuing new guidance to management in performing their evaluation process.

The central argument advanced by the PCAOB for dropping the attestation, however, is to eliminate unnecessary costs. Implicit in the PCAOB's argument is the assumption that the information being provided (to both the auditor and, ultimately, to financial statement users) from the attestation process is essentially redundant and, thus, does not provide benefit commensurate with its cost. On page 16, the AS 5 Exposure draft goes even further by stating that, "the Board also believes that the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process."

I take issue with the PCAOB's position for several reasons. First, if the auditor's attestation were to be dropped, financial statement users will be deprived of assurance that management has actually fulfilled its control testing obligation under SOX. As I argue below, this has the potential of undermining registrants' compliance with SOX. Second, the PCAOB's position fails to recognize the potential information being provided to the auditor about the effectiveness of controls. I contend that, even if the attestation report on management's testing process were to be eliminated, auditors still should have reason to evaluate the adequacy of management's testing process. An important component of the COSO framework currently used in evaluating controls includes regulatory compliance. Failure on the part of management to test its controls adequately would lead to a high risk of violating SOX. Furthermore, inadequate testing would also be a strong indicator of a bad "tone at the top" and/or incompetent internal auditing--both indicative of a weak control environment. Thus, the evaluation of management's testing process can provide the auditor with potentially strong evidence regarding management's commitment to maintaining an effective control system and also evidence regarding the capability of the internal auditors who are likely to perform many of the tests on behalf of management. Such an understanding of the control environment is of critical importance in implementing the "top-down" risk assessment perspective now being advocated (an overarching objective of the AS 5 Exposure Draft.) Thus, my response to question 14 (see page 18) of the Exposure Draft is that the auditor cannot perform an effective audit of internal control within the COSO framework without evaluating the quality of management's testing process.

Perhaps an even more serious concern is that the AS 5 Exposure Draft is virtually silent regarding the importance of reviewing management's testing process when evaluating the control environment (see paragraphs 19 and 20). Thus, if the separate attestation requirement were to be removed, there is no reason to believe that auditors following the guidance in the AS 5 Exposure Draft would necessarily perform an in-depth review of management's testing process.

The close parallel between the control evaluation process used by management and the auditor during the past three years may have created the appearance of redundancy and also contributed to the perception by some managers that auditors are dictating how their controls are to be evaluated. However, this parallel structure is unlikely to continue in the future. Indeed, the recent SEC guidance encourages management to develop their own control testing approaches rather than simply following the auditor's guidance in AS 2—a recommendation that I fully support. An important point to keep in mind is that the testing objectives of management are somewhat different from those of the auditor. To ensure that the effectiveness of controls is maintained consistently throughout the period, it is important that management evaluate the performance of its controls on an ongoing basis. Ideally, management's control evaluation process should <u>not</u> be a once-a-year test performed over a narrow time interval like the external auditor's evaluation process. Rather, it should be a continuous, ongoing process that ensures that any control weaknesses are promptly brought to the attention of management and remediated at interim subject to cost-benefit considerations. Absent an ongoing control evaluation process by management, there is no assurance that interim (quarterly) financial statements and disclosures will be reliable. The auditor's attestation report on management's evaluation process should provide assurance to users and regulators that management is in fact performing its fiduciary responsibility of monitoring control effectiveness on an ongoing basis and, in particular that management has performed quarterly evaluations of disclosure controls as required by SOX.

A further argument in favor of retaining attestation is that the auditor's evaluation process drives expectations and, thus, exerts a strong motivational effect on management and internal auditors to get their testing "right." The rigorous and timely testing by management and the internal auditors, in turn, will motivate employees who perform control activities to be more careful and attentive to their responsibilities when they know that their performance is being evaluated. Furthermore, rigorous and timely testing by management makes it more likely that any existing control problems will in fact be identified and, thus, helps to strengthen the overall effectiveness of the control system. If the external auditor's evaluation and report on management's control evaluation were to be eliminated, management may not have the same incentives to test its controls as rigorously or as frequently as is now the case. Thus, the auditor's evaluation of management's control testing process not only enables the auditor to obtain a deeper understanding of the control environment—it also has the potential to help motivate management and, in turn, client employees to maintain a strong control environment.

While I have argued that the auditor's evaluation of management's control testing process is important in encouraging compliance with Section 404 for all corporations, the testing of management's evaluation process is likely to be of critical importance in the future. As the 404 requirements are gradually extended to a wider group of firms, smaller firms will become subject to 404 requirements. Smaller firms are less likely to have the same degree of internal audit capability as larger firms and, thus, are likely to derive an even greater benefit from having their control testing process evaluated than would larger, more mature firms. Thus, as smaller firms become subject to SOX, the benefits of having auditors attest to the adequacy of management's control testing process should grow over time. Furthermore, to the extent that auditors become more efficient in performing this attestation, this attestation cost should decline over time as both management and the auditor become more experienced in performing their respective testing processes. Rather than eliminating this attestation, I would strongly encourage the PCAOB to move in the opposite direction by providing additional guidance to auditors in performing their evaluations of management's testing process.

Given the importance of management's tests of controls under SOX, I would also encourage the PCAOB to add "inadequate control testing by management" as a "strong indicator of a material weakness" or else identify it as a specific example of a weak "general control environment." (Failure by the audit committee and management to remediate significant deficiencies is the example now cited in AS 5 for a "weak general control environment.")

Guidance Regarding Strong Indicators of Material Weaknesses

Under AS 2, a material weakness exists when the auditor concludes that a material misstatement could occur with a higher than remote probability. The AS 5 Exposure Draft replaces the "higher than remote probability" with "reasonable possibility." I have no problem with this definitional change in the AS 5 Exposure Draft. However, I do have major reservations regarding related changes in the guidance to auditors.

Currently, PCAOB's AS 2 (see paragraph 140) identifies six conditions that are "at least significant deficiencies and strong indicators of a material control weakness." The six conditions are: 1) restatement of previously issued financial statements (for reasons other than a change in accounting principles), 2) identification by auditor of material misstatements in the current period's financial statements that were not detected by the control system, 3) ineffective oversight by the audit committee over the financial reporting process, 4) ineffective internal audit function, 5) fraud perpetrated by senior management, and 6) an ineffective control environment.

In my opinion, AS 2 makes a conceptual error in lumping the auditor's identification of an undetected material misstatement together with the other five indicators and, unfortunately, the AS 5 Exposure draft perpetuates this error. My point is that the auditor's discovery of an undetected material misstatement in the current period's financial statements is not merely an indicator of a material weakness, but is by definition a material weakness (under either the existing AS 2 criteria or under the AS 5 Exposure Draft criteria). (The remote probability condition (or reasonable possibility condition) is certainly satisfied whenever at least one material misstatement has already been detected by the auditor.) Thus, I would encourage the PCAOB to recognize this important distinction in its new standard.

A related change introduced by the AS 5 Exposure draft is to remove the statement that the six indicators are "at least significant deficiencies." The AS 5 Exposure Draft supports this proposed change by arguing (see p. 11 of the Exposure Draft) that, "[eliminating the significant deficiency] would reaffirm the degree of judgment required to make these evaluations."

I agree with the point that all control evaluations involve judgment on the part of auditors, but I personally cannot envision any possible scenario wherein the discovery of an undetected material misstatement by the auditor would <u>not</u> imply at least a significant deficiency. Indeed, as discussed above, I believe that the auditor's discovery of an undetected material misstatement provides the strongest possible evidence of a material weakness. How could members of the audit committee or the auditor possibly conclude that controls provide reasonable assurance that financial statements are reliable in the face of the auditor's discovery of an undetected material misstatement? Although the discovery of a material misstatement should not be necessary to conclude that a material weakness exists, it certainly is sufficient. By pooling the undetected material misstatement event into the six "strong indicators" group, and then eliminating the "at least significant deficiency" wording, the AS5 Exposure Draft makes it possible for an auditor to reach the absurd conclusion that controls are effective even after finding a material misstatement. Given that evaluation, the auditor would be under no obligation under the AS 5 Exposure Draft even to notify the audit committee or the public.

I would now like to discuss the material misstatement issue in greater detail. Some have argued that many misstatements are due to GAAP issues and that they do not necessarily imply that there is a control weakness <u>per</u> <u>se</u>. However, AS 2 in its discussion of the six “strong indicators” is careful to make clear that they mean restatements associated with error or fraud and by stating that restatements associated with changes in accounting principles are excluded. A second argument for changing AS 2 guidance is that misapplications of GAAP are often due to complexity, rather than to control problems per se. Thus, advocates of this position would argue that auditors should be allowed to give their clients passes when they make errors in applying GAAP.

When considering the complexity issue, however, it is important not to lose sight of the fact that firms have a fundamental obligation to disseminate reliable financial statement information. This obligation requires firms who routinely engage in complex financial transactions to recognize the elevated risk of non-compliance with GAAP and to maintain sufficient accounting expertise to manage their financial reporting process in the face of complexity just as is done in the tax reporting domain. SOX also makes explicit the registrant’s obligation to maintain effective controls to protect the financial reporting process in contexts where inherent reporting risks are high. Given the central role of accounting policies in the financial reporting process, management should be cognizant of the elevated risks and impose controls that are commensurate with the elevated risk due to complexity. Thus, a firm’s failure to manage the risks associated with its accounting policies in such an environment is perhaps the strongest possible example of a material weakness in controls over the financial reporting process. For this reason, I do not believe that complexity really provides a justification for failing to conclude that there is not a material weakness—much less a significant deficiency.

Currently, despite the “strong indicator” guidance in AS 2, there are numerous examples where auditors have issued unqualified reports on controls and current period financial statements after the client has restated the prior period’s financial statements. (Compliance Week statistics indicate that many firms making restatements have not received adverse control reports.) Perhaps most of the firms who made restatements changed their GAAP or were able to remediate their control problems in time for the auditor to re-test before year-end. However, I remain a bit skeptical when many of the firms receiving unqualified control reports after restatements have gone through yet another round of restatements during the following year. I fear that the proposed softening of the AS 2 guidance will only weaken the ability of auditors to withstand client pressure and encourage to the aggressive reporting days of the late 1990’s.

In summary, I believe that the auditor’s finding of a material misstatement must be separated from the other material weakness indicators and that guidance should be strengthened rather than weakened. I personally would favor language to the effect that the finding of an undetected material misstatement during the current year’s audit (whether it relates to a transaction in the current year or a prior year) is clearly sufficient (but not necessary) for the issuance of an adverse opinion. I would also state that the presence of one or more of the other five indicators should create the presumption of a material weakness. This would place the burden squarely on the auditor to justify not issuing an adverse audit report in the presence of such indicators. Strengthening, rather than weakening the guidance to auditors will help to ensure that, regulators and other financial statement users will not be deprived of an early warning signal regarding reliability issues in the client's financial reporting process. I also urge the PCAOB to retain the auditor's attestation report on the adequacy of management's control evaluation process. Maintaining the attestation will help to ensure that auditors obtain a deep understanding of their clients' control environments and also help strengthen their clients' control environments by enhancing managers' incentives to test their controls robustly so that weaknesses can be identified and remediated. Ultimately, this will allow management to develop more efficient and effective audits of control systems to enhance the reliability of the financial reporting system.

I fully support the SEC's position that management should have greater flexibility in testing, but I would stress the need for the SEC to provide guidance about performing control evaluations on an ongoing basis throughout the year rather than attempting to mimic the testing performed by the external auditor near year-end. Similarly, the PCAOB should provide more guidance to auditors in structuring their tests of the adequacy of management's control tests, rather than abandoning the attestation altogether. These changes in guidance would help to make management's control evaluation process complementary to the evaluation process performed by the external auditor. I hope that the PCAOB's current focus on reducing short-term SOX compliance costs does not inadvertently undermine Congressional intent in passing SOX to enhance the reliability of the financial reporting process.

Respectfully,

Paul J Beck

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Via Email

February 26, 2007

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

Dear Board Members and Staff of the Chief Auditor:

I am writing in my capacity as an accounting professor at the University of Tennessee (UT), where I serve as Director of Research for UT's Corporate Governance Center. I appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (hereafter AS #5 – ED) *and Related Other Proposals* (hereafter AS #6 – ED).

I have spent much of my career studying fraudulent financial reporting and audit committee activities and performance. I write from the perspective of one who believes that Section 404 of the Sarbanes-Oxley Act (SOX) and Auditing Standard No. 2 are essential in improving the quality of financial reporting, including reducing the incidence and severity of fraud – in my view, the fundamental motivation behind the passage of SOX. Therefore, although efforts to reduce unnecessary procedures, and hence cost, are laudable and appropriate goals, the ultimate litmus test is that any successor standard must not be any less effective in having the capacity to improve the quality of financial reporting.

I applaud the PCAOB for its work in an environment characterized by intense lobbying by well-funded and well-organized groups that often were more concerned with their narrow self-interest than with the public good. Given this political cauldron, I think the PCAOB has crafted a remarkably well-balanced standard – one that should reduce costs without sacrificing quality for most registrants. Nonetheless, I have some significant concerns with AS #5 – ED. AS #5 – ED is less detailed, some would say more principles-based, than was AS #2. But critically, for a principles-based regime to work well, there must be vigilant and effective enforcement. Is this the case? The PCAOB has largely adopted an inspection model, not an enforcement model. This puts the onus on the Securities and Exchange Commission (SEC), but the SEC's budget has been squeezed in recent years. The backstop to insufficient or ineffective enforcement by the SEC is private securities litigation, but accounting firms are seeking liability relief and even the SEC has recently filed a friend-of-the-court brief with the U.S. Supreme Court that would make it harder for investor lawsuits to succeed. Therefore, in the presence of less vigilant enforcement, I believe that AS #5 – ED (coupled with the SEC's ED on management's report on internal control) will likely reduce costs without hurting effectiveness for "good actors," but at the cost of reducing effectiveness for "bad actors." Is this result socially optimal? Is this result in the best interest of investors? These are the questions that should be asked.

Overemphasis on Efficiency

The PCAOB's public statements surrounding the issuance of AS #5 – ED, as well as statements regarding the recent focus of its inspection program, seem to suggest a focus by the Board on efficiency. Although efficiency means accomplishing objectives with the minimum effort and cost needed (certainly an appropriate goal), a focus on efficiency is sometimes interpreted, especially by accounting firms or registrants whose only focus is cost, as an excuse to do less work. The role of a regulator is to prescribe a certain level of performance (i.e., effectiveness) that must be met by the regulated entity. Concerns with efficiency are best met via a market test. If an accounting firm spends too much time performing an audit of internal control over financial reporting the audit committee should fire that firm and hire another firm. A focus on efficiency, especially by a regulator, can easily lead to insufficient audit work and a decline in audit quality.

Assessing Effectiveness of Audit Committee Oversight

AS #5 – ED indicates that an ineffective control environment is a strong indicator of a material weakness, and an example of an ineffective control environment is ineffective oversight of financial reporting and internal control by the audit committee (see p. A1-30). No guidance is offered in AS #5 – ED (or in the SEC's ED on management's report on internal control) as to the characteristics of effective (or ineffective) audit committee oversight. This lack of guidance is particularly problematic because: (1) there is no evidence in the literature that suggests that auditors are proficient in evaluating audit committee oversight of financial reporting, and (2) there is a natural conflict in making such an assessment given that the audit committee now has the authority to hire, fire, and compensate the external auditor. In addition, there is excellent guidance available for audit committees to use in evaluating the financial reporting process, particularly the area of that process most in need of audit committee oversight – the ever present risk of management override of internal control.

That guidance – *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention* – should be included in AS #5 – ED as guidance that can be used by auditors in assessing audit committee oversight of financial reporting, at least as it relates to the risk of fraudulent financial reporting.

Scaling the Audit for Smaller Public Companies

A primary motive for issuing AS #5 – ED is to provide a more "scalable" audit approach, an approach designed to lower costs for smaller public companies without sacrificing effectiveness. AS #5 – ED suggests that, for smaller entities, control objectives can be met through daily interaction of top management (see p. A1-8). What if senior management is corrupt? For example, fraud is more prevalent when the founder is still involved with top management, and smaller entities are more likely to have continuing founder involvement.

AS #5 – ED suggests, for smaller entities, that inquiry and observation of a control may provide sufficient evidence of whether a control is effective (even if the control being relied upon is not documented) (see p. A1-8). If fraud is going on top management is not going to tell you that via inquiry, and the very act of observing behavior changes that behavior.

AS #5 – ED seems to suggest that smaller entities can get by with relatively unsophisticated financial reporting staffs (see p. A1-9). Even if a business enters into simple transactions (no derivatives, no leases, no defined benefit pension/postretirement benefit plans), they still will have deferred taxes and still will have to prepare a statement of cash flows. FAS-109, FIN-48, and FAS-95 (not to mention any applicable EITFs and FSPs) are complex standards requiring high-level skills.

Elimination of the Principle Evidence Provision

AS #5 – ED eliminates the AS #2 requirement that the auditor gather the "principle evidence" to support his or her opinion. It appears that if management personnel (not just internal auditors) appear objective and competent that they could gather the principal evidence, and not just for the audit of internal control over financial reporting but also for the financial statement audit. If so, what do we need auditors for? And, roll back the clock to the late 1990s, I think most everyone would have described Mr. Fastow and Mr. Sullivan as honest and competent (both men were recognized for their excellence by *CFO Magazine*). The risk of incorrectly assessing managerial objectivity and competence, and then relying on their work – particularly for the financial statement audit, seems to appreciably increase of the risk of material financial statement misstatements not being detected on a timely basis.

This AS #5 – ED provision is particularly problematic given certain recommendations contained in the Panel on Audit Effectiveness' Report (2000).[1] The Panel on Audit Effectiveness recommended that, "The external auditor should *not use* (my emphasis) the work of internal auditors in carrying out tests directed at the possibility of fraud" (p. 91). Two to three years before the Enron and WorldCom frauds (which cost investors billions of dollars), this blue-ribbon group recommended that auditors should not rely on internal auditors for performing certain substantive tests. Internal auditors are almost universally regarded as a more appropriate source for auditor reliance than management. But AS #5 – ED would seem to permit the auditor to rely on management, with no obvious restrictions as to amount and audit area. I ask the Board – does AS #5 – ED or the recommendation of the Panel on Audit Effectiveness Report provide greater protection to the investing public?

Replacement of the Term "More than Remote" with "Reasonable Possibility"

AS #5 – ED replaces the term "more than remote" with "reasonable possibility" in evaluating the likelihood of a financial statement misstatement as a result of an internal control deficiency. Amer, Hackenbrack, and Nelson (1994) report that audit managers assign a mean (median) probability threshold of 12.33% (10%) to the term remote and 58.57% (60%) to the term reasonably possible. If these probability assessments are still valid today, I believe that it is problematic to only consider the effect of an internal control weakness if there is a 60% or greater chance that the weakness would result in a financial statement misstatement.

Importance of Audit Committee Independence, Regardless of Exchange-Listing Standards

AS #5 – ED indicates that a lack of audit committee independence may indicate ineffective oversight of financial reporting, but only if the entity trades on a stock exchange requiring an independent audit committee. The language in AS #5 – ED seems to suggest that it is acceptable to not have an independent audit committee unless the entity is required to have such by stock exchange listing rules. The COSO framework's discussion of the control environment emphasizes the importance of audit committee independence. Moreover, there is

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[1] The Panel on Audit Effectiveness was created under the auspices of the Public Oversight Board, at the encouragement of the SEC. This group was chaired by the former chairman of Price Waterhouse, and had among its members two former SEC commissioners and an academic who currently is a senior staff member at the SEC. The recommendations of this group were made two years before revelations of the fraud at Enron and three years before revelation of the fraud at WorldCom.

an extensive body of research literature that documents the salutary benefits of audit committee independence. For example:

- Audit committee and/or board independence is associated with a lower incidence of fraudulent financial reporting (see Dechow, Sloan, and Sweeney, 1994; Beasley, 1996; Farber, 2005)
- Audit committee independence is associated with a lower incidence of restatements (see Abbott, Parker, and Peters, 2004; Carcello, Neal, Palmrose, and Scholz, 2006)
- Audit committee independence is associated with less earnings management (Klein, 2002; Bédard, Chtourou, and Courteau, 2004)
- Audit committee independence is associated with a higher incidence of going concern reports for financially distressed companies (Carcello and Neal 2000)
- Audit committee independence is associated with a lower incidence of auditor dismissals following the issuance of a going concern report (Carcello and Neal 2003)

Moreover, recent research (Bronson, Carcello, Hollingsworth, and Neal, 2007) finds that even *one* non-independent audit committee member reduces the effectiveness of the committee. Therefore, it seems that AS #5 – ED should emphasize the importance of audit committee independence regardless of whether independence is required by any applicable stock exchange rule.

<u>Inclusion of Size Thresholds</u>

AS #5 – ED indicates that the auditor should consider the company's size and complexity when planning and performing the audit of internal control (see p. A1-7). This is appropriate guidance. But then AS #5 – ED defines size using cutoffs from the report of the SEC Advisory Committee on Smaller Public Companies. The risk in including these size cutoffs is that certain registrants will seek a "less rigorous" audit based solely on these size thresholds and some accounting firms may comply with this request. I suggest the elimination of the Note to paragraph 9 and the elimination of footnote 6. Neither are necessary to support the concept embodied in paragraph 9.

<u>Reliance on the Work of Others</u>

As discussed previously, I think it is a mistake to allow the auditor to rely on the work of management, especially in auditing the financial statements and in auditing certain areas of internal control (e.g., the control environment). If the Board decides to allow the auditor to rely on the work of management, I think the Board should limit such reliance and proscribe reliance in certain audit areas.

AS #6 – ED indicates that the auditor cannot rely on the work of others unless these individuals are objective and competent, and factors for making these judgments are included in the ED. However, AS #6 – ED does not differentiate between the work performed by management and the work performed by internal audit. I believe there is an important difference between these two groups. Although I agree that objectivity and competence are paramount, job titles do matter. Job titles often create a mindset, and they may involve compliance with a set of professional standards and a code of ethics (e.g., many internal auditors follow the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing*).

My comments are meant to help the Board in improving AS #5 – ED and AS #6 – ED. Although these comments are constructively critical, they should in no way be interpreted as an overall criticism of what I view as a superb job by the Board and its staff in developing a standard that will reduce the cost burden on companies without generally reducing the effectiveness of internal control reporting.

Thank you for the opportunity to comment. I am happy to respond to any questions or to provide any further information.

Sincerely,

Joseph V. Carcello

Joseph V. Carcello
Ernst & Young Professor
Director of Research – Corporate Governance Center

2/26/2007

VIA ELECTRONIC MAIL

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

Re: PCAOB Rulemaking Docket No. 021

Office of the Secretary,

Ventana Medical Systems, Inc., welcomes this opportunity to comment on the PCAOB's *Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of the Financial Statements and Related Other Proposals*. Compliance with the provisions of the Sarbanes-Oxley Act of 2002 and the guidelines derived from Audit Standard No. 2 comprise an important part of our daily corporate finance and governance duties. Ventana recognizes the importance of maintaining investor confidence and believes that establishing a strong internal control system is one measure companies can take to contribute to the integrity of the securities markets.

Ventana (NASDAQ: VMSI) is a Tucson, Arizona-based mid-cap developer and manufacturer of medical systems utilized in the diagnosis and treatment of cancer. Our Company, like many accelerated filers of our size, spent considerable internal resource time and monies to achieve compliance under the Sarbanes-Oxley Act as of 12/31/2004. While costs of compliance have decreased slightly over the past two years these activities still comprise the most costly segment of our external audit and occupies a disproportionate quantity of internal resource time.

Ventana was committed to establishing and maintaining an effective control environment before the requirements under the Sarbanes-Oxley Act and has been in each year since. We have not had any control issues during this period warranting disclosure, but believe that the required compliance activities under Sarbanes-Oxley have come at a cost to Ventana and our shareholders and we feel that improvements could be made to make the audit of internal controls more efficient and valuable.

There are many provisions of the proposed rule changes which would support Ventana's ongoing effort to achieve a strong internal control environment while reducing compliance costs. Ventana would like to express its support for the following key provisions of the proposed rule.

- Removing the Requirement to Evaluate Management's Process – this change over the current requirements under AS No. 2 should translate into immediate external audit fee savings. While we believe that our external auditors make an attempt to integrate their assessment of management's testing when re-testing work that is relied-upon, the removal of this requirement will eliminate non-valued added external audit work steps around evaluating management's assessment of internal controls altogether.

- Clarifying the Role of Materiality in the Audit of Internal Controls – by directly correlating the materiality considered in audit of internal controls to that considered in the substantive audit of the financial statements will help to focus the internal and external audit of controls on only those most material aspects/accounts within financial reporting.
- Permitting Consideration of Knowledge Obtained During Previous Audits – this provision in theory will reduce external audit fees related to the audit of internal controls at Ventana each year as the auditor's cumulative knowledge of Ventana's internal control environment grows. Currently, the AS No. 2 does not directly support a 'continuous improvement' perspective that permeates nearly every other aspect of our business today. The support of the 'growing and learning' audit will support Ventana and similar companies to continuously improve our compliance methodologies and challenge our external auditors to do the same.
- Removing Barriers to Using the Work of Others – removing the 'principal evidence' and testing reliance provisions of AS No. 2 will allow the external auditors of companies including Ventana the ability to leverage a far greater degree of work already being performed by internal auditors and expert third parties. This will in turn reduce the amount of work required for external auditors to assess the internal control environment.
- Use of a Benchmarking Strategy to Evaluate Application Controls – this approach was one Ventana had requested our external auditors to adopt and after much deliberation this method of testing was accepted by them. This strategy will certainly save internal and external audit time without compromising the integrity of the audit. This specific guidance should help other companies adopt this methodology without the delays we experienced.

While we support the vast majority of the proposed rule there is one small provision that could create non-value added work and additional audit fees for companies similar to Ventana which have material subsidiary operations with non-integrated financial systems. This concern is discussed below.

- Evaluating Information Technology Controls – the language in the bulleted section under item 12 of the Introduction which states "the auditor's testing of information technology controls should focus on the application controls built into the pre-packaged software" may encourage external auditors to inappropriately 'over-audit' out-of-the-box software without considering alternative approaches to testing these systems. In the case of our Japanese subsidiary which utilizes out-of-the-box software for logistics and accounting record keeping we place limited reliance on these systems. One could argue under this statement that even this limited reliance could warrant the hiring of a Japanese-based expert to audit these systems forcing us to incur costs disproportionate to the relevant risks. We recommend less specific language here allowing for judgment of risk to determine the extent of testing on out-of-the-box software relied upon.

In general we believe that the Board's assessments of the strengths and weaknesses of AS No. 2 are accurate and the changes made appropriately address the weaknesses identified. We look forward to the positive impact these rules will have on our ongoing internal controls compliance process and additionally appreciate the Board's intent to ensure that compliance rules do not negatively impact the competitiveness of US-based stock exchanges.

Sincerely,

Nicholas Malden
Senior Vice President, Chief Financial Officer
Ventana Medical Systems, Inc

February 26, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 21 - Proposed Auditing Standard – *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements; And Related Other Proposals*

Dear Mr. Secretary:

Veris Consulting, LLC ("Veris") is pleased to respond to the request for comment from the Public Company Accounting Oversight Board ("PCAOB" or the "Board") on the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements* (the "proposed standard") and related other proposals. We set forth below our comments for consideration by the Board as it deliberates regarding a final standard on this subject. Our comments are intended to assist the Board in its efforts to enhance the quality of financial reporting by public companies and the quality of audit with respect to such financial reporting with the overall objective of restoring confidence in our capital markets system.

Our comments have been organized into two main sections: 1) Executive Summary – which includes a detailed analysis of our basic difference with the Board's approach in the proposed standard; and 2) General Section – which covers our response to the specific questions posed by the PCAOB in its release.

We would be pleased to discuss our comments with you or other members of the Board. If you have any questions, please contact Noeleen Doelger, Managing Director, or Vishal Mehta, Director, at (732) 747-9800.

Very truly yours,

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I. Executive Summary

We would like the Board to consider our comments in light of their and the SEC's stated objective of reducing the cost of compliance with the Sarbanes-Oxley Act's requirements, while enhancing the quality of the audit of the financial statements of public companies.

Given the above objective, we concur with and endorse the Board's proposal to eliminate the auditor's opinion on management's process for reporting on internal controls over financial reporting ("ICFR"). However, we fundamentally disagree with the Board's dichotomy between the test of controls in an audit of financial statements and the test in an audit of internal control, as it defeats the purpose of integrating the "two" audits. In fact, we believe that there should be a single audit with dual objectives – 1) opining on the internal controls and 2) opining on the financial statements.

Therefore, we recommend to the Board that they should consider revising Appendix B – Integration of Audits (pages B1 – B11) of the proposed standard and clearly state that, while performing an ***audit of financial statements and ICFR***, the auditor ***must*** adopt a wholly compliance-based approach -

i. Requiring the performance of substantive tests for financial statement assertions that are deemed insignificant or in the case of controls which the auditor evaluates as deficient; and
ii. Considering the results of his/her test of controls to alter the nature, extent and timing of substantive procedures, otherwise.

We believe this approach will truly integrate the audit process and significantly reduce the cost by ensuring the use of or directing auditors to use a single audit team to conduct a risk-based audit. Please refer to the flow chart in the attached Appendix for additional clarification.

We do recognize that the above mentioned approach would require a change in the auditor's mindset since, under traditional auditing standards, performing a wholly substantive audit has always been a valid option. In addition, the Board would need to revise the language of the proposed standard to delete any references to the separate audits, as well as to emphasize the importance of the link between materiality, significant account balances, financial statement assertions and control risk as the drivers of audit efficiency.

Some of the other areas that the Board would also need to reassess in the proposed standard are as follows:

- Broaden the scope of the proposed standard to include and address multiple control frameworks, given the SEC's guidance to management that it may

select any control framework, other than COSO, for purpose of its assertion regarding internal controls.
- Timing of testing of information technology ("IT") controls directly related to financial reporting, since the pervasive and evolving nature of these controls affects the accuracy of financial statements on a continuous basis during the year.

II. <u>General Section</u>

A. Focusing the Audit on Matters Most Important to Internal Control

1. Directing the auditor's attention towards the most important controls

We believe that the Board has adequately described the "top down approach" as well as the intended benefit of using this approach on the audit. However, the Board should consider reorganizing the paragraphs to mirror the logical sequence of tasks followed while applying the top-down approach. That is, paragraphs 24 to 29 under "*Identifying Significant Accounts*"; paragraphs 30 and 31 under "*Identifying Relevant Assertions*" and paragraphs 32 through 40 under "*Identifying Major Classes of Transactions and Significant Processes (including performing walkthroughs)*" should precede paragraphs 17 through 23 under *Identifying Company-Level Controls*.

The rationale for this reorganization is that, while applying the top-down approach, an auditor first determines the significant account balances ("SAB") and then the relevant financial statement assertions applicable for each significant account balance, followed by identifying the major classes of transactions ("MCOT") and significant processes. In other words, the identification of company-level controls important to an auditor's conclusion, without identification of significant account balances, appears to be counterintuitive.

Further, we believe that the Board should consider enhancing the guidance relating to fraud. Since fraud risk is present both at the entity-level (e.g., management override) and at account balance level (e.g., cash, accruals, write-offs, etc.), the Board should clarify that fraud risk should be a required criterion during the auditor's risk assessment process as well as during the identification of important internal controls to test.

2. Emphasizing the importance of risk assessment

Please refer to our suggested comments in the Executive Summary section above. In addition, we believe that performance of a walkthrough would be a sufficient test of the design and operating effectiveness of a low risk control and recommend that the proposed standard reflect this.

3. Revising the definitions of Significant Deficiency and Material Weakness

The Board's current proposals to:

- replace "more than remote likelihood" with "reasonably possible" and "more than inconsequential" with "significant"; and
- define material weaknesses more narrowly to exclude an aggregation of significant deficiencies

will simplify the auditor's evaluation of control deficiencies, but only to a limited extent. We strongly believe that the PCAOB should consider enhancing the guidance in paragraphs 74 and 75 to include language that requires the auditor to assess the magnitude of a potential misstatement based on the materiality threshold established for the audit of the financial statements. This linkage will further promote the Board's (and the SEC's) underlying objective of integrating the audit of internal control and financial statement audit (See questions 8 and 9 on page 11 of the PCAOB Release 2006-007).

4. Revising the strong indicators of a Material Weakness

We concur with the Board's proposal and believe that the proposed standard should allow an auditor to conclude whether a deficiency exists or not when one of the strong indicators is present based on enhanced testing and use of judgment, rather than automatically conclude that a deficiency exists.

5. Clarifying the role of materiality in the audit

We believe that further clarifications to the scope of the audit are not necessary. In addition, the reference to interim financial statements should be retained in the definition of significant deficiency and material weakness. ***However***, as stated in section 3. above, even though the Board has clarified that auditors should use only one materiality threshold, it should consider providing further guidance to auditors on how to apply the concept of materiality to evaluation of risk (scoping) and measuring control deficiencies (opinion).

6. Clarifying the role of interim materiality in the audit

Please refer to our comment in section 5 above.

B. Eliminating Unnecessary Procedures

1. Removing the requirement to evaluate management's process

Please refer to our comments in the Executive Summary section above.

2. Permitting consideration of knowledge obtained during previous audits

The proposed standard appropriately incorporates the value of knowledge obtained by the auditor in prior year audits, such that it should only affect the auditor's assessment of risk related to a specific account balance and his/her determination of the nature, timing and extent of test of controls in a subsequent year audit.

Further, with specific reference to Question 17 on page 20, we believe that a walkthrough would normally be sufficient evidence of operating effectiveness for controls that have been assessed as low risk.

3. Refocusing the multi-location testing requirement on risk rather than coverage

While the Board's intention is to limit testing to only those locations which present a reasonable or higher possibility of a material misstatement in the entity's consolidated financial statement, we believe that the proposed standard should include specific language indicating that this assessment of risk of misstatement should be made at the account balance level. This will prevent situations where the auditor (and company management) may exclude a location on the basis that its net result of operations is immaterial (in light of the consolidated entity's net income/loss), in spite of the fact that such location may have revenue or expense account balances which include one or more balances that present a high probability of risk of material misstatement.

4. Removing barriers to using the work of others

We concur with the Board's views on proposing a single standard framework for using the work of others (proposed standard to replace SAS 65). We also believe that the removal of the "principal evidence" clause will reduce the overall audit effort and that the proposed standard adequately and appropriately captures the scope of activities and an auditor's responsibilities, as well as the factors for evaluating the competency and objectivity of "others" etc.

5. Recalibrating the walkthrough requirements

We partly agree with the Board's proposed changes to the walkthrough requirements. While the proposal to perform walkthroughs at a process level will lead to efficiencies, it should be further clarified in the proposed standard that often there will be circumstances that would merit performing a walkthrough at a ***major class of transaction*** level. For instance, if an insurance filer's revenues are comprised of multiple lines of property and casualty business, and each line of business is equally material/significant to the financial statements, the auditor should perform the walkthrough for each line of business (***i.e. MCOT***) and not at the overall revenue process level.

However, we disagree with the second proposal, and strongly believe that the auditor (or audit staff) must perform all walkthroughs himself/herself as the primary objective of the walkthrough is to obtain an understanding of the process "end-to-end" and that objective should not be delegated. In addition, given that the SEC has allowed management some flexibility in the nature and extent of documentation that should be maintained on processes and ICFR, the auditor's walkthrough assumes even more significance as it eliminates any reliance on potentially deficient documentation.

C. Scaling the Audit for Smaller Companies

We are in general agreement with the Board's proposed guidance on the audit of small companies. However, we believe the potential to scale the audit should be based on complexity, rather than "size and complexity" as it currently reads. Therefore, scaling the audit would be applicable to all filers, not just small companies. The following are suggestions for enhancements for the Board's consideration:

Company level controls

Most small companies have a relatively flat organizational structure and, consequently, an extensive involvement by senior management in day-to-day control activities, as well as period/year end financial close activities. Given this reality, we believe that the Board's statement in the last sentence of the second bullet of paragraph 12 (page A1-9 of the proposed standard) is prone to subjectivity and susceptible to misuse. Hence, we recommend that the Board provide examples of "alternative controls" for situations where an auditor establishes that management is extensively involved in performing key control activities. In such cases, the auditor should expand his test of controls beyond the test of company-level controls to test such additional controls so as to mitigate the risk of management override or lack of segregation of duties.

Evaluating IT controls

The small business IT control discussion (page A1-12 of the proposed standard) should be expanded to highlight differences between small companies that use prepackaged software and those that rely on home-grown or proprietary systems.

Proprietary systems offer more challenges as the auditor needs to understand risks, such as programmer access to production systems and change controls. In addition, system development lifecycle controls must be assessed. Issues such as ensuring management buy-in for the source code changes, QA testing, integration testing and edit checking should all be considered as part of the overall risk assessment process. These types of risks directly impact the accuracy and completeness of financial data processed on an ongoing basis by the entity's financial reporting system.

Further, prepackaged software rarely facilitates all aspects of financial reporting for a small company. Finance departments often generate several end-user controlled and developed desktop applications (i.e., spreadsheets) that are either fed by source systems or feed source systems. These "desktop" end-user owned applications form the crux of general IT control confusion when small companies attempt to comply with Sarbanes-Oxley requirements for IT controls. Desktop applications are inherently weak in terms of supporting Sarbanes-Oxley related change and security controls. In order to comply with Sarbanes-Oxley, smaller companies are required to create burdensome assessment matrices that depend on an unclear and sometimes arbitrarily defined combination of human and IT controls in order to prevent or detect potential flaws in the logical processing of data within the application. This "gray area" between IT and financial process controls needs to more clearly defined so that companies can adopt standardized approaches to documentation and testing. Ideally, a move from reliance on desktop applications to a more robust and centralized solution maintained by IT should be encouraged by the Sarbanes-Oxley compliance community to alleviate this issue.

In addition, IT controls should be evaluated on a quarterly basis as the systems being evaluated are typically more dynamic and subject to change as compared to the business processes they support. Often systems are implemented or decommissioned within an accounting period or cycle. To address this issue, the auditor should ensure that documented risks, controls and tests support the relevant systems during the relevant time frames.

Proposed Rule 3525 – Audit Committee Pre-approval of Services Related to Internal Control

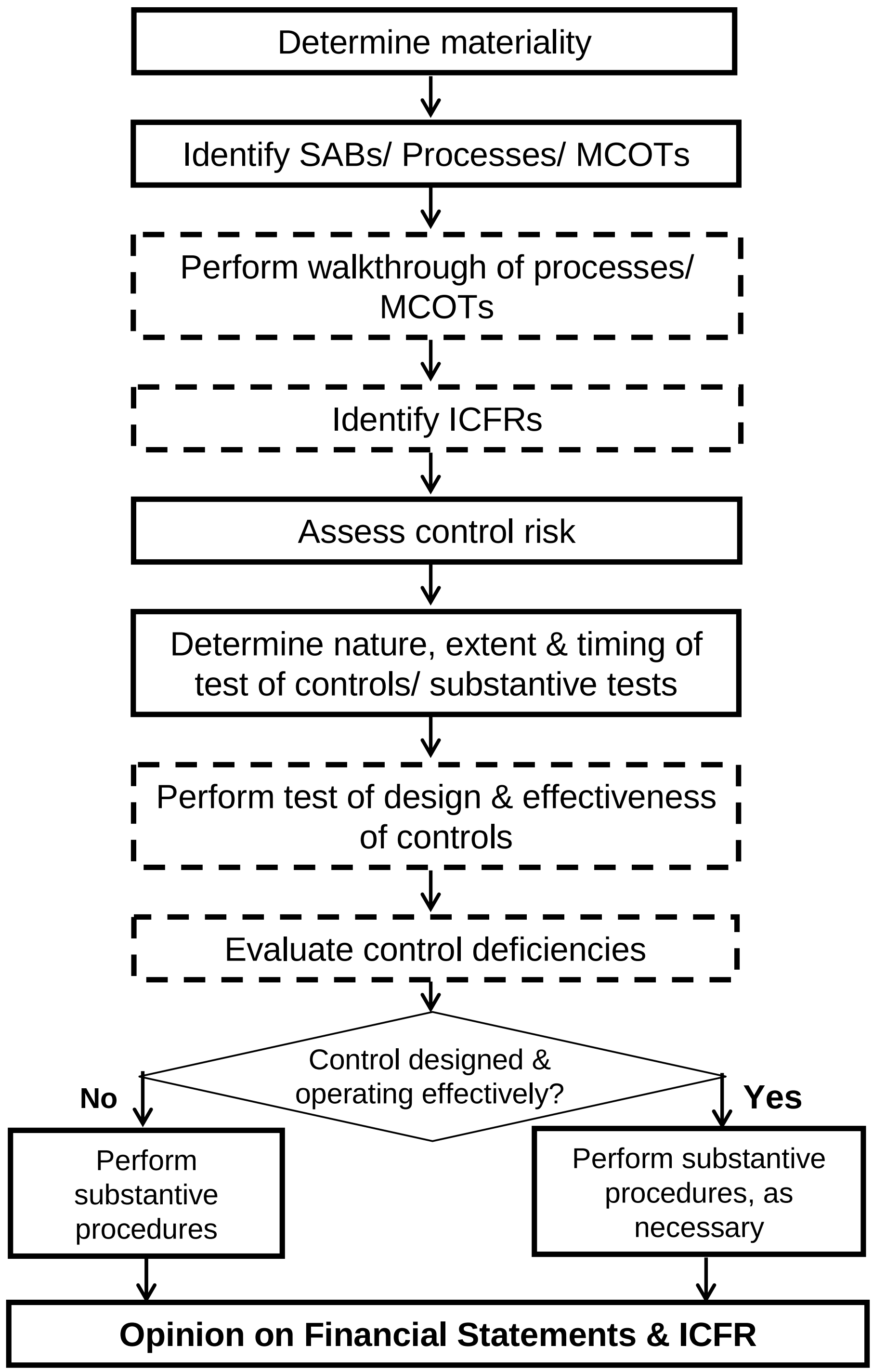
We concur with the Board's proposed Rule and have no additional comments or amendments.

Effective Date

In order to determine the effective date of the proposed standard, we recommend that the Board consider that the revised guidance will impact not only the auditor's approach, but also management's process for making the assertion. Hence, it is important to make the final guidance available in time for both filers and registered public accounting firms. In addition, given that the Board's objective of issuing the proposed standard is congruent with the SEC's goal of providing guidance to filers on how to make the assertion process cost effective, it is important the Board deliberates and gives due consideration to all comments received.

APPENDIX

Flow Diagram for Integrated Audit of Financial Statements and ICFR



Note 1: Activities within dotted lines represent activities that are optional or not applicable in an audit of financial statements

Note 2: In a traditional audit of financial statements, the auditor may perform wholly substantive procedures even if he/she assesses a control as effective

26 February 2007

Office of the Secretary, PCAOB
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20006-2803

Dear Sirs

PCAOB RULEMAKING DOCKET MATTER NO. 021

PCAOB Release No. 2006-007 issued on 19 December 2006 invited interested parties to submit written comments to the Board.

Whilst Vodafone agrees that there have been benefits derived from the application of s404 of the Sarbanes-Oxley Act, we have some concerns in relation to the costs of compliance. This is measured in terms of the initial implementation, the ongoing overhead and the increase in audit fees. We welcome the Board's stated intention to drive a more efficient, risk-based audit approach. We also support the reconsideration of associated areas as set out in the overall proposal. Our primary concerns relate to how the proposals will be applied in practice.

Having considered the detailed proposal, we have a number of comments, each of which is cross referenced to the relevant sections in the PCAOB Release.

A. Focusing the audit on the matters most important to Internal Control

1. Directing the Auditor's Attention Towards the Most Important Controls

We agree that, to date, the emphasis on detailed, process-level aspects of internal controls has been disproportionate to the actual risk. Clear focus should be on 'what can really go wrong'.

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

Having learned from the experiences of some US companies which had an earlier compliance date, Vodafone designed its s404 methodology based on a top down risk-based approach. We have identified Company Level Controls, Reporting Controls and other Key Controls at in-scope locations.

Whilst the new standard describes this concept, it does not give a particularly clear picture of how it should be applied in practice. Further, there is a close link between the application of a top-down risk-based approach and the identification of in-scope locations. Using the proposed standard, we believe there will continue to be discussion and debate with external auditors in relation to what should be included in scope.

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

In our view, adequate focus is placed on the importance of identifying and testing controls designed to prevent or detect fraud.

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

The guidance is clear and, if applied logically, will focus audit attention on the most important controls. However there remains the risk that client and auditor may not agree on the extent to which the use of top-down risk based controls identification should reduce lower level 'transaction' testing.

Question 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?

Whilst the principle is explained, the practical application is not clearly set out. There is currently a strong desire to attach numbers to areas such as testing coverage, to gain comfort that management and the external auditor has done sufficient work. In order to generate efficiencies, external auditors will need to move away from this and we are unclear at this stage about how will they come to terms with the relative 'significance' of higher level controls, especially when the 'coverage' of each can not easily be quantified.

2. Emphasising the Importance of Risk Assessment

Question 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?

The discrimination between smaller and larger companies tends to cloud the matter. An alternative approach would be to determine scoping based on in-depth risk assessment (focus on 'what could really go wrong'), with all in-scope areas requiring a 'standard' level of evidence.

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

In our experience, the results of walkthroughs are a very strong indicator of the overall effectiveness of the control environment and, if done properly, it is extremely uncommon for exceptions to be noted in subsequent operational effectiveness testing.

Further, we believe that for such lower risk controls, it is hard to justify a need for auditor testing at all. Failure in such controls could not result in a reasonable probability of a material misstatement. The auditor should be able to place reliance on management activity.

3. Revising the Definitions of Significant Deficiency and Material Weakness

Question 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?

In the proposal, 'significant' is defined to be "less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting." If applied in practice, it should result in better focus during the audit.

Question 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?*

In conducting a top-down risk-based s404 audit, the auditor has the opportunity to identify material weaknesses when an actual misstatement has not occurred.

Question 9: Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analysing deficiencies that do not present a reasonable probability of material misstatement to the financial statements?

The change in definition is of benefit, because it reduces the real confusion surrounding the "more than remote likelihood" terminology. However, it would be useful to understand what "reasonable probability" means in practice. This guidance should ideally come from the PCAOB.

4. Revising the Strong Indicators of a Material Weakness

Question 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?

We support the proposed change. It will allow the greater use of judgment, which we consider to be appropriate. Our expectation is that audit firms will apply rigorous professional standards to ensure deficiencies are evaluated appropriately.

5. Clarifying the Role of Materiality in the Audit

No questions are raised by the PCAOB in relation to this area.

We observe conflict between this section of the proposal and the practical application of the audits required by local law around our Group. Specifically:

- Group s404 scoping of entities and significant accounts is based on Group materiality. Our auditor has planned the nature, timing and extent of s404 procedures on the same basis.

- However, at each operating company, the local materiality is less (sometimes significantly) than Group materiality. In each case the auditor will conduct more work than is required for s404 sign-off in order to issue the overall opinion that the statutory accounts of the operating company are fairly stated. It is very likely that, at a given location, some accounts will be out of scope for s404 but in scope for the local audit.

We believe that the following statement should be modified to reflect this practical difference:

"inherent risk also is the same for both audits and, therefore the proposed standard clarifies that significant accounts identified in the audit of internal control should be the same as the significant accounts identified in the financial statement audit"

6. Clarifying the Role of Interim Materiality in the Audit

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

We believe the matter is clear.

Question 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?

It may be of benefit to remove reference to it, if it causes confusion.

B. <u>Eliminating Unnecessary Procedures</u>

1. Removing the Requirement to Evaluate Management's Process

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

Having carefully considered the proposal, we believe that it is not necessarily the most effective way to eliminate unnecessary work. In our view, an alternative option would be for the auditor to evaluate management's process, and if it is adequate, rely on it. The extent of reliance needs to be considered carefully but a reasonable approach would be for the external auditor to perform their own work in high risk areas and rely on the work of management in all others.

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

Yes, however this is not necessarily the most effective way of delivering and assessing s404 compliance (please refer to our response to Question 13).

Question 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?

Not necessarily. The reader may not be clear what procedures the auditor engages in to opine on the effectiveness of internal controls. They may presume that the auditor has reviewed the quality of management's assessment. The only certain way to avoid lack of clarity would be to put in an exclusion clause in the audit report ("we have not reviewed the quality of management's assessment").

2. Permitting Consideration of Knowledge Obtained During Previous Audits

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

We welcome the move to omit the statement "each year's audit must stand on its own", because we consider it to be one of the major contributory factors to high audit costs. However we do not consider the standard makes it sufficiently clear exactly how cumulative knowledge should be applied.

Question 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?

Based on our practical experience, the walkthrough is the key mechanism for identifying operating ineffectiveness. Where walkthroughs have been done, and the required remediation put in place, operational effectiveness generally follows as a matter of course. We believe there is a strong argument for the auditor relying on walkthrough procedures (including, in low risk areas, those performed by management) as sufficient evidence of operating effectiveness.

3. Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage

Question 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?

We agree that the wording of AS2 results in excessive and unnecessary work.

Whilst there is some consideration of risk by our auditor, there is also an overriding expectation that we will achieve a certain percentage coverage across defined key metrics. This coverage is measured in terms of direct testing of transaction level controls, and excludes the assurance gained from Company Level Controls and similar testing, where the coverage is less easily quantifiable. Taken as a whole, we consider that management and auditor are conducting too much testing and incurring avoidable costs.

We believe that risk should become the real priority, and the application of a 'required' level of coverage should be discouraged. The focus should be 'what can really go wrong'.

As such, we support the removal of the provision requiring testing of controls over a large portion of the company. However we are concerned as to how the auditor would react in response to the direction to use a risk based approach to determining the proper strategy for auditing multiple locations. We believe that many auditors will be tempted to fall back on more tangible 'measurable' criteria. The extent to which a true risk-based approach is adopted by companies will be dependent on whether auditors are in practice able to make themselves comfortable with something they can not easily measure and may lead to large variations in the amount of work performed by management and auditors at different companies, potentially impacting the consistency of reporting.

4. Removing Barriers to Using the Work of Others

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

We believe it is appropriate to have a single framework – failure to do so would cause greater mismatch between activities under a financial statement audit and activities under the integrated audit. We have some reservations about the achievability of a truly integrated audit (please refer to section A5) and our primary concern is that the application of local materiality at subsidiary entities by default results in more audit work on the financial statements than is required in relation to the audit of internal control over financial reporting.

Question 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?

The proposed definition appears clear.

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

There is an expectation that the auditor would conduct such a review as part of their routine audit work.

However, specifically referring to the requirement should ensure this occurs and enable the auditor to target audit activity and potentially achieve a higher quality of audit.

Question 22: Is the principal evidence provision that was in AS2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?

No. We believe that provided the circumstances under which the auditor may rely on the work of others are clear, the auditor should use its discretion.

Question 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 framework provides adequate guidelines which we do not believe are restrictive.

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

The Board has identified the common factors.

Question 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?

This may cause an issue for smaller companies where such clearer segregation is harder to achieve. However provided compensation arrangements are only one element of the assessment, a balanced picture of objectivity should be achievable.

5. Recalibrating the Walkthrough Requirements

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

A single walkthrough per process rather than a walkthrough of every class of transaction in a process would undoubtedly reduce the number and detail of walkthroughs. Given that management has performed walkthroughs to the higher level of detail, we do not consider that the reduction in auditor activity would compromise audit quality. The auditor could reasonably limit their walkthroughs to the high risk areas.

Question 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?

It is our view that the auditor should rely on the walkthroughs done by management in all areas except those agreed to be higher risk. Please refer to Question 4.

We also support the proposal referred to in Question 27 specifically, that the auditor should more broadly use the work of others in performing walkthroughs.

C. Scaling the Audit for Smaller Companies

Question 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?

No comment.

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

No comment.

Question 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 comment.

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

No comment.

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

No comment.

D. Simplifying the Requirements

Question 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?

We are not aware of any.

Question 34: How can the Board structure the effective date so as to best minimise 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?

Any changes arising from the final AS5 will be too late to benefit Vodafone in its first year of compliance, as of 31 March 2007. However, it is important that the final standard is issued as quickly as possible such that all companies can optimise the available efficiencies. Ongoing audits should be subject to transitional arrangements, such that the auditor reduces audit activity in line with AS5 even though management has conducted more extensive documentation and testing under AS2.

Yours faithfully

Linda Lewis
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February 26, 2007

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Oversight Board
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RE: PCAOB Rulemaking Docket Matter No. 021
Proposed Changes to Auditing Standard No. 2

GRACE

I appreciate the opportunity to comment on the Board's proposed changes to AS2. Set forth below are my responses to each question with commentary, as necessary, to explain my perspective on the issue.

Question 1

No. Although directionally sound, the proposed standard does not provide sufficient guidance about risk factors that should be considered when planning an audit. A top-down approach should result in a more effective audit, but it needs to start at the "very top" and include factors that impact market valuations, company strategy and organizational risk. Guidance should be expanded to include obtaining an understanding of over-arching control characteristics and assessing audit implications in the following areas:

- Market value drivers and analyst expectations;
- Governance structure, particularly for non-US subsidiaries;
- Audit committee diligence and accounting expertise;
- HR and pay practices toward accounting/finance professionals;
- Competency of accounting/finance/legal professionals;
- Accounting literacy of executives and key process owners;
- The degree of centralized vs. decentralized control;
- The client's risk profile and appetite; and,
- The client's "real" ethical culture as reflected in actions.

I am advocating a more "enterprise risk" approach, which will require both better guidance and a new focus of training for most auditors. It will be critical for an auditor to have a working knowledge of corporate finance, industry/company value factors, and sound risk mitigation approaches to effectively determine how best to apply a top-down risk-based set of audit tests and procedures.

GRACE

Question 2

Yes, but more and specific guidance should be considered regarding factors that may encourage fraud such as reward system biases and cultural impediments to bad news. Also, the Board should consider how best to link the CEO/CFO certifications (under SOX Section 302), regarding responsibility to prevent and detect fraud, with the work of external auditors. Auditors should be required to assess the processes used by certifying officers to make their fraud-related assertions, and conclude if such are effective in the auditors' report on controls.

Question 3

Yes, it should. Obtaining a working understanding about how client executives assess and address risk is key to an effective top-down audit.

Question 4

Yes, it seems to. However, it could be made clearer regarding how to assess and conclude that lower level work can, indeed, be eliminated.

Question 5

Yes.

Question 6

Yes.

Question 7

Yes, but. The determination of "important enough to merit attention" requires the auditor to have a relative sense of risk that may, more often than not, result in most deficiencies being judged significant.

Question 8

No. More guidance is needed to help auditors understand enterprise risks and direct them to evaluate such risks in the context of financial reporting. For example, HR practices and philosophy can encourage the attraction, retention and development of qualified finance professionals, or discourage the same.

GRACE

Question 9

Yes, they should.

Question 10

These changes make sense. The problem is that auditors need guidance on how to view deficiencies from a top-down perspective. For instance, at what level in the financial reporting process should a problem be identified? Is it ok if the CFO or CEO find a problem? It may be that they are the only individuals that had all the facts and indicators to identify it. This area will likely continue to be misapplied in practice without better guidance.

Question 11

Should be enough.

Question 12

Yes, the reference should be removed. Materiality relative to control testing should be determined from a full year perspective only. Also, guidance is needed on making judgments of materiality especially when income is small relative to the size of the enterprise.

Question 13

Yes, it should. Good change!

Question 14

Yes, they should.

Question 15

Yes.

Question 16

Yes.

GRACE

Question 17

In almost all circumstances. The current requirement for selective tests of details is not a productive way to assess controls.

Question 18

Yes, it should.

Questions 19-25

These changes appear reasonable and well designed. I caution, however, to require auditor diligence in assessing qualifications of others and not simply accept advertised credentials or expertise.

Question 26

Yes, it should.

Question 27

No. This change is not likely to lower cost, but it may lower quality. Suggest it not be implemented.

Questions 28-32

This guidance seems appropriate at this time.

Question 33

This process appears sufficient.

Question 34

Target an effective date by mid-year 2007.

****

I would be pleased to clarify or otherwise address of any of my responses as the Board or Staff may desire.

Sincerely,

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February 1, 2007

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Reference: Rulemaking Docket Matter No. 021

It is very encouraging that the PCAOB has recognized that the benefits of Section 404 have come at a disproportionately high cost. Its efforts to bring cost into line and be exceeded by the benefits of Section 404 are to be commended. Should the proposed auditing standard be implemented as proposed, it will improve the cost/benefit relationship, but several hurdles will remain. Some hurdles will be within the PCAOB's ability to control, and others outside:

1. Will the PCAOB field offices follow the proposed audit standard in conducting audits of external auditors? Attention by the PCAOB National Office in training its field staff in protecting against not just poor audit quality, but from excessive audit cost, is appropriate.

2. Will the external auditors accept the new audit standard in spirit? For most external audit firms, the new audit standard will likely reduce public company client billings and a natural reluctance to reduce their income substantially should be anticipated.

3. Will the audit standards be accepted by the courts and juries in dealing with the class action plaintiff's bar, or will external auditors be expected to adhere to higher audit levels than the PCAOB sets forth? The external auditors can be expected to resist reducing their procedures and fees for this reason, and with considerable merit as in practice they are serving as an investor insurance carrier. Comments from KPMG during their 404 Institute webcast of December 18, 2007 stated that while management efforts could decrease under the proposal, external auditor efforts (which are far more costly than internal efforts) could increase significantly to make up for the decreased management efforts.

4. Congressional or judicial action to limit the actions of the plaintiff's bar, who are seemingly sailing under Letters of Marque and Reprisal (Article I, Section 8 of U.S. Constitution), and moving securities violations prosecution from the private sector to governmental authority would be helpful in reducing system cost. This would assist in more rational audit behavior by the external audit firms who are reacting like a lamb in the midst of a pack of hyenas: the occasional bleat followed by a merciless slaughter [1].

5. Following the Canadian example of not having the auditors opine on ICFR would also be helpful, though it would require Congressional action to eliminate the independent certification requirement of Section 404. The Company (the Board) would still formally attest to ICFR. Boards rarely undertake economic exposure without significant due diligence, and in Canada practice is evolving that Boards ask the external auditor to conduct an assessment of management's assertions on ICFR. The objective is to remove the litigation exposure of the external auditor and thereby significantly reduce auditor costs while improving internal control.

The Proposed Auditing Standard has 34 questions that the Board seeks comments on; the following are responses to some of those questions.

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

Yes. The top down approach should produce far more focused and effective reviews of ICFR. The current approach is backward in identifying materiality and decreases audit efficiency by having first to identify all transactional activity, then ferreting out the material.

#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?

Yes. The proposed standard does appropriately incorporate risk assessment as it uses a top down approach.

#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?

Response combined with question #9 below.

[1] The current defendants of the predatory bar could identify well with the victims of the Aragonese Archbishop of Narbonne, Arnold Amaury, who in the early 1200's said in response to a question about distinguishing Cathar (Albigensian Christians) from Catholic, "Kill them all, God will know his own". The contemporary version, in a turn of "capital" punishment, might be "Sue them all, let the courts sort it out".

#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?

Materiality (reasonable possibility, significant) now appears coordinated with SEC SABs 99 and 108 and that consistency is positive. However, many regard the SEC materiality guidance as flawed as they result in restatements that investors consider immaterial. For simplicity, the new PCAOB guidance should track to whatever the SEC determines is the appropriate level of materiality, whether it is the current method or some new metric. This would leave struggling with materiality to the SEC.

#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?

One would expect that a restatement (one of the strong indicators) would normally be evidence of a material weakness in ICFR. Nonetheless, an event theoretically could occur where a restatement did not lead to a material weakness. If management, the audit committee, board and external auditor all concur that there was no material weakness, then it may be appropriate to conclude a material weakness was not present. It seems reasonable that the Standard should permit such a finding, though the occurrence of such findings would be rare, particularly if the SEC re-addresses materiality to reduce the amount of immaterial restatements.

#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?

Yes. As the attestation to ICFR is on an annual basis, the relevance of interim materiality would seem moot unless there was a significant interim failure in ICFR. If there were a significant interim period failure in ICFR (for instance, a restatement) materiality should remain the same dollar value as annual periods.

The PCAOB should avoid the difficulties that the SEC finds itself in when attempting to apply percentage materiality to interim periods and either missing a material item, or more often, finding more material items than exist. Both the SEC and PCAOB need to recognize that a material percentage of a financial statement number may or may not result in a material valuation change in shareholder value. Shareholders are concerned with the DCF of future cash flows and if the error materially affects those flows investors are quite concerned. If they are merely backward looking classification errors that will not affect future cash flows, then one should expect investors to exhibit far less concern unless the error is indicative of incompetent or unethical behavior.

The purpose of ICFR is not just annual periods, however the determination of materiality for an interim period is an area that the SEC needs to address further as SABs 99 and 108 can result in immaterial items causing restatements. The PCAOB should not compound the problem by developing a materiality standard different from the SEC definition, but track to that definition, even if flawed, and use that definition on an annual basis only.

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

Yes. Removing the requirement for an evaluation of management's process will eliminate unnecessary audit work. However, as the appropriate number of auditor hours are opaque to most companies, how much will be removed is uncertain. A pessimist would observe that the applicable audit hours were considerable before the external auditor found those hours were being removed, and after removal that the hours were immaterial; thus hours and fees will remain unjustifiably high.

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

Yes. The question for purposes of the attestation is the quality of the controls, not the means by which those controls were attained. The auditor can contribute value without a formal report on management's process.

Shareholders should be able to expect that an auditor would comment to management (¶ 87) and the audit committee about the quality of ICFR to point out areas where the company is just passing, or incurring excessive costs or procedural hours in achieving a control objective. The external auditor should be encouraged, preferably required, to comment on the quality of ICFR to management and the audit committee; not just that the company passed or failed.

#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?

Yes. Simplicity imparts clarity.

#19: (a) 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? (b) If different frameworks are necessary, how should the Board minimize the barriers to integration that might result?

(a) Yes, (b) no comment submitted at this time.

#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. The question is whether external auditors can perform the task economically in relation to the risks – including the risks to the company as well as to the audit firm from litigation.

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

(a) Yes, (b) Yes, though it will obviously depend on the application of the spirit of the framework by the external auditor, (c) No.

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

Yes. Both education and experience are appropriate elements to be considered, though formal education (or its lack) alone should not preclude consideration of experience. The complexity of the audit or control area should dictate the appropriate combination of education and experience.

#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?

Positive. Conceptually, Internal Auditors and others involved in the assessment of ICFR should be independent of the outcome of the ICFR audit, including financial independence. The compensation of Internal Audit staff should be independent of the results of the audit, though audit efficiency and efficacy could fairly be considered in bonus plans.

#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?

"Market capitalization" should be clarified to be "equity market capitalization" utilizing a definition of equity consistent with that contained in Securities Exchange Act Rule 12b-2. The use of revenue as a defining measure does not appear to necessarily relevant to shareholder risk – shareholders invest in equity instruments, not in sales. There are numerous industries (particularly more mature industries, but not exclusively) that have high revenues and low gross and net margins, and accordingly lower equity values; at the same time there are companies with small revenues but the market attributes great expectations to future cash flow growth and assigns very large equity valuations. Shareholder risk is correlated with equity value, not sales volume.

The Securities Exchange Act Rule 12b-2 definitions for non-accelerated (<$75m), accelerated (>$75m, <$700m) and large accelerated (>$700m), which use the amount of outstanding equity instruments not held by an affiliate, are reasonable size determinates are suitable for use by the PCAOB. Using the SEC definitions would also avoid yet another size definition for preparers and users to deal with.

The SEC itself may wish to move in the direction of the Advisory Committee report describing "Smaller Public Companies" as those with under $787.1 million in [equity] market capitalization (bottom 6% of public companies) and "Microcap Companies" as those Smaller Public Companies with [equity] market capitalization under $128.2 million (bottom 4% of public companies) as a very good starting point. Whether it is the SEC or the PCAOB that sets the thresholds, they should round the amounts up to provide an easier reference, perhaps using the thresholds of greater than $800 million or $1 billion for "Smaller Public Companies" and under $200 million or $150 million for "Microcap Companies". Further, the Agency setting the level (SEC or PCAOB) should schedule reconsideration of the definition thresholds not less often than every five years to reflect inflation and market developments, and changes should be in large amounts (e.g., minimum $100 million for Smaller and $25 million increments for Microcap companies).

It would seem appropriate for the SEC to set the threshold levels and for the PCAOB to track the SEC levels.

#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?

I have not seen difficulties in this area from the company perspective; auditors may see greater issues in the loss of revenue from conflicted services. The projected cost of the proposed service and relationship to the projected audit fee would be valuable for the Audit Committee to know. However, anecdotal comments indicate external auditors are currently reluctant to provide many audit committees with estimates of audit fees.

#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?

Any date selected will be disruptive – either the date will be too late to alter ICFR audit practices to eliminate inefficient ICFR audit practices, or too soon for some audits that might require a significant change in process. A reasonable approach set the effective date for fiscal years ending on or after December 15, 2007, and to permit early adoption. This approach would allow companies to make the determination of whether early implementation would provide the most practical and economic means of making the change.

Thank you for the consideration of the above comments in your process of improving the auditing requirements related to Sarbanes-Oxley Section 404.

Sincerely,

/s/ James Wall

James Wall

From: Tim Breeding [mailto:Tim.Breeding@wal-mart.com]
Sent: Monday, February 26, 2007 8:16 PM
To: Comments
Subject: Rulemaking Docket Matter No. 021 - SOX Audit Standards

Thank you for the opportunity to review and comment on the proposed updates to the SOX audit standards. I am glad to see the general direction and support the top-down, risk based approach. My experience has been that if Internal Audit and external audit agree on the framework to be used, the scope, testing steps, etc… and both groups are highly competent in their ability to execute the audit, that the external auditors should be able to place more reliance on the internal audit (management's assessment). My organization understands the need for the audit and has been supportive. However, they perceive the external audit to be a repeat of the internal audit and they challenge why they are taking time from important projects to be available for an audit that Internal Audit just completed. In this regard, I am extremely appreciative of the new position that allows the external auditors to place more reliance on the internal audit.

Another improvement is allowing for knowledge gained about the control environment in previous reviews to be used. This, along with consideration of change frequency/results to the control environment in lower risk areas allow for more intelligent use of resources to the areas of higher risk. Allowing for the use of rotational schedules in these areas, I believe, would add further efficiency.

The concept of the Auditors evaluating management's assessment is confusing to me. On page 14, there is mention of the Auditors no longer having to evaluate the process used for management's assessment. Yet page 72 offers the Auditors must render an evaluation of the management assessment. These seem conflicting to me and could result in management being surprised at the end of the review. If the Auditors are not pleased with the process used by the management assessment, yet they only opine on the end assessment, it is akin to seeing problems with a software development effort but waiting until the software is installed before mentioning the concerns. As part of our external auditors quest to independently opine on our assessment, they frequently will not answer questions that would help provide clarification as to approach, scope, or the use of frameworks. In the areas of general controls where there is not a lot of specific guidance, this can be very frustrating. They often refuse advising in any capacity or offer their opinion as to concepts and control structures. This seems counter to the intent of the Act. Furthermore, I do not see the value in the Auditors solely opining on management's assessment. Rather it makes more sense to me for them to opine on the internal controls, of which the internal assessment can be considered a part.

I sincerely appreciate the time and effort your organization has applied to this important matter. Thank you for the opportunity to participate in the commentary period.

Kind Regards,
Tim Breeding
Senior Director - IS Audit
Wal-Mart Stores, Inc.
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E-Mail: Tim.Breeding@wal-mart.com

-----Original Message-----
From: Bennion, Jeanette [mailto:Jeanette.Bennion@wgint.com]
Sent: Monday, February 26, 2007 4:55 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 021

I would like thank the PCAOB for taking a thorough look at AS-2 and proposing suggestions for improvement. I am a vice president of an accelerated filer responsible for Sarbanes-Oxley compliance, particularly Section 404. I share the view others have expressed about the proposed change that would eliminate the requirement for the independent auditor to express an opinion on management's assessment of internal control over financial reporting. I believe the Board is proposing to eliminate the wrong opinion.

Management is responsible for maintaining effective internal control over financial reporting. Section 404 ensured that management assumed responsibility for effective internal control as a key accountability. By eliminating the requirement that the auditor opine on management's assessment, the perception exists that management can "lighten-up" or if not lighten-up, then adapt a scope and approach to Section 404 that may look quite different from the scope and approach utilized by the independent auditor in performing their audit of internal control.

I believe the Board should maintain the independent audit of management's assessment of internal control over financial reporting and removed the redundant independent audit of internal control. This view was reinforced when I recently attended a seminar presented by a Big 4 accounting firm on the proposed PCAOB regulatory changes and SEC guidance. In that presentation, the audit partner stated, under the PCAOB's proposals, the cost of the 404 audit might actually increase if management's approach to 404 changes enough in comparison to the independent accountants. In that situation, it may actually cause the independent accountant to do more work than in prior years in performing their audit of internal control.

I think the elimination of the requirement for the redundant independent audit of internal control and maintenance of the requirement for an audit on management's assessment would preserve management's accountability for internal control, provide shareholders the assurance they deserve, and provide meaningful relief to industry resulting from some of the overbearing aspects of AS-2.

Sincerely,
Jeanette Y. Bennion
Vice President Financial Compliance
Washington Group International
PO Box 73
Boise, ID 83729
(208) 386-5185

WELLS FARGO

Richard D. Levy
Senior Vice President & Controller

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February 23, 2007

Via E-mail

Office of the Secretary,
Rulemaking Docket Matter No. 021
Public Company Accounting Oversight Board
1666K Street, N.W
Washington, D.C. 20006-2803

Re: Rulemaking Docket Matter No. 021 – Invitation to Comment on Proposed Auditing Standard – *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals ("Proposed Standard")*

Wells Fargo & Company (Wells Fargo) is a diversified financial services company with over $482 billion in assets providing banking, insurance, investments, mortgage and consumer finance services. As a public company, we appreciate the opportunity to comment on the issues being considered by the Public Company Accounting Oversight Board (the "Board") regarding the proposed standard on internal control over financial reporting.

Wells Fargo supports the Board's efforts to address the concern that the existing standard on internal control over financial reporting has been misinterpreted, resulting in excessive management and audit work at significant cost to public companies and investors as a whole. We appreciate this opportunity to provide you with our views on the Board's proposed changes.

- We believe that rotational testing is a natural result of a top-down, risk-based audit approach and would result in more effective audits at lower cost. Therefore, we disagree with the Board's complete prohibition of rotational testing.

- We believe the Board needs to provide additional guidance on the role company-level controls will play in the audit. Specifically, the Board has not gone far enough to encourage auditors and their clients to discuss and reach concurrence as to how company-wide controls will be leveraged to reduce process-level control testing.

- We believe the absence of guidance on what characteristics designate controls as "key" controls has led to a focus on *all* controls over financial reporting. A focus on key controls over financial reporting would increase the effectiveness of the audits and is consistent with the top-down, risk-based approach to audits of controls over financial reporting.

Rotational Testing

Auditing Standard No. 2 (AS No. 2) currently requires management to perform an annual standalone assessment of the internal controls over financial reporting, requiring management to re-perform tests of controls for significant processes regardless of the risk associated with the process or the results of testing in prior years.

The proposed standard omits language requiring the standalone audit and allows the external auditor, and presumably, the registrant's management, to take into account the results of prior year testing when determining the nature, timing and extent of procedures to be performed in the current year. However, it does not allow any form of rotational testing. Rotational testing, such as testing specific areas or process once every three years, provides companies with important strategic flexibility, and could be structured to annually verify a *subset* of all internal controls over financial reporting within the rotational cycle, or testing all controls in alternative years.

We believe that by not allowing rotational testing, the proposed standard limits the effectiveness of a risk-based audit approach and prevents companies from maximizing efficient application of Section 404's requirements. When well planned and executed, rotational testing is the natural culmination of a risk-based audit approach. It is not an effective use of resources to perform 100% testing of low or medium-risk processes whose controls have been validated without exception in prior years and which has not undergone significant change over the past twelve months. Additionally, we believe that even stable, mature, high risk processes could be subject to rotational testing under certain circumstances.

We recommend that the Board revisit the prohibition on rotational testing and suggest implementation of a risk-based rotational testing program. For example, a company could establish a risk continuum where at one end, high-risk, volatile processes are subjected to complete annual testing.. At the other end, low risk processes that have not experienced significant change and have historically been validated without exception would be subject to control testing on a three-year cycle. In those years when detailed testing is not scheduled to be performed, the company would heighten its testing of company-level controls linked to those low risk processes.

Identifying Company-Level Controls

The proposed standard places strong emphasis on a top-down approach to the audit, calling for the auditor to begin by identifying company-level controls that are linked to significant processes within the company. The auditor may be able to reduce testing at the process level by focusing on company-level controls linked directly to process level controls or are strong enough to detect or prevent material misstatements to relevant assertions.

We endorse the steps taken by the Board to focus the auditor's efforts on the most important controls in the company with the aim of making the reviews more effective and efficient.

However, we do not believe the current proposal goes far enough in requiring a formal process of evaluating how the existence (and subsequent testing) of company-wide controls directly impacts the reduction of process-level testing.

We recommend the Board adopt more concrete guidelines in this area, requiring that prior to audit commencement the auditor and management jointly discuss and reach general agreement upon the extent to which the existence of sound company-wide controls will be leveraged to modify the level of required process-level controls testing.

Key Controls

We recommend that the Board introduce the concept of "key" controls. A key control should be defined as a control whose absence or failure would significantly increase the reasonable possibility of a material misstatement in the financial statements. The key control concept should be closely tied to the top-down risk-based audit approach and provides the benefit of more effective testing by focusing on high-risk controls.

AS No. 2 discusses two types of controls; preventative controls which prevent errors or fraud from occurring in the first place and detective controls which detect errors or fraud which have already occurred. AS No. 2 discusses how it may be effective to use a combination of the two types of control to achieve a specific control objective.

In both AS No.2 and the proposed standard, we believe the Board gives the erroneous impression that all controls over financial reporting (preventative or detective) should be viewed as having the same importance. There are some controls over financial reporting that are so critical that their absence or failure to operate effectively would result in material misstatements in the financial statements of a company. For example, the absence of a reconciliation process in the preparation of a company's financial statements could result in material misstatements going undetected. Conversely, there are other controls that if they failed would not have a significant impact on the accuracy of the financial statements.

Because the proposed standard does not effectively differentiate between "key" and "non-key" controls, companies and their auditors are focusing valuable resources testing controls which are not considered critical to reducing the risk of a material misstatement. Failing to differentiate between "key" and "non-key" controls is also at odds with a risk-based audit approach, which would dictate that companies and their auditors focus on areas of high-risk.

Conclusion

We recognize the importance of maintaining a rigorous, risk-based process for validating our internal controls over financial reporting. Additional Board direction and clarification in the above areas will assist our effort in this endeavor, as well as help us to direct our resources in the most efficient manner. We therefore encourage the Board to revisit its prohibition of rotational testing, especially for low and medium–risk, stable processes that have not undergone significant change in the past year. We urge the Board to clarify its guidance on company-level controls and introduce the concept of key controls. In closing, we believe these three changes, taken together would increase the effectiveness of the audits and result in a significant reduction in the burden to public companies.

* * *

We appreciate the opportunity to comment on the issues contained in the Board's proposed standard on an audit of internal control over financial reporting that is integrated with an audit of financial statements and related other proposals. If you have any questions, please contact me at 415-222-3119.

Sincerely,

/s/ Richard D. Levy

Richard D. Levy
Senior Vice President & Controller

From: Lee Matecko (CE CEN) [mailto:Lee.Matecko@wholefoods.com]
Sent: Monday, February 26, 2007 5:42 PM
To: Comments
Subject: Docket 21

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

Thank you for allowing the opportunity to comment on the proposed standards. We are pleased that these changes are being proposed to bring this closer to a reasonable cost-benefit balance. We have endured several years of spending millions of dollars working very deep in the details that are often insignificant, and we are ready to focus on the controls that really matter from a higher level.

We have two specific points of feedback:

1) We believe the there is a significant gap between the proposed standards of the SEC and PCAOB. The audit firms will likely continue to drive the compliance requirements, making the SEC version far less relevant. We think this gap should be narrowed, and that the SEC version provides a more reasonable approach. The SEC version appears to allow different ways of evaluating whether controls are working, with fewer specific documentation requirements to allow flexibility appropriate to different circumstances. We believe that greater professional judgment is must be allowed, and if such judgment is made reasonably and in good faith, then this should prevail.

2) We believe the application of reasonable professional judgment is necessary, and that the PCAOB auditors must allow for this in their inspection of the audit firms. This will in turn allow the firms to exercise reasonable audit steps in their work with companies. We believe this lacked in the last two years, and is a primary reason for the excessive costs associated with section 404 compliance. We believe that in the first year, firms established very stringent, detailed steps necessary for companies to demonstrate compliance. Based on the interpretation of PCAOB auditors, and their evaluation of firms after the first year audits, the firms took an even more detailed approach.

For example, we finished our first year of the 404 audit with very high marks. Our Big 4 audit firm noted that our internal controls and compliance rated in the Top 1% of companies our size within their client base. Yet our second year requirements were even greater, and we spent even more time drilling much deeper into what we consider insignificant details with limited internal control implications. The feedback from our audit firm was that in part, the PCAOB auditors were enforcing a much deeper level of documentation and testing, so they had no choice but to do the same. We have heard this same feedback from other companies as well.

The actions of the PCAOB auditors create a multiplier effect. The auditor's interpretations will determine the minimum requirements on the firms, which will determine the minimum requirements the firms place upon companies. In each case the minimum requirements are only the minimum, with greater actual requirements being determined in each step based on each layer covering their bases. We believe this has cost companies hundreds of millions of dollars of unnecessary spending.

Respectfully Yours,

Lee Matecko
Vice President, Operational Finance
Whole Foods Market

From: Sagar, Manan [mailto:sagarm@willis.com]
Sent: Monday, February 26, 2007 3:58 PM
To: Comments
Cc: Shahmir, Farrokh
Subject: Docket 21- Proposed Auditing standard on the Audit of Internal Controls Over Financial Reporting that is integrated with an Audit of Financial Statements

DearSir

I would like to begin by expressing my gratitude for giving us thisopportunity to comment on your proposal.

Introduction of the Sarbanes-Oxley("SOX")Act has resulted insignificantimprovementofpublic confidence in financial reportinginformation. There has also been an increase in focus on corporateresponsibility and governance.

With the third year of implementation drawing to a close, it is importantthat we look back and evaluate the Industry's concerns (particularly due to therising cost of implementation) and the learnings noted by the Industry and theIndependent auditors.

Following are some suggestions that I would like to present to you, thatin my opinion would make compliance with the provisions of theSOXActandAuditing Standard 2more value adding for the Industry, the Independentauditors, the public and the Regulators.
1.Top Down approach- Themanagement sets the tone of governanceandcontrolsacross the organisation.Managements'commitment to maintaining anappropriate toneacross the organisationcould be evaluated. The'Entity Level Questionnaire'can be used to goodeffect to evaluate the same which could take into account the results frompprevious years.
A'risk-based'approach could beconsidered to determine'Key Processes'instead of the current scoping approachbased on the account balances. A'risk-based'approach will require themanagement to implement adequate controls for the key risks facing theorganisation.
2.The management's /Independent auditor's testing plan for testing Internal Controls over FinancialReporting (''ICFR'') could also be derived from the above mentioned risk-basedapproach.
A'point scoring'system could be used to determine the risk profilefor each process with points assigned for inherent risk, process complexity,previous year testing results, major changes in controls during the year etc.Testing plans could be based on this risk assessment, wherein'High Risk'processes could be tested more than once a year,'Medium Risk'processes once ayear with a certain percentage of'Low Risk'processes tested eachyear.
This would make management testing morefocused to the'Key Risk'facing the organisation which include'EnvironmentRisk'(Legislative Risk, Competitors Risk) and'Operational Risk'(e.g.Financial Risk, Liquidity Risk, Control Risk).
3.The above mentionedrisk- based approach could also be applied to select the International locationswhere control testing is performed. The'pointscoring system'mentionedabove could be used and High Risk locations could be tested yearly, Medium Risklocations once in 2 years and Low risk locations once in 3 year. We could doaway with the requirement to test locations contributing more than 5% of NetRevenue / Net Assets.
4.Thesample size used to test ICFR could alsobe based on the risk rating assigned to a particular process. Hence, a largersample could be used to test a'High Risk'processes and a smaller sample sizefor'Low Risk'processes. This would help make the testing effort more focusedand lead to a reduction in effort.
5.The PCAOB may considerdoing away with the requirement to quantify all open deficiencies. The exerciseis very time consuming, involves a lot of judgement and adds little value tobusiness. Instead thematic issues noted during evaluating ICFR could bedisclosed by the Management to the Independent Auditors and by the IndependentAuditors tothe Management.

The SEC / Board may also consider doing away with therequirements of classification of a weakness into a‘deficiency’,‘significantdeficiency’and‘material weakness’. Deficiencies may only be noted as‘deficiencies’and‘material weakness’, the later being reported to theSEC.
6.ThePCAOBmay also consider doing away with therequirement for the independent auditors to evaluate Management’s assessment ifthe Independent Auditor’s evaluation does not reveal any‘material weakness’inthe ICFR.

7.The PCAOB may considerrecommending to the Independent Auditors to link SOX audits to evaluate ICFR toFinancial Statement audits and useexperience gained from pastSOX and Financial Statement Audits.

I hope the above helps thePCAOB to introduceregulatory changes that will benefit the market, the independent auditors, thepublic and the industry.

Regards

Manan Sagar

Willis

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For information pertaining to Willis' email confidentiality and monitoring policy, usage restrictions, or for specific company registration and regulatory status information, please visit http://www.willis.com/email_trailer.aspx

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WithumSmith+Brown Global Assurance
A Limited Liability Company

February 26, 2007

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

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

Dear Mr. Secretary:

WithumSmith+Brown Global Assurance, LLC ("WS+B GA") is pleased to submit our comments to the PCAOB with respect to its 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 comments of WS+B GA are based on our experience as advisors to public and private companies in assisting them with achieving compliance with Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX"). WS+B GA is a division of WithumSmith+Brown, P.C. ("WS+B") , which is a registered public accounting firm serving middle market issuers, and our comments include those of WS+B in its role of performing integrated audits.

In general and overall, WithumSmith+Brown Global Assurance, LLC supports the PCAOB's efforts to align the expectations of the marketplace for an effective and efficient audit process with the fundamental need to have all companies, large and small, operate under a sound system of internal control over financial reporting. We believe that any action to move small public companies toward compliance with Section 404 of SOX is a move in the right direction. We have long been critical of the constant delays with compliance that continue under the unproven guise of excessive costs, which has been measured based solely on the experience of accelerated filers attempting to comply with a new standard. We applaud the PCAOB in its stand to apply a single set of rules to all public issuers as anything less would cause confusion and misinterpretation of the results by the investing public.

We applaud the PCAOB's attempt to provide more flexibility in the auditor's approach to implementing Section 404 of SOX. Particularly noteworthy are the permitting of auditors to use company level controls as a basis for expressing an opinion on the effectiveness of certain internal controls over financial reporting, expanding the use of risk assessment to adjust procedures, considering the results of prior year audits to determine the nature, extent and timing of testing and removing the barriers to using the work of others to reduce testing. The appropriate use of these techniques will most certainly reduce the time the auditor will spend retesting controls.

We do express some concern on the principles-based nature of the proposed standards as this may result in an inconsistency of the application of the standards by auditors. The use of a top down, risk-based approach, in theory, is a viable solution. However, in practice, significant control issues that could materially effect the financial statements in supposedly low risk accounts, such as property, plant

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and equipment (as noted in both the WorldCom and Health South frauds) may be missed based on auditor judgment and audit predictability.

We believe that SOX has been a complete success insofar as it accomplished the goals set by its authors, namely to improve investor confidence in the integrity of the financial statements, achieve greater auditor independence and focus on corporate governance through the creation of an effective system of internal control over financial reporting. However, the initial implementation of SOX has required a much greater effort than anticipated and the cost of implementation has been greater than anyone could have possibly envisioned. Although we do not believe that the institution of the top down, risk-based approach will be the complete answer to reducing SOX compliance costs, we still believe the initial cost of SOX compliance was way out-of-line and implementing a modified risk-based approach is certainly in order. We believe that high costs in the initial year for accelerated filers were due to four critical factors that we think will be resolved:

1. The learning curve associated with the implementation of a new standard such as SOX always takes longer the first time around. The increased experience by the SOX consulting firms coupled with improved software to manage the SOX project will reduce costs.

2. Companies neglected their internal control documentation during the 1990's and beyond due to the advent of risk-based auditing. Firms once again will be keeping the documentation up-to-date after the painful process to get the documentation current.

3. Companies waited until the last minute to start their SOX compliance process causing an increased demand for qualified SOX consulting firms that could not be met in time for many of the companies to complete their documentation and testing requirements. There are more firms today that are qualified to do SOX compliance consulting work and the non-accelerated filers have been granted extensions through December 31, 2008 to comply. If the non-accelerated filers act soon, the deadline will not impact them and their costs will be reduced.

4. The revisions proposed by the PCAOB to AS 2 clearly provide for auditor reliance on the work of independent and competent internal auditors and SOX consulting firms. However, many of the independent auditors failed to utilize this provision and chose to retest all of the accounts. It is anticipated that less retesting will occur.

As discussed above, we are supportive of the PCAOB's overall proposal to streamline the implementation of Section 404 of SOX. Our major concern with the issuance of an entirely new statement is the potential for continued delay in requiring non-accelerated filers to comply with SOX. We believe that any further delay will have a negative impact on achieving the cost efficiencies expected by the marketplace. The proposed new standard does not require any change on the part of the company to implement a system of internal control over financial reporting. In fact, it provides the company with the ability to provide less documentation and undergo less retesting than AS 2 allowed. Therefore, we strongly urge that the PCAOB and SEC to stand firm in opposing any further delays in the implementation process and make the non-accelerated filers comply by the new due date. We have supplied some specific comments to certain questions in the attached Appendix.

WithumSmith+Brown Global Assurance
A Limited Liability Company

We appreciate the opportunity to comment on these proposed standards and would be pleased to discuss any of our points in more detail. If the staff has any questions regarding our comments, please contact Tom Basilo, Chairman and CEO at 609-734-9090 x 211.

Very truly yours,

WithumSmith+Brown Global Assurance, LLC

WithumSmith+Brown Global Assurance, LLC

WithumSmith+Brown Global Assurance
A Limited Liability Company

APPENDIX

**Comments to Certain Questions Raised
In PCAOB Release 2006-007
PCAOB Rulemaking Docket Matter 021**

Questions 1-4: Use of the Top-down approach to auditing internal controls

We believe that in theory this approach can work effectively and significantly reduce the amount of audit hours needed to test the internal controls over financial reporting. However, in practice, this approach has risks that may supersede the time benefits that such an approach allows. There appears to be no guidance on how to assess whether company-level controls are operating effectively. In the past, company-level controls were assessed based on inquiry and observation. In reviewing paragraph 20, it appears that a great deal of subjective auditor judgment will be required to make these assessments. This will be a greater issue with small public companies because auditors are not present at the Company facilities all year long to observe the operating style first-hand. There is also no correlation made between positive assessments of the items listed in paragraph 20 and the corresponding transaction level controls that could qualify for non-testing. This needs to be developed in order for the approach to provide the desired impact on cost savings. How does an auditor test whether management's philosophy and operating style promote effective internal control over financial reporting? If the Company has an incentive-based compensation structure for management, does that mean that company-level controls are inherently ineffective since the Company did not mitigate the reasons for misstating the financial results?

The use of the top-down, risk-based audit approach has been blamed by many for the frauds that necessitated the need for SOX. It is difficult to believe that its use will now be the solution to the high costs associated with SOX compliance. We do not think that the top-down approach will better focus the attention of the auditor on the most important controls in most situations. The common financial statement deficiencies, such as revenue recognition, would be difficult to detect at the company level.

We believe that the top-down approach will not work in achieving the objectives of the PCAOB in reducing audit costs. The PCAOB Inspection process will likely raise serious questions and challenges to the auditor as to the basis of the judgment to rely on the company-level controls. Because the judgment of both the PCAOB inspector and the auditor are based on subjective evidence, disagreements are likely to occur and auditors will quickly abandon the top-down approach out of fear of retribution by the PCAOB.

Questions 5-6: Risk Assessment

We believe the proposed standard appropriately incorporates risk assessment and we believe that the use of walkthroughs for low risk controls is appropriate.

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Questions 7-9: Revising the Definition of Significant Deficiency and Material Weakness

This has been a difficult area for most auditors and companies to agree upon since it naturally requires a high degree of professional judgment. Utilizing terms similar to those in FASB Statement No. 5 is a positive step since it provides a sense of familiarity with terminology missing previously. However, there will likely be disagreements with the assessment since it is a judgment area. Therefore, we do not believe that the changes will have a significant impact on the amount of effort to make the determination, but we do believe that the revision is an improvement over AS 2. This is an area that the auditor and management should spend time on so assessing whether the change is good based on time is irrelevant.

Questions 10-27

We believe our general comments co0ver the factors we consider important and we will offer no further comment on these matters.

Questions 28-32: Scaling the Audit for Smaller Companies

We believe that the proposed standard addresses the differences that the auditor should take into account when auditing smaller public companies and we are supportive of the guidance provided. There are no hard and fast rules covering smaller public companies that should limit the implementation of controls. In many respects, smaller public companies have a higher degree of complexity than larger companies, especially in the areas of revenue recognition and debt and equity issues. The controls over these complex areas are no different from those needed in larger entities. Therefore, size alone cannot be a factor in assessing risk of material misstatement of financial statements. The complexity of the transactions and the abilities of the internal accounting staff are more definitive than size in determining the risk of material error in the financial statements. Since these cannot be objectively measured, market capitalization is as good a criteria as any other measure.

Question 33: Audit Committee pre-approval

We believe the information already provided is sufficient.

Question 34: Effective Date

We believe that the PCAOB must act quickly in to preserve the current effective date for years ending on or after December 31, 2007. We strongly urge the PCAOB to move forward and approve a standard by May 15, 2007 so that independent auditors, SOX consultants and companies can collaborate on an appropriate plan to address the new implementation standards. As mentioned previously, additional delays will create more procrastination on the part of small public companies in becoming compliant with SOX and 5 years is an adequate reprieve.

Other Comment

We again recommend that the PCAOB and SEC consider requiring auditor assessment every other year for small public companies and every third year for micro caps once the company has complied with Section 404 of SOX and obtained a clean opinion.

XILINX®

February 26, 2007

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

Dear Sir or Madam:

Re: PCAOB Rulemaking Docket Matter No. 021

We appreciate the PCAOB's efforts to provide clarification on the auditor's role in auditing internal control over financial reporting.

Xilinx Inc., based in San Jose, California, is a high tech company that engages in the design, development and marketing of programmable logic solutions. The company has significant operations in Europe and Asia and annual revenue of approximately $1.9B.

We are generally pleased with the benefits derived from the SOX compliance process. Nonetheless, we appreciate the opportunity to provide some observations from our experiences.

Using the work of others

In our view, one of the most important revisions made by the PCAOB, and also one of the biggest potential cost-savers, is in the auditor's use of the work of others. This includes the use of company management's own internal control evaluation, as well as past audits. Duplicating control evaluations of low-risk areas increases audit costs unnecessarily. Allowing auditors to evaluate and utilize past work would definitely allow them to focus resources on high-risk areas and help reduce costs.

However, the PCAOB should be wary of creating an additional new standard that would explicitly guide auditors on how to consider and use the work of others such as internal auditors or internal SOX compliance groups. AS2 disallows auditors use of others' work, but that language is missing from the proposed AS5 standard. As of today, our external auditors' fees still represent half of our SOX compliance direct costs. We believe that some of these costs could be reduced by allowing the external auditors to rely on management risk assessment and internal audit testing to a greater extent, especially in "low-risk" and "medium-risk" areas (after the completion of initial audits of internal controls).

Auditors should also be allowed to rely on management walkthroughs when completed by competent and objective personnel. Requiring external auditors to perform a walkthrough and testing only for significant processes would reduce the number of walkthroughs and scope of testing performed without impairing audit quality.

Report

The draft proposals call for elimination of the audit opinion on management's assessment process and retention of the auditor's subjective opinion on internal controls effectiveness. Removing the requirement of an evaluation of management's process would not eliminate unnecessary audit work and will make reliance on management more difficult or risky for external auditors. We believe that an auditor cannot perform an effective audit of internal control without performing an evaluation of the quality of management process.

Also, investors want assurance that the attestations of the CEO and CFO are actually justified. Presently, the external auditors' attestation on management's assessment is the only means to ensure investor confidence.

The dual requirements of a "clean" audit report on the financial statements and a "clean" attestation on management's assessment of internal control allow external auditors to perform an adequate assessment of internal control. Having to prepare another new "Report on Internal Control" seems somewhat redundant and creates unnecessary duplicative work by the external auditors.

Timing

It appears that the new standard may not be finalized in time for our next fiscal year (ending March 31, 2008). The public comment period ends at the end of February 2007. The PCAOB will likely need several months to go through the public comments before proposing a revised standard to the SEC proposed rule.

To ensure that companies benefit from revised guidance from the SEC and PCAOB, both regulatory bodies should issue their guidance simultaneously, and as soon as possible, if companies are expected to follow the new guidance in Year 4 of SOX.

Also, the SEC and PCAOB may want to consider merging their final guidance, to avoid unintended confusion and complexity. We noted that the SEC proposed rule is more high level, as compared to the PCAOB guidance, in a number of key areas. These include control environment evaluation, the identification of significant accounts, and indicators of material weakness. The PCAOB standard comes across as being more granular, prescriptive and control-focused. We believe the AS5 focus should be solely on audit considerations, with the SEC guidance being more detailed and comprehensive. Alternately, the two sets of guidance should be integrated to avoid confusion for companies and their external auditors.

Again, we appreciate the opportunity to comment on the exposure draft and would be happy to provide any additional clarification.

Yours truly,

L. Tracol.

Laurence Tracol
Senior Manager of Worldwide Compliance
Xilinx, Inc.

NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on February 22, 2007 that related to the Board's proposed auditing standard titled "An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements." The February 22, 2007 meeting also included a panel discussion on forensic audit procedures that was not related to the proposed auditing standard. That discussion is not included in the transcript.

The Public Company Accounting Oversight Board does not certify the accuracy of this unofficial transcript. The transcript has not been edited and may contain typographical or other errors or omissions. An archive of the webcast of the entire meeting can be found on the Public Company Accounting Oversight Board's website at http://www.pcaobus.org/News_and_Events/Webcasts.aspx.

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

STANDING ADVISORY GROUP

Thursday, February 22, 2007

8:30 a.m.

The Army and Navy Club

901 17th Street, N.W.

Washington, DC

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MS. VIRAG: We presented the topics of audit control over financial reporting to the SAG on several previous occasions, most recently June of 2006.

As you know, this was shortly after the board announced that it would be undertaking rule making to change Auditing Standard Number 2 and we had the opportunity to discuss with the SAG several major areas of potential change.

The input that we received from the SAG in June was an important and helpful part of the development process of that proposal.

We are very pleased to have the opportunity to obtain further input from the SAG on these proposals to consider along with the rest of the public comments that we receive. Just to remind everyone, the comment period on these proposals ends next Monday, February 26.

The topics we have selected for today's discussion are among those that have been raised in comments we received so far. We are presenting these

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issues here today to promote additional discussion and provide as much input as possible for the board's deliberation.

The topics we have singled out for discussion include whether the proposed standard allows for the appropriate use of auditor judgment while sufficiently safeguarding the quality of the audit, whether the proposal adequately emphasizes the importance of company level controls and the effect they may have on the auditor's testing, whether the direction in the standard on scaling the audit sufficiently addresses differences in company's size and complexity, whether differences between the process management would follow to perform its evaluation of internal control under the Securities and Exchange Commission's recently proposed guidance, and the process the auditor would follow to complete his or her audit under the board's proposed standard would result in any implementation issues. And if so, how those issues might be addressed or managed.

Finally, whether the proposed audits standard on considering and using the work of others

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would meet the objective of removing unnecessary barriers to using the words of others and to promote better integration of the audits.

Additionally, we plan to have time left at the end of the discussion for SAG members to bring up any other topics related to the proposals that they believe need to be addressed.

In order to keep time for that, we plan to move through the questions by devoting 30 to 40 minutes to each topic. With that, I'd like to open the discussion with our first topic, auditor judgment.

We have two questions on the topic and you're welcome to discuss either or both at this time.

Cynthia Cooper?

MS. COOPER: I think that the new standard is definitely going to be less prescriptive and allows for more auditor judgment, which is good.

Hopefully, we'll start to see more reliance by the external auditors on others. It will be interesting to see how that plays out. As far as

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the quality of audits, I think that really will come back to the competence, to the objectivity, to the independence of the individual audit team.

And I also think that the inspection reports are going to play a key role in setting the tone. While the inspection reports I think are an excellent way to give feedback to the firms, I think it is critically important that the inspection process be in sync with the tone that we want the standard to set, because if the auditors use judgment and these inspectors come back and second-guess that judgment, for example, obviously it is going to impact the audit going forward. In some cases, maybe that's necessary but we need to make sure they're both in sync.

MS. VIRAG: Joe Carcello.

MR. CARCELLO: I applaud the SEC and PCAOB for their work. In an environment characterized by intense lobbying by well-funded and well-organized groups that often were more concerned with their narrow self-interest than with the public good.

Given this political cauldron, I think

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both groups have crafted reasonable standards. Nonetheless, I have reasonable concerns with the exposure drafts. AS-5 is less detailed, some would say more principled, than was AS-2. And since principles-based guidance is currently in favor, this must be good.

But critically, for a principles-based regime to work, there must be vigilant and effective enforcement. Is this true? The PCAOB has adopted an inspection model, not an enforcement model. That basically leaves it to the SEC. The SEC enforcement budget has been squeezed in recent years. What is the back stop? The back stop is private securities litigation.

But accounting firms are seeking liability relief with some support, it seems, from the SEC. And even the SEC has recently filed a friend of the court brief with the U.S. Supreme Court that would make it harder for investor lawsuits to succeed.

My overall conclusion is the PCAOB and PCAOB's efforts would likely reduce costs without hurting good actors, but at the cost of reducing

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effectiveness for bad actors. Is this socially optimal? Is this in the best interest of investors?

These are the questions that I think the board should be asking itself.

MS. VIRAG: Bob Kueppers?

MR. KUEPPERS: Thank you, Sharon.

Two things to the questions on the table right now. I agree that the changes in the standard do provide for the appropriate level of auditor judgment. What we had before AS-2, as Cynthia said, was a prescriptive standard, but guidance suggesting that overlaying that is all kinds of opportunity for judgment. I think this standard finally brings into line that notion and the construction of the standard itself. I think it will give us the appropriate flexibility. I welcome and I think my partners will take the spirit of that in implementing the standard which I think will be good on the cost side.

The second question about safeguarding the quality of the audit, I think the fundamental safeguard built into the standard is the fact the standard applies equally to all entities. In other

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words, it is a single standard for all, scaleable based on size and complexity. I think size is an interesting metric, but I think complexity is much more the driver of how much work is appropriate in a given set of facts and circumstances.

I think the standard has a single model as opposed to a multiple model or other construction that should serve if scaleability is -- I'm sure we'll talk about scaleability. If that's appropriately dealt with, audit quality will be preserved and overall I think the exposure draft is an excellent move in the right direction.

MS. VIRAG: Jeff Steinhoff.

MR. STEINHOFF: I'd like to reinforce a couple of comments already made. I do support strongly the move toward risk-based. I think it is a big improvement over standard 2. This, though, on its own -- I think Cynthia was getting to it -- does not assure quality. It will be very important that the PCAOB and SEC reinforce what the overarching goal is and that is to protect the investor and to assure there is a quality audit.

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I think it is very important -- the point Cynthia was making -- that there be a direct tie between the standard, how the inspections are done, and the messages that are being conveyed. The point that was made about good and bad actors, those that want to do the job will see this as an opportunity to do it in a efficient and effective way. And those who perhaps never wanted to do it will see this as a way out.

So you want to assure that people don't see it as a way out. They see it as a more efficient and effective way to do the job better.

MS. VIRAG: Kimberly Gavaletz.

MS. GAVALETZ: I want to applaud the efforts of the PCAOB. I think they listened to a lot of things people around this table have brought forward in a thoughtful way. I do agree with the less prescriptive nature of the standard as written. I believe it sets the appropriate level. It says in a way it had to be done relative to risk-based. That in itself will have to be evidence that the inspectors will be able to look at.

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I do share Cynthia's opening comment relative to the concerns that tie with the inspections to ensure that that risk base is interpreted in an appropriate way. And really I think you can do that by looking at how risk base is applied and look at the process that the audit firms are doing to try to get their judgments without necessarily questioning the judgment underneath.

So I would -- you will have to say there may be appropriate judgments announced in some of the early inspections that had to be dealt with, but a focus on the process will be important as you go forward.

MS. VIRAG: Gaylen Hansen.

MR. HANSEN: I would also like to add my thank you for all the hard work. I'm sure this was very difficult to do, and we've had a lot of discussions about that. I think there's some changes that really will help us, in particular, some of the definitional changes of significant deficiencies, material weaknesses, clarifying the objective of what we're actually trying to accomplish here. I think

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going to some of the language in standard number 5 on probability measures was really helpful from my viewpoint.

With that said, I think there's still room for improvement. I think on the -- all of the language about the small business scaling and complexities is great. How to apply this judgment, the latitude we get and our clients get is really the real issue.

I recognize that really defining what that judgment means in this kind of standard is extremely difficult, probably can't be done unless you are approaching it from a principles-based standpoint. And I wonder whether or not anyone has given some thought to something along the lines of a prudent man approach to this, a reasonableness standard that you see in some of the legal definitions.

By that, what I mean is I am very hesitant to approach a client and say, well, you need to add people to your staff just so that you can provide separation of duties. To me that wouldn't be prudent. I probably wouldn't do it.

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So I think we need some examples of what clearly would be a material weakness, some instances of what wouldn't be. And then the difficult part of this is what falls down in between.

And I do have an example that I would like to share this morning. We have a client in the Rocky Mountains, a SPAC -- a special purpose acquisition company -- subject to AS rules this year because it has in excess of 150 million in cap. And that 150 million in cap is cash. Has two employees. A few equity transactions. All of its expenses are professional fees and salaries.

Where does this fall out as far as segregation of duties and does it have a material weakness when the CFO is basically doing everything? And the only judgment the CFO has to make is whether or not the small amount of goodwill on the books needs to be impaired.

So that's an example of the things that we are dealing with in our office. And I think that maybe this prudent man definition would help some of the small filers, some of the small firms deal with

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the forthcoming AS-5.

MS. VIRAG: Ted White.

MR. TED WHITE: Thank you. It seems to me to be inevitable that some level of judgment is going to be maintained here. And I generally support that concept. But it also appears that the question on the table is maybe missing the larger issue which is the risk-based approach from which those judgments are based upon.

First, let me say, I think the concept is solid, and I very much like the philosophy of a risk-based approach. It seems in a resource constrained world, investors can benefit from a truly rigorous risk-based approach that is functional and accurate and gets auditors to focus the resources in the right places.

I have a simple question about the definition of risk-based and what it actually means going forward, and is it different than what people have, this sort of negative perception of whether risk-based worked in the past.

First, I'd like to understand, what are

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the fundamental differences going forward in how we define risk-based approach from a past -- from a top-down risk-based approach? Is it different? Are we doing the same things?

It seems that even your most recent inspection report would indicate that at least in these anecdotal cases, the assessment of risk was not making the auditor focus their attention in the correct places. They missed it. Didn't pay attention. First, is it okay to get that concept on the table under this point? Is that question fair?

MR. RAY: I'm sorry, Ted.

Specifically what question would you like to throw on the table at this point?

MR. TED WHITE: First, I'd like a basic explanation of the risk-based methodology that we would use to be making the judgment calls here. It seems to me -- first, tell me if I'm wrong in that that would really be the underpinnings of whether the appropriate level of judgment is applied in this standard? So if the judgments are going to be based upon a risk-based approach, is the risk-based

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approach appropriate to set those judgments?

Whether or not there's judgments or not, seems to me to be -- that's a foregone conclusion. Auditors have to make judgments. There's no -- unless you have no resource constraints where they recreate everything -- and that's ridiculous, they have to make judgments. I'm willing to just accept that.

But it is the process that drives them to make those judgments and where they're going to apply the resources that seems to me to be more important.

MR. RAY: Well, I'll go ahead and add a commentary here. My colleagues perhaps would like to add some color to it as well and then throw it back to the floor.

But basically my view on the risk-based approach is that the concept of risk is an important aspect of many of the points through the process of conducting the audit of internal control. In order to evaluate the risk, the auditor doesn't just evaluate in a vacuum. The auditor must go out and obtain knowledge and evidence related to the various

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risks that the auditor needs to assess, then perform a judgment about those risks.

So there is a due diligence or a due care standard I think that would be applied around the auditor's procedures, around the -- what the auditor does to obtain the information necessary to assess the risk and then support the judgments that the auditor needs to make.

MR. TED WHITE: Uh-huh. That's not exactly the question. Does that work? Has that worked? Isn't that the fundamental underpinnings of this question, this position?

MR. RAY: The standard itself does try to provide direction around what the auditor should be doing to satisfy that -- those requirements, that standard, and the objectives. With regard to your question, I think I would turn to the various members of the group here to comment.

MS. VIRAG: Craig Omtvedt, do you want to comment?

MR. OMTVEDT: Just to set the stage a little bit, I would say to you that I think the

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guidance that's come out from the SEC to give management perspective on how to approach its fulfillment of its control responsibilities, I think, is a very positive thing.

I think the changes that you're proposing here with AS-5 to go to a more risk-based approach is fundamental and aligned with basic concepts of assuring we get appropriate return on investment for the activities that take place.

The return on investment here, obviously, is greater investor confidence in the financials that are being put out.

But to play off Ted's point a little bit, I think there are modifications that we need to be considering and perhaps institutionalize in terms of how the auditors perform their risk assessment.

And I would suggest to you that it should be more than simply operating within the company to get a sense of what's the tone at the top, what's the quality of the control process put in place.

I think there's external diagnostics that candidly I don't think are being given enough

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attention. I think things that should be looked at would be things like sell side analysts reports, looking at peer companies, making sure the firm and engagement partner really understand the dynamics of the industry within which the company is operating.

I think there's things such as looking at company's margins. Do they make sense in the context of the overall industry?

You know, there's evidence in the past -- and I'm not going to get into particular frauds -- but with all the competition, we're saying there's no way in hell those margins can be right.

You ask yourself: Why aren't the auditors focused on those kinds of things?

So I think as we think about not just this risk-based assessment makes sense, we need to come back to what's the guidance and what's the standards, what are the factors that need to be considered in performing that assessment, and it needs to go beyond just the company itself.

MS. VIRAG: John Morrissey?

MR. MORRISSEY: I guess I'll jump around

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and go back to the questions initially on the table. I think it's important just to remind even myself that I was not a big fan of opening up AS-2 to begin with. I thought it was a good standard, rigorous standard.

It was intended to be such. And I guess I was a little concerned when I lost that debate that AS-2 was going to be opened up. Having said that, also, the concern is, is there enough opportunity for professional judgment in the proposed standard? My view is that AS-2 was fraught with opportunities to exercise professional judgment. The words I think were there. For whatever reasons, people weren't reading the words and weren't following what the words allowed people to do.

You look at the notion of risk-based audit as being the new way to do auditing. That's nothing new. It was available to preparers under AS-2. A lot of companies weren't using a risk-based approach. That's really not anything that's terribly revolutionary.

Risk-based audit proposals, unfortunately,

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were in vogue back in the late '80s and weren't executed very well. That's a concern people have to this day that it is used as an excuse to cut back on work and not focus in on the quality of what you are trying to do. And risk-based approaches sometimes are done by lower level staff people that aren't in a position to have that in-depth knowledge of the business and industry in order to properly assess those risks.

If properly executed at the right levels, it could be very, very effective.

To the last point, is the proposed standard sufficiently rigorous to safeguard the quality of an audit. I think the new proposed standard neither diminishes nor enhances that notion. It will still be left up to the people executing and the auditor to look over the shoulder of the preparers and make sure the standards are properly followed.

So to answer the question, I guess I'm sort of neutral on the second one.

MS. VIRAG: Ted, we had more input. I

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wanted to check back in with you. Did you want to continue your remarks?

MR. TED WHITE: Maybe I didn't do a good job asking the question.

I guess what I'm saying is, isn't the risk in what we're talking about here a risk-based approach? It seems to me that while it is an attractive concept, there is evidence coming from your latest inspection report that it doesn't work right or hasn't worked right. First, is that comment accepted? And what is different about the process going forward? How do we fix that? My personal opinion is that investors are accepting of a risk-based approach and can see this is a way to locate resources to where they're most useful.

But any time you have a process that has a lot of judgment calls, then each step along the way, you're relying upon thousands upon thousands of individuals in firms to make these judgment calls.

Is the inspection process different such that we can support that? Is there enough in the standard that drives that differently?

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Or is there any difference? Is this approach new or is it the same?

MS. VIRAG: Sam, do you want to comment?

MR. RANZILLA: I didn't think I was next line. Let me try to address Ted's questions. I'll play a little bit off John's comments. Risk-based is nothing new, and maybe to try to put it in some context. Assume that you accept that the implementation of AS-2 was bottom up instead of top-down. We have instances obviously of that happening.

That was risk-based. I know there's horrific stories about petty cash and things like that. But the approach if you accept that AS-2 was primarily implemented on a bottom up approach, that was a risk-based bottom up approach.

The difference between AS -- a bottom up and a top down is, I mean, sort of obvious. You attempt to come from the top down, and identify controls where you can, say, that covers my risk as opposed to testing a bunch of controls down at the bottom level.

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But there's nothing new about risk-based approach. To John's comments, I think there is some concern because there was late in the '80s or some period of time some approach done that way that probably wasn't implemented very well.

But risk-based is -- I mean, one, you can't do an audit unless it is a risk-based audit. There's simply not enough time in the day to do that. But the risk-based is now just the focus, the focus of coming down versus coming back up.

MR. TAROLA: I just wanted to comment on this part as well. I think the proposed standard is directionally sound. Where I think it does need guidance is in assessing risk and how one should assess risk from an auditing and financial reporting perspective.

And in my view, it's more of an enterprise risk assessment than a failure of the accounts being correct. Understanding the investor expectation, understanding concerns of rating agencies, understanding the strategy of the company, understanding the governance structure, understanding

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how the finance organization works and its effectiveness and competencies and the qualitative factors affecting risk, I think could be built out more in the proposed standard and serve as some guidance to auditors in making the risk assessments. And then in turn making the judgments as to how and to what extent they might be performing auditing procedures.

But to Craig's point, I think that the external implications to risk are important. And from an insider's point of view, an officer certifies financial statements, I look at our risk more from an enterprise perspective than purely from a financial accuracy perspective. I think you could build that out.

MS. VIRAG: Jeff Steinhoff?

MR. STEINHOFF: Going to Ted's point, risk-based approaches are not rocket science. I think Sam was saying that.

I think people know how to do it well. It shouldn't be difficult to do it well. When this group discussed this at the time that AS-2 was being

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contemplated, there were a number of examples cited where risk-based approaches didn't work well.

And I viewed all those examples as an execution problem. Not a problem with the fundamental nature of it.

I agree fully with John's comments which I think should be memorialized somewhere because he hit the nail right on the head. I think there was always an ability to apply risk-based approach even under AS-2. I can understand, however, the reluctance of practitioners to do so, given the very prescriptive nature of the standard and the fact that they were being inspected against that standard.

And the fact that there had been a lot of problems in recent years.

I think the real key is that a risk-based approach does require hard work. It does require very knowledgeable people to make the proper judgments up front. There's skill required. Rigor is required.

And I think it is just very, very key that the profession, we all get it right.

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We at the Government Accountability Office have been applying a risk-based approach in our audits from the beginning and we are strongly supportive of the way the PCAOB is going here on this and we were really pushing for that at the time of AS-2.

But it is really up to people to learn from some of the experiences of the past where this was at times used as sort of a proxy for reducing audit scope. We'll kind of fly through and we trust top management and everybody is good on top here and they're nice people; so we don't have to do a whole lot of work here.

And that I think won't work real well and -- but if we do apply it, in a rigorous manner, I think it will, in fact, provide the same level of assurance and provide for a much more effective audit because you'll be focusing on the more important things.

MS. VIRAG: Thank you, Jeff.

Ed Trott.

MR. TROTT: I think AS-2 was an

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implementation issue. My biggest concern is, are you appropriately trying to get the right message out?

I would say that many people I expect look at AS-5 as a relaxation of the goals and the needed effort. I know that is not your objective, but I think the problem is that in issuing AS-2, you've not have done it that way. If I was going to do anything, I would have amended AS-2 not to make this look like, well, we learned our lesson, we're going to significantly back off of the need to be diligent.

And I think that's the message that many people have gotten from your actions.

I hope that you can work with the firms, work with the SEC, work with FEI, work with other organizations to emphasize AS-5 is not a back off of the objective, AS-5 was to try to incorporate the so-called efficiencies that should be learned in implementation.

Unfortunately, I think your actions are likely to be misinterpreted and deemed to be a back-off of the objective that you, one, set with AS-2 and that you're trying to articulate in AS-5.

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But that's going to be a hard message to get through to those persons who, quote, are doing this basically from the 50,000-foot level and that influences behavior and everything else.

MS. VIRAG: Arnie Hanish?

MR. HANSEN: Let me try to touch on a few topics. First of all, let me say I believe that AS-2 -- I'm sorry, AS-5 is a giant leap forward in trying to deal with some of the issues that had been discussed and addressed over the last several years.

I think that it does -- as I think John was saying -- I believe that it was an implementation issue. I believe that the opportunity for the auditor to extend the use of appropriate judgment was there, but that it was an issue at the individual local practice level where it wasn't consistently applied.

I believe that -- maybe using an example of a risk-based approach and judgment, one of the examples that I like to use internally all the time is in the payroll area. Very seldom do you -- at least we don't find in ours, as well as large

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organizations, a fraud being perpetrated or a material risk that there was a financial misstatement in a payroll area.

But I believe that in at least the way it had been previously interpreted, since that was a significant level, a material level of cost and expenses embedded in our financial statements as well as the costs of our products, the auditors felt obliged to spend a significant amount of time testing payroll, as an example. The flows of payroll.

But the risk that that was ever going to produce a material misstatement was extremely low.

I believe this new standard, at least in the dialogue I've had thus far with our auditors, we can try to get out of the trenches and get up to higher levels and focus on the areas where embedded within, for example, the cost of our products, focusing in on the existence of inventory or how the costs are developed of those products that we can spend more time from an auditing standpoint focused where is the real material risk that a financial statement failure would occur, as opposed to worrying

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about the transactional activity as to whether or not we pay 20,000 people appropriately on a semi-monthly basis.

I think that to me is where the judgment -- auditor judgment needs to come in and be applied in this new standard. It is truly looking at where are the risks of a material financial misstatement. I believe it affords us this opportunity to have the appropriate dialogue.

MS. VIRAG: Joe Carcello?

MR. CARCELLO: I want to maybe second what Ed said and directly get at your second question there.

An overarching concern I have is what I view as the overemphasis on efficiency. Some people ask me where I'm getting that from. Let me be specific. If you look at page 3, first full paragraph, second sentence, now I quote, the board agrees that auditors should perform internal control audits as efficiently as possible for companies that are required by the SEC's rules to obtain an audit report on internal control.

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And then if you go to the SEC's exposure draft, they are advocating increased reliance on management judgment. That may work well where management is competent and honest. In situations where management lacks integrity, i.e., fraud situations, increased reliance on management's judgment is going to result in management's opinion being totally worthless.

It seems to suggest the need for greater auditor assurance, but the focus on AS-5 is on increasing efficiency, not necessarily effectiveness. In my view, the role of a regulator historically is to prescribe a certain level of performance, effectiveness, that must be met by the regulated entity. Concerns with efficiency are best met via market tests. If Ernst & Young spends too much time performing the audit, fire them. Hire another firm.

Focusing on efficiency --

(laughter.)

-- or any of the other firms.

Focusing on efficiency, especially by a regulator, can easily lead to insufficient audit work

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and a decline in audit quality which is your second question.

MS. VIRAG: Bob Kueppers.

MR. KUEPPERS: A couple points. We all want to make sure Ted is satisfied with his good question about risk-based. Let me point out that the judgment areas don't -- aren't limited to the initial assessment of risk.

And I say initial, because let's assume you're doing a first audit and you go through your process to try to concentrate your testing in areas of greatest risk. As you go about the work, you will find your initial assessment needs to be adjusted and updated. Some of the areas you viewed as risky might turn out to be otherwise and some other categories you had in a low category might contain more risk as you learn more and perform related testing.

The judgment cascades throughout the entire standard including the decisions on the nature, time, and extent of procedures that flow from that initial risk assessment.

And I think that one of the things you

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might speculate about is if you don't use a risk-based approach, what's the alternative? The alternative would to be somehow test across the span of the population, if you will, at the same level. And I think over time, the profession, the GAO, others have used a risk-based approach appropriately to focus the testing where the greatest risk lies. But that is a -- that's an analysis that needs to be updated as you go through the course of an audit as you learn more.

Second point I have is as to the sufficiency point, I don't think, at least from my firm's standpoint, and I think probably the other major firms as well, that we're getting the wrong message. I think that the thing that troubles me about the efficiency point and wouldn't bother me to see it in adopting release language and things like that, I don't think it is a good idea to have it embedded in a standard.

I think standards generally should -- historically and in the future -- should represent a minimum level of work that needs to be achieved.

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When you introduce efficiency as a requirement, that may work most of the time, but we all have situations that are frankly difficult. And you may not get their efficiently, but you may get to the end of the journey as is needed.

If in fact this doesn't protect investors, then we wouldn't support the standard. And I think that all that said, the reason we're supporting the standard as an improvement is we think it will be easier for our partners to implement with the appropriate guidance from the firms. And I think it does preserve the investor protection requirements in the Act.

MS. VIRAG: Randy Fletchall?

MR. FLETCHALL: First, Joe likes to do a lot of research. In research, you come up with hypotheticals. I'm sure what he was giving was a hypothetical about a particular audit firm doing too much work and the market would react.

This goes back to Ted's question, but to what Bob said, and Craig said about the need to understand the business and industry in which an

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audit client is operating. That is clearly important to a risk assessment.

What you have to be careful about is thinking that is in lieu of actually understanding how the financial statements get prepared and where there might be errors or material errors. So that's kind of incremental. I just don't think we should get into the thought that if I understand the business, I understand the industry, to Craig's point, I don't see anomalies, therefore I conclude everybody is right.

Clearly if you see anomalies, that requires work to determine if you have a problem. As we talked -- Sam mentioned, look how we do methodologies over the years. If we got into problems back in, say, the late '80s or '90s, it was trying to take too much of the fundamental out and focus on if I know the business, I know the industry, the company looks healthy, maybe I've done an audit. That's not necessarily the case. That's where we had problems. Yes, it is important. It is essential in an audit to understand the business of the company

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and where it operates within its industry, but you can't infer from that that therefore the financial statements are correct and I don't have to do other work.

MS. VIRAG: John Kellas?

MR. KELLAS: First of all, I want to say without commenting on the details, the general direction towards a slightly more principled, slightly higher level standard seems to me to be absolutely right. I think my general approach would be to start at as high a level as is consistent with improving and creating good practice and necessarily make the standard more detailed if inspections, for example, indicate that that is necessary.

There was a comment about judgment and the need not to second-guess the judgment of the auditor. I think that there's obviously truth in that. It is true, judgment should be allowed to flourish. At the same time, I know regulators elsewhere are concerned that judgment is used almost as a trump card.

One point we are keen to make is auditor judgment is not that trump card, but it is to be a

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reference to what other experienced auditors might do in similar circumstances. So there's no one answer to anything. But on the other hand, there must be ranges of reasonable and maybe there's something that ought to be written into the standard along those lines.

Just picking up the efficiency point, it is right that standards are concerned with quality first and foremost rather than efficiency. I think a standard setter, any regulator, cannot ignore efficiency. And if one of the problems with AS-2 has been inefficient implementation, it may not be just dealt with in the way that Ed indicated by amending the current standard. But it may be that there's something about the current standard that breeds a certain inefficiency, albeit that all the right words are in all the right places.

Sometimes it is easier to start again and to indicate that fresher approach, provided you accompany it with the message that Ed was concerned about, that you should not be portraying this as some how a rather relaxation, but a different approach to

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a quality audit that will promote efficiency while maintaining the quality.

MS. VIRAG: Lynn Turner?

MR. TURNER: I'd echo the comments that Dr. Carcello made as well as those that Ed made. I think -- as well as the question that quite frankly Ted asked, but never got an answer to.

We have been doing these type audits for the last few decades. SAS 55 came out in 1988. It is not like it is something new. It is the exact approach we used on many of the audits that have failed miserably and resulted in mega claims against auditors, not without reason.

So I think there is a concern, because when I compare the language in SAS 55 with the language in this particular document, what I find this is document is similar, but if anything lacks some of the guidance in the old AS-5 and certainly the guidance in the old audits guide. I know the auditing standards board did a nice job of trying to update that recently. Maybe that's something that needs to be taken a look at as well.

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But it is a continuation of exactly what we've been doing, and there is nothing in there that indicates really any significant change despite the fact that there was a fairly thorough study done in the '98, '99, 2000 timeframe in the O'Malley panel report. If you go back and read the O'Malley panel report, all the major firms sitting around this table at that point in time did indicate they weren't doing this notion of top down and stop, they were in fact doing a full top down risk assessment.

And the O'Malley panel came back and found that there were two problems, a couple of problems with that standard. One involved the attitudinal issue and something has to be changed in the standard if we're going to address attitudinal issues and how auditors were approaching the risk assessment, which clearly hasn't happened because if you look at the last 4010 report, we see people not showing up for the brainstorming session required by the audit standards board.

So clearly we haven't got that issue addressed yet. Yet that's a major hole and

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shortcoming in this document.

I think the other shortcoming which O'Malley aptly pointed out was the fact that there are procedural issues that haven't been adequately addressed in the standard nor in this one. And to that point, I really would like to echo what Craig said. I think this standard is still written up by and for auditors and doesn't consider adequately how you really get to some of these issues.

The points Craig made about the auditors need to get outside their little box of ticking and tying and need to look at things like analyst's reports and other things that, what's going on with that company and the market price and understand where the market is on that.

If you look at the cases, you know, in some of the major cases in Micro-strategy cases, the enforcement release notes, it was a Forbes article that highlighted the problem. The auditors didn't find it, yet a Forbes writer did. At Ride-Aid, the auditors didn't find it, but an SEC staff review from Washington found it. It is because they aren't

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looking at the type of things that Craig mentioned.

That's a gaping, gaping hole in this very particular document. And if you go out with the document as it is, especially with the tonal issues that Ed talks about, because there is no question in the most recent months even the Colorado state society came out with a summary of this thing and headed it up, PCAOB reduces testing.

There's no question how this thing is going to be perceived by the public in general. That's quite frankly what I think your goal is. If that's your goal, you need to tell the world. But if that's the case, then I think you're going to have the same thing we had for the last two decades; and, eventually, the PCAOB will be held accountable for that.

This is more than just, quite frankly, about accounting and auditing. We've done some of that research. Ours isn't hypothetical, we actually use your clients, Randy, and they provide us fantastic data, great data to work off of. But when you look at the companies that have gone through

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these restatements and gone through these material weaknesses in the last year and going back to 2004, that population of companies have underperformed the market indexes by 18 to 20 percent.

And for this population of companies to be underperforming that index by that amount, that is humongous.

The notion that we're relaxing and may not see that information getting out to investors so they know to stay away from those companies would be a travesty. Because that is a big cost and a lot more cost in terms of tens and hundreds of billions of dollars than what these audit fees even remotely come to.

MS. VIRAG: Ted White.

MR. TED WHITE: Thanks. First, to Lynn, I would echo what Joe and Harold said so eloquently. While efficiency is a fine term, that should not be the preeminent purpose here.

I think from an investor viewpoint, of course, we want our money spent wisely. But the quality of the audit is first and foremost. I

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personally found it very interesting that the pressure back on the system, particularly on the SEC and even here has been from the cost standpoint, not from the people paying the bills. In my opinion, investors ultimately foot the bills. You have not heard widespread complaints from investors about the cost of audits. Sure we want it efficient. But effective has to be number one. My perception is the staff has been aligned with us on that.

Now, to the question earlier. I think the fairness part of it has been answered. I think I heard these people's opinion that it is an implementation problem or it has been an implementation problem in the past.

The second part of my question, I would like some perspective from others here and from the staff as to what's different. If that is truly the case, do you agree with that? What is different now? Is the inspection process alone something that fixes that? Is the standards -- differences in the standard fixing that? I was alarmed by what Ed said. If there's a perception the PCAOB is relaxing

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standards, that's -- that doesn't seem right to me. Maybe that's a bad perception, but -- maybe I could open that question up.

I'd like to hear from the staff if you feel you have addressed those problems from an implementation perspective, should we be comfortable with that?

MR. RAY: I'd be happy to make a couple of comments with regard to your question.

Is this different? I think the question is probably asked -- in substance, I would say it is not different. I would say what we've -- are attempting to do is really emphasizing more in this standard the focus on risk and the focus on judgment. And the attempt is to try to appropriately, again emphasizing appropriately, permitting auditors to exercise judgment in performing the internal control audits.

I think what is different fundamentally, what is different about the environment today is the existence of the PCAOB and its inspection function. We now do have an inspection, a quality inspection

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function that is independent of the auditing profession. And so I think that that is a very significant factor to be considered as we complete our rulemaking in this standard.

MS. VIRAG: We'll go to Craig Omtvedt.

MR. OMTVEDT: Thanks. I just want to add a couple of comments. First, I think in terms of the concern about this being viewed as a relaxing of the standard, I can tell you that for those of us out in the field, no one views it in that light.

I think universally we all view it as an opportunity to have better quality audits and be more effective. I think one of the concerns with AS-2 and anybody who has done any degree of auditing will tell you if you are looking across the board at everything equally, you are going to dilute down your effort and you're not spending your time in the areas that are critically important. I think, again, the modification you are making here is going to allow for much more qualitative audits.

I personally think one of the things we are all grappling with here -- and I want to lay this

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out a little bit -- I think we have an audit approach today, playing off of Joe's point, that assures the good people are effective in trying to do it right. I don't think we have an audit process today that helps detect the bad people intent on doing it wrong.

And by that I say that as we look at the audit approach today, first we look at, do we have control processes in place to see that transactions are recorded properly?

Do we have a financial organization with a sufficient understanding of GAAP to prepare the statements in accordance with GAAP?

And at the end of the audit process, we get opportunities to improve our control processes and correct errors. Again, the people who are trying to do it right get assistance in getting it right.

But when you have a situation of management override and outright fraud, I would offer up that the audit approach as it stands today is highly ineffective in detecting those kinds of situations.

We had somebody be here -- I don't

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remember his name -- who six months ago raised the whole issue of how are we approaching the whole aspect of fraud in the risk assessment process in the audit process.

And I would suggest to you that until we get that sorted out and get that right, all you're giving people in the certification is comfort that those who are trying to do it right got it right and they've given you statements in accordance with GAAP.

I would offer up from an investor's standpoint, I would suggest that the certification should be -- and these are my percents now, so I'm doing something ballpark -- the certification is probably -- should be 30 percent, that the financial statements are correct and proper and in accordance with GAAP; and should be 70 percent assurance that there isn't a fraud.

Now, I accept the fact that people aren't going to catch everything. But I would say to you today, the audits are woefully inept in detecting fraud.

MS. VIRAG: We have time for two more

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commenters, Charles Noski and Cynthia Richson.

MR. NOSKI: I am probably one of the few people who has listened to everything this morning and can say I agree with almost everything I've heard. I've been an auditor. I've been a preparer of financial statements.

Today I sit on several boards of directors and chair two audit committees. I am listening through my filter as an audit committee member and trying to think about how AS-2 and AS-5 affect what I do and how I think about the work of the auditors whose client I am.

The thing that strikes me that is going to be important if you go forward and adopt AS-5 is that there needs to be a much more robust dialogue between the independent auditors and the audit committee about the risk judgments and the risk assessments that the auditor is making, because my concern will be -- as I listen to this -- and, of course, what I've heard from both preparers and from audit firms is that AS-5 is actually viewed as an expectation for a much reduced level of work and more risk-based.

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And I, too, can remember back to the '80s and '90s where that was code for doing less work and being more competitive and reducing audit fees.

Having been a preparer and an audit partner at one point in my career, I have different perspectives on audit fees. As audit committee chair, I have different perspectives on audit fees because I am now more interested in the effectiveness as well as the efficiency in the audit.

So I do think that as you think through the communications between the audit firms and their clients, the audit committees, that there should be a much more robust dialogue about those judgments because as audit committee members and as board members, we are focused on risk assessment and risk management and we spent a lot of time looking at, frequently at some companies, looking at the performance of audit companies versus others, and trying to understand why we are better or worse than the performance of others and challenging management to explain to us why the financial statements reflect the reality of their business and their performance.

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So please don't forget the audit committees and our needs as you reflect upon the requirements that you're proposing in AS-5.

MS. VIRAG: Thank you.

Cynthia Richson.

MS. RICHSON: Thank you. The discussion this morning has been very insightful and very interesting. I agree with a lot of what's been said. But I do think Ed sort of hit it on the head.

I've been talking to a lot of audit committee members, independent directors, and I think the perception out there is really that the PCAOB is relaxing the internal control standard and the testing standard; and I think that's a very big problem.

I think part of it -- even I, when I first learned about this -- was surprised that the PCAOB didn't say we've got two years of inspection reports under our belt, of which, of course, only part of that is public and parts are not. So we don't have the full story even sitting here. But that they weren't going to tweak it to make it more effective

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and efficient. Instead it is a brand-new standard.

I think that's feeding into the perception that this is -- the companies have complained loud enough and often enough that we need to do something about this crisis. And in talking to audit committee directors and members, basically I hear horror stories -- and these are widely circulated -- about how the auditor came in and spent the entire day looking through my day book to make sure that the meetings I said happened really happened. In other words, a complete waste of time.

And so you say, gee, that doesn't make any sense. That strikes me as being very wasteful. On the other hand, some good points were made by Ted and Lynn.

I don't think any investor who ultimately bears the burden of cost of these audits has complained. For the most part, it is about audit quality and that's where the focus ought to be.

When I hear the focus on the new proposed standard is business efficiency, while we're all very much in favor of efficiency, I think the bottom line

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really needs to continue to rest with quality of audit.

That's where the focus needs to be. And if implementation really is the problem, that's where we ought to be focused. What I'm hearing was the experience of the '80s when risk-based assessment was out there and used as a code word for doing less work. I keep hearing about inexperienced auditors -- which we heard at other SAG meetings are doing all the work, young people out of college. I think that needs to be addressed. And the fraud standard.

We are on the heels again of the back-dating stock option scandal. There has been no breathing room of generally the PCAOB is being allowed to do its job properly, it really is functioning as independent of the audit profession, accounting profession and we're getting it right.

Incremental steps, we learn as we go through inspections and other processes. I encourage you to keep public perception in the back of what you do as you go forward.

MS. VIRAG: Do you want to comment?

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MS. GILLAN: I should start out by saying the views I express today are my own and not necessarily the board's. I am a little bit perplexed at some of the statements I'm hearing. I am the first to acknowledge that perception of what one is doing can sometimes be as important as what one is, in fact, doing.

And so when I hear that the perception is that the PCAOB's proposed standard was intended to water down or to relax standards in a way so that there is not an emphasis on quality, that concerns me.

However, at the same time, I'm a little bit at a loss to understand why people haven't read the statements that the board made when we proposed the standard, which was that our definition of efficiency is, per se, doing the high quality audit with the least resources possible.

So that is the focus.

Cindy, when you say that some people think our focus is saving costs, no, it is not. It absolutely is not. I'm not sure how much more clear

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we can say that, but the fact there is so much misperception out there -- and I hope this comes out in comment letters, please send your comment letters in soon -- tells us that we probably need to look at how we say things.

But I guess I just didn't want the record to go by -- and I know there are reporters in the audience -- with it being unrebutted that in this board member's mind, the proposal was not intended to focus on saving costs, was not intended to water down in any way the standard. If we said it wrong or got it wrong, I hope commenters will let us know that.

MS. VIRAG: We're going to go ahead and give this a few more minutes.

Christianna, do you want to talk?

MS. WOOD: First, I want to echo the comments of my fellow investors that as one of the larger pension plans in the world, we are willing to pay whatever it is, whatever it takes to get audit statements right.

And also the comments about identifying gross fraud. I mean, that ultimately is the largest

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cost that we face. While there is plenty of talk about AS-5 being a back-off or a back down, I think really I appreciate Kayla's comments that we need to recognize there has to be a balance. I want to say I support the PCAOB in all of their efforts to find a balance and to get this right.

But what would really be the test is in the future and how they respond to the audits in the next few years, and the proof of the pudding will be sort of right there in how they respond to whatever changes or perceptions or changes in behavior that are in the marketplace.

I think it is incumbent upon them to hold to what they believe they've done which is to try to find the right balance.

But I do want to say that -- you know, acknowledge the perceptions, but say that ultimately the PCAOB will have to send the right messages to the marketplace. And I want to support them in being firm on the effectiveness side as opposed to the efficiency side of the balance.

MS. VIRAG: I really mean it this time.

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We're going to take two last comments and then cut this discussion off.

Gaylen and then Arnie has a comment, and then we'll be done.

MR. HANSEN: I do agree with you. I don't think we have gone overboard with that. I can say from a CPA perspective that this standard is telling us that we should apply more judgment. But I just went through an inspection where almost every single comment was addressed and critical of the judgment that we did apply.

So I think there's a balancing act and that is where the inspection process comes in to play.

And I -- then just briefly, we had some discussion about the audit committees and their oversight function, and I think it's very important that they be utilized properly. And in this process, it can't be overstated how important that that is.

I've seen a huge improvement in the functioning of audit committees and the role that they play. But on the other hand, I don't think you

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can expect audit committees to ever do -- to do everything that -- to identify management override and reduce to an acceptable level what might be going wrong within these companies.

You can't expect the audit committee to be the back stop here. And so if that's what we have in mind, I don't think that works. And especially not some of the smaller filers where some of them don't have audit committees to rely on. I think that we need to kind of rethink that.

MS. VIRAG: Arnie?

MR. HANISH: I guess -- I'm trying to figure out how to frame this.

I find it regrettable that many people around the table are trying to sort of tear away at what I think the staff and the board have done an admirable job of trying to address, issues over the past several years that have been brought forward.

I would challenge many of the people around the table to maybe try to get into the trenches and understand where some of the criticisms have come from from the companies. It is in our best

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interest as a company to make sure our investors have the utmost confidence in our financial statements.

We look to our internal processes and people preparing those financial statements to ensure those financial statements are accurate and present fairly the financial position and condition of our companies.

But the way these audits were implemented is where the rub is. And I just really don't know how many of you have ever in recent years been in the trenches to see the incredible level of detail we are being put through.

We can talk all we want at high levels about risk-based approach. But put yourself in the position of us within the company having to deal with some of the -- what I'll call ridiculous questions that were being posed to us because there wasn't a lot of judgment being exerted or commented on the part of many of the auditors.

I think these words enable us to have the appropriate dialogue with the auditors to get them to focus and help them focus on areas where there is the

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greatest risk.

And I guess maybe we need to -- as SAG members -- have an auditing 101 lesson for some of the members around the table to get people to really experience what some us who are sitting here as preparers have really complained about for the last several years.

We're willing to pay whatever it takes to create a situation and an environment where the investors truly do have confidence. But the level of detail and the lack of focus on those areas where many of us believe where there was a significant risk of a material misstatement was really misplaced. And I think this enables us to get the focus in the right direction to provide what you all who are investors want, the high quality audit that's efficient and effective.

Thank you.

MS. VIRAG: At this point, I'm going to put up the questions for the next session and people can be thinking about those and we can kind of move on to that.

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I see we already have a tent up. I'll call on Damon.
MR. SILVERS: I apologize. I'm still on the last session. I hope you'll indulge me. I think Arnie's comment about who's in the trenches deserves some sort of response.
In my capacity at the AFL-CIO, I have a variety of duties. Among them has been advising a preparer who was attempting to comply with 404, and doing so voluntarily.
And I am deeply aware of what Arnie is talking about. I have experienced it firsthand. The AFL-CIO and I personally have been very determined in the dialogue about section 404 and AS-2 to be clear that we sympathize with much of what we have heard from the preparer community by what appeared to people of good faith about unnecessary burdens being imposed.
And for that reason -- among others -- we were supportive of the general direction which the PCAOB and the staff took in considering changes to AS-2. And I think if you Google or whatever our

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comments in relationship to this process, you will see that's where we have been.
And I don't think we're alone in that. The Council on Financial Investors is in a similar position. I think most thoughtful, long-term investors had a similar point of view. Unnecessary expense and unnecessary distraction from the business of running companies is not in our interest.
What's happened, I think in the last few weeks as people have -- as people have read carefully the proposed draft standard is that -- and I think this reflects perhaps the tone of Arnie's comment about people tearing things down.
What's happened here is that a number of concerns are being raised from a number of expert quarters, more expert than I -- academics, auditors -- about what the implications are of certain phrases in the proposed draft standard.
In particular, the implication surrounding the question around the issuance of the reliance on the work of others and on the ability -- on whether or not all -- either issuers or auditors are being

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instructed, encouraged, hinted that merely the conclusion that somebody at the top of the company seems like an honest fellow is going to be enough to -- is going to be enough not to have to actually look at actual controls.
I'm not enough of an expert to be able to get deeper into these things, but I keep getting ambushed by people who I think are to my right and turn out to be on my left on this and it makes me uncomfortable.
I want to reiterate my support for the work of the board and the staff around this area which I think has been admirable, and has done great credit to the board and the expectations Congress had for the board when it put it in place. These issues being raised are serious ones and are what the comment period is for.
We believe that the foundations, the conceptual pillars, so to speak, of what is being done here are correct. The board and staff need to be vigorous in rooting out any of these hints that under a new AS-2 or AS-5 auditors or preparers are

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going to be allowed to look the other way.
MS. VIRAG: Joe Carcello.
MR. CARCELLO: Before I make my next comment, let me reiterate something I said to some people yesterday. I think on balance the standard is a good standard. But I don't think we bring a whole lot of value if we come here today and just applaud you.
So what I'm trying to do is point out things that I think are at least worth thinking about. And so that's what I'm trying to do.
One comment I have related to this question and this again interacts with the SEC's guidance. The SEC's guidance talks about a strong indicator of a material weakness and ineffective oversight of financial reporting by the audit committee. And I clearly disagree with that. But no guidance is offered in either the SEC exposure draft or AS-5 as to what ineffective oversight looks like.
I think this is particularly problematic because no evidence -- no evidence that I'm aware of, maybe you guys are aware of some -- that auditors are

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proficient in evaluating audit committee oversight of financial reporting.

And there's an actual conflict, given that the audit committee now has the authority to hire, fire, and compensate the external auditor.

Also relating to company level controls is the whole discussion we had this morning by a few people about fraud. I would agree with what Craig said. I think this is a major issue.

In your exposure draft, there's a quote from Craig Jonas that there needs to be increased controls on fraud. I clearly agree with that. I think AS-5 should have a more robust discussion of this issue or the PCAOB should accelerate its possible reconsideration of SAS 99, especially given the numerous -- and as Lynn said -- really rudimentary deficiencies documented in the board's recent 4010 report.

MS. VIRAG: Okay. I forgot to read the question for everybody. The company level controls discussion is based on the question, does the proposed standard adequately articulate the

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appropriate consideration of company level controls and their effect on the auditor's procedures?

Bob Kueppers?

MR. KUEPPERS: I didn't think you were serious about this question. I was going to answer the last one. So I might as well take the license you've given me.

I guess I want to make one point. Maybe a final point hopefully on this issue of tone.

If you compare AS-2 and the exposure draft AS-5 and look at things like, well, principle evidence is gone, a large portion disappeared, you might be able to -- you could turn that to be that we don't have to do much work in order to issue our opinion.

But I'm not troubled by that simply because where that leaves us as auditors is that we need to have sufficient competent evidential matter to support our opinion. That is true for the financial statement audits. It is the same standard.

By introducing, as AS-2 did, new terms, you know, I think all of that does not signal to me

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we should greatly reduce work because now it is no longer required that we have evidence.

It is in there. It is in the body of standards that we have to comply with. I do recall Kayla's point sitting in the open meeting when the proposal was approved by the board. The tone of the comments by each of the board members individually, some of the questions of the staff I think were -- will resonate with me. It was not about dumbing down AS-2. It was not all about cost. It was trying to strike that balance between preserving the quality of the audit, protecting investors, and I still maintain that. I think that the exposure draft largely achieves that.

We're going to have thoughtful comments where we think little adjustments need to be made; but on balance, I think it is a very good standard.

I don't have any comments for the moment on company level controls.

MS. VIRAG: Vin Colman?

MR. COLMAN: Obviously, I agree with Bob's comments. Maybe I'll move on to your question as

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opposed to going beyond.

I think what you're going to see in our comment letter and other comment letters is a couple things. The interaction between the management guidance from the commission and your guidance and perhaps this is one area if you look at the guidance there's some actually very good discussion in the SEC's guidance with respect to the direct and indirect level of company level controls, and the impact that would have.

And then you look at the PCAOB standard and where the level of precision -- actually paragraph 43, if you look at paragraph 43, it is not necessarily in the assessment, it is in deciding how much to test. Right?

And perhaps that needs to be moved up, and that should be part of your assessment. So that drives the decision-making around, you know, how aligned the company level controls are, your evaluation, and then determine the nature, time, and extent of your procedures.

This is a very delicate plan where I think

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people could begin to misunderstand similar to a number of the comments that are here where the implementation is going to be key. I think being able to -- it was discussed, I remember, at great length with respect to the COSO for small business and other areas. I think one of the examples came up around segregation of duties.

This alignment of company level controls and the level of precision and how it drives the nature, time, and extent of procedures is very delicate. I ask you to continue to think about how it is aligned with the SEC guidance on both sides.

So that when we talk about efficiency, the most efficient way to do this is for management to be able to consider what they do and to have the auditor, the whole spirit of being able to understand what management is doing, being able to rely to the extent necessary, and adjust your needs to the time and extent of your procedures.

MS. VIRAG: Randy Fletchall?

MR. FLETCHALL: Thank you, Sharon. This is an area I have concerns with, too. I think

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clearly it is very, very important to any kind of top down risk-based approach that you start early on in the level of company level controls. I think that is clear in the guidance. That sets the right stage.

What I am concerned about is similar to something Vin mentioned. Many company level controls kind of indirectly affect whether you get something right. We haven't found in the past that many that directly tell you if you have effective company level controls, if financial statement assertions are correct.

So I think it is one of those areas, again, if you clearly have ineffective company level controls, an auditor has a lot of work to do. Where you think you have effective company level controls, again you can't infer that that means transactions are processed correctly and everything is accurate.

I made the statement in a SAG meeting, a couple of SAG meetings back when we had a panel talking, going back a few years ago to when we were looking to become more efficient and looking at methodology. We looked around the world, very hard,

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to find a lot of company level controls that operated with a precision that if they were in place and operating effectively, you said that gives me assurance the financial statements are correct.

My only concern is what you have written is accurate, it sets out the possibility of relying on company level controls. My fear is like an expectation that you actually find company level controls that directly affect the accuracy of financial statement assertions and therefore you are finished and that gives you the efficiency, when I think it is dangerous to rely on company level controls.

MS. VIRAG: Sam Ranzilla?

MR. RANZILLA: Well, this may be the first time I've ever agreed with Randy Fletchall.

I could not articulate it any better than you did, but --

MR. FLETCHALL: I agree with that.

MR. RANZILLA: But I would say that if there were two flash points in this standard that if I were to look today and think forward to two years

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from now, the SAG meeting where we have -- hopefully it is a SAG meeting, not another SEC-PCAOB roundtable on 404 -- but at some point, we're obviously going to have to see how standard 5 holds up.

And ultimately, I think the success of auditing standard number 5, from an auditor's perspective, is in two areas: One is getting the risk assessment correctly. Secondly, whether or not company level -- how we deal with company level controls, we're able to discern the difference between those that are directly linked to assertions and those that are indirectly linked to assertions which have very different effects on our audit approach. And then even those that are directly linked to the assertions, is the precision there close enough so that you can ultimately conclude that little or no more work is needed on that company level control.

I think how the auditors implement that aspect of AS-5 would depend upon whether we're coming back here in two years having a discussion about the need for more efficiency or the fact that we just

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don't get it and we're not doing enough work.

And so my suggestion is that that is a place where the SAG could provide maybe some more guidance in terms of -- and I think -- I can tell you for a fact, my firm would be willing to participate in some sort of practice aid or the like, because I do honestly think as I look at my own firm's implementation of AS-5, that is the place where we're either going to get it right or we're not.

MS. VIRAG: Jeff Steinhoff?

MR. STEINHOFF: I'll let go of Sam's echoing of Randy's remarks. This is a very delicate area. It tells you a lot if they're bad. So if the high level controls are bad, you know you've got a serious problem. It tells you less if they're good.

They are somewhat difficult to assess. I think probably more guidance is necessary. Probably more guidance is needed in order to tell an auditor where their reliance would enable them to reduce testing.

And it perhaps is not clear what evidence one must pull together to support the assessment

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itself, much less the reliance on it and reduction. I do have a concern that the way the standard is drafted, people might think that there's a lot of focus on this versus other things. And I think somewhere in the standard, in paragraph 17, as it was noted to me, the auditor must test the company level controls, very definitive.

And I think a lot of auditors will read it as if this is really the keystone. And once I tested those, and I find those are all right, I can greatly limit everything else I do.

I'm not sure that's what you want to convey, but I do have a concern that there's a need to have a proper balance and to perhaps provide some more guidance in this area either through the standard or in another way.

But to make it very, very clear what this tells you and what it doesn't and how much priority and how much weight the auditor must place on this at the end.

MS. VIRAG: Richard Dietrich?

MR. DIETRICH: As an academic, my role

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often is to ask a question. So in thinking about Ed Trott's comments earlier, and in this message that it sends, and Kayla's comment, when I look at this issue, my question is, do we think that this proposal is intended to increase the effectiveness or the efficiency? And if we think it is really intended to increase effectiveness, it would be helpful to explain how we think it will do that.

Otherwise, it will be interpreted as increasing efficiency by telling the auditors if you do this, you need not do other things.

I think that's the point that is being made here.

MS. VIRAG: Lynn Turner?

MR. TURNER: As usual, I agree with Randy and Sam.

(Laughter.)

MR. TURNER: Nice articulation, Randy. But I think there is a risk here that goes back to some of what Craig said earlier about risk at the company level or whatever, and how that translates -- how then the auditor translates that down into more

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of the detailed basic work.

Once again, there's less guidance in this standard than what was in the prior standard, and even the prior standard didn't work. And under the prior standard, we know time and time again that the auditors were unable to make that assessment at the top. And yet you're making that assessment at the top very, very key, and I actually think it is very, very key.

If it isn't working there, so far as I'm concerned, you can cut it off there and forget about testing the rest of the stuff and go on from there. It is a total waste of time to be doing that. And yet at the end of the day, when we look at all the various cases and you can name one after the other, you know, for whatever reason, that never got assessed right. And yet as we heard here not too long ago, this standard really hasn't changed and isn't different.

So my question is, why are we using the same standard that didn't work that people were never able to assess, and where we are given less guidance

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than before? What is it that we are looking at to turn around and say that it didn't work?

Maybe back again to some of Craig's comments about the fraud stuff. It doesn't seem to be there's enough focus on those controls that deal with fraud.

Quite frankly, this gives you almost no guidance, very little definition of what is meant by the control environment where the audit committee is so key. There's hardly a mention of the audit committee in this particular one, and the importance of that role and what the expectations are with the auditor with respect to that.

So again, it looks to me like we are very much close to what we've had for the last 20 years, which I suspect will give us pretty much the same result in the next 10 to 20 years. I just wonder why we're going down that path unless we want to repeat history, which it seems like we are destined to turn around and do with this document.

By the way, Arnie, I sat on three audit committees and gone through this nitty-gritty in the

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last few years and chaired three. I appreciate what you say. I agree that you don't want people going overboard, but this standard is a repeat of history.

MS. VIRAG: Cynthia Cooper.

MS. COOPER: I agree with most of the comments made. It is dangerous when we rely on company controls to reduce the amount of substantive testing. I think that is one of the reason that some of these big frauds in the past have not been detected through the external audit that I think the frauds like WorldCom, Health South, other big scandals are more likely to be detected through more rigorous substantive testing and more forensic audits.

I think it is important to make sure that while auditors are testing company level controls, we don't forget the risks we are trying to meet. Everything should go back to risk in the end, and we should make sure we keep our eye on what these company level risks are.

One is management override of controls, collusion that goes all the way to the highest levels

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of a company. That's one thing we have seen consistent with most of these big frauds. And in my view, there are very few controls, when you have collusion and override, that will prevent these frauds and detect them.

I think it is important we be in agreement with what will prevent these controls, perhaps fraud hot lines to prevent these frauds and make sure we don't use reliance on controls as an excuse to decrease our substantive testing.

MS. VIRAG: Kimberly Gavaletz?

MS. GAVALETZ: I want to reflect on prior conversations we've had relative to this topic and some of the key points that I think you've tried to include in the standard revision relative to the timeliness and the timing of when you looked at the company level controls.

I think one of the points we haven't quite discussed in here was early in the process. We've alluded to it, saying that basically you look at something, decide not to test. I think it is important that some of our prior conversations said

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these weren't focused to the end where they might have been able to help with the scoping.

I tend to agree if they're really good, you don't have to test. If they're really bad, they do give you signals and that's where you need to go. What I heard was there were a lot of experiences and this might have changed through the last year or so, but a lot of experiences with company level controls being looked at at the tail end of the audit, which I felt was inappropriate and didn't give you the information. They're very informative from the outset. That is an important part you have to have incorporated.

I think Lynn touched on it. Whoever does this, it is very important to really look at the company level controls and to discern what's really being told by that. It will take a lot of senior level support to go do the level of substantive testing which I agree is necessary to really get to the foundation of things.

It also involves looking at what the audit committee role is. There is a little bit of conflict

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in there that has already been pointed out.

I think it is a place that does need to be focused on at the right time in the overall -- by the right people and rightly resourced, so you can get the most impact out of it. Otherwise, if you're doing it, I'm not sure what the reason you're doing it. If everybody is external to it and independent of it, it is another check. But a potential leap too far down in the process.

MS. VIRAG: John Kellas.

MR. KELLAS: Thank you.

Perhaps I stumbled slightly over paragraphs 16 and 17. One reason was the reason Jeff raised. I stumbled over the must test. It is wrong to read that sentence without reading the whole of it because you do say that they are important, blah, blah, blah.

I think when we were revising the international risk standards a few years ago, we came under a great deal of pressure to acknowledge that company level and overarching controls were capable of providing the auditor the assurance they needed.

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At the end of the day, we did resist that. I think our position is much closer to what Randy said at the beginning.

They are a very negative indicator, if they're rubbish, but even though they're brilliant, they are unlikely to do your work for you. At the end of the day, the only question to be asked about control is, is it good enough to achieve the objectives I'm looking for.

I think you say that in your document somewhere if I remember correctly.

That's the point to be focused on rather than -- well, as I say, read the whole sentence. It did make me think maybe the message was a little bit strong on the overarching controls.

It is rather like the point Lynn raised earlier about knowledge of business, external information and so on. I think if there's one -- you know, over my years in auditing, one thing I think I came to the conclusion that is really, really important is that the auditor understands the business program.

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And so when things go wrong, people aren't saying how could it be that the business failed to provide this. But again, that doesn't do the audit work. It is the basis of good audit. I think the control environment, upper level controls are in exactly the same category. They deserve more focus than they've had in the past.

But they are underpinning a good audit not substituting for other matters.

MS. VIRAG: I'm going to go ahead and put up the next question. We'll get started before the break. We have 12 or 13 minutes before then to start with comments on scaling the audit.

The question is, does the discussion of size and complexity within the proposed standard appropriately describe when and how the auditor should scale the audit?

Joe Carcello?

MR. STEINHOFF: Yes.

MS. VIRAG: I promise to call you next, Jeff.

MR. STEINHOFF: I said yes. That was my comment.

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MR. CARCELLO: I have a few comments on what you guys are suggesting as it relates to smaller public companies. And one of the things suggested in the exposure draft is that small companies' control objectives can be met through daily interaction of top management. For maybe most companies this will work.

What if senior management is corrupt? For example, we know from the research that fraud is more prevalent when the founder is involved with top management. That's been well documented. Smaller entities are likely to have continuing founder involvement.

So that would seem to be a risk to me. The exposure draft also suggests that inquiry and observation of a control may provide sufficient evidence of whether a control is effective even without documentation. If fraud is going on, top management is not going to tell you that during an inquiry. The very fact of observing behavior changes that behavior.

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Finally, in my opinion, the standard seems to suggest -- although I will recognize it is not explicitly stated -- that smaller entities can get by with relatively unsophisticated financial reporting staff. But even if a business enters into simple transactions -- no derivatives, no leases, no defined benefit pension, post-retirement benefit plans -- they still will have deferred transactions, and they'll still have to prepare a statement of cash flows.

FAS 109, 1048, FAS 945, not to mention any applicable EITFs and staff positions are complex standards requiring high level skills.

MS. VIRAG: Jeff, did you want to comment more than your yes?

MR. STEINHOFF: No.

(Laughter.)

MS. VIRAG: Gaylen Hansen.

MR. HANSEN: As I read the standard, it appears to me that scaling applies to all companies. I think the standard says it does. It is not just small companies. I'm not sure it really articulates

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how that works, other than it is based on risk which I think that should be the approach.

Then just to speak to what was said by Jeff, I mean, I agree with the idea that you have to have competent people internally. But let's face it, in a small business, in the small companies, it is really 95 percent people and 5 percent systems and not the other way around like in the bigger entities.

I mean, I do know that there are specific technical issues that have to be handled by those competent individuals, you have to have internally. But it is not as pervasive in the larger companies.

So I think the idea of scaling is what is going to make this work for the smaller businesses.

Some of them don't have deferred taxes. I know my clients don't because they don't make any money. They're losing money. I wish they had deferred taxes. 109 is particularly difficult for them.

MS. VIRAG: Richard Dietrich?

MR. DIETRICH: Two questions about this. One, I am unsure about the word "size" in there. Bob

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Kueppers mentioned it earlier in his comments. It seems to me that that's making somehow implicitly an argument about cost-benefit analysis of the internal control testing relative to the size of the company.

Alternatively, the term complexity that's used is really talking about the need for evaluation and judgment. And I think of those things as very different. It is quite probable they are correlated. Smaller companies may be less complex. But I think those two things, at least in my mind, are muddled.

The other thing Gaylen Hansen mentioned earlier was this two-person entity. And so I asked myself what if one of the two people quit. And then we had a one-person entity.

Do we really have to say that we expect every entity to have effective internal controls? What if it is a one-person entity?

MS. VIRAG: Damon Silvers?

MR. SILVERS: When the question comes up, do we really expect every entity to have effective internal controls, that's like hitting a button.

Before I do my automatic playback on that

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subject, I want to say a word about just the way in which the board approached this issue of scaleability. As a conceptual matter, I think this is exactly -- as a broad conceptual matter, exactly the right way to do it. Not to say some companies the auditor ought to have a scaled approach and others they shouldn't, or anything like that.

And also not to fall into the trap of saying that any particular financial metric is a proxy for complexity. There are relatively large companies that are relatively simple and relatively small ones that are relatively complicated. Financial service companies that are small may be more complicated, and a biotech start-up might be large on a market cap basis. So I think this is an area -- my prior comment talked about getting the foundations of the pillars right.

I think this is an area, together with the notion of shying away from a design audit approach, and a few other areas, where the board and the commission have gotten this right.

Again, I think we need to be wary here

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that in the interstices and details, the standard messages are being sent that somehow smaller or simpler companies shouldn't be audited.

And that a perfunctory kind of -- that it is okay for either the company's assessment, the SEC's business, or the auditor's audit ought to be kind of a pro forma exercise. It absolutely should not. I think if the collective opinion of those who know best is there are any words in this that point in that direction, they ought to be changed.

Now for the auto-play part. Anybody who wants to have access to the public's money, whether it is a one-person company or a no-person company -- right -- should be able to say they have adequate internal controls. I do not believe that anyone should be allowed to call up one of our union members on the phone at home and offer them a security for a company which does not have adequate internal controls. I do not believe anyone can say they should with a straight face.

Thank you.

MS. VIRAG: Leroy Dennis?

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MR. DENNIS: I want to comment a little bit on some of the things Joe mentioned. I agree with him. I'm concerned about the messages. I support the standard and where it is going. When I look at smaller companies, complexity is going to drive what the words are going to do, not necessarily the size. A company that invests in its controls, whether it is a small company or a large company, is probably going to have a more efficient process performed by the auditors.

But if I look at a smaller company that has -- where you are relying on management to make sure controls are implemented properly, and to your point of how do you test management, you've got to rely on the audit committee. The audit committee has to be more effective probably in that environment than in an environment where you have much more robust transactional controls.

If you have a situation where you don't have that oversight of the management by an effective audit committee, I think you're going to have proportionally more harm done than a company that

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does have those controls. I think the messages have to be that this is really in the company's control as to how much they want to invest in their systems.

And if they invest the proper amount, as their shareholders would want, then they could have a more effective process. If they decide to invest a minimal amount, I would guess proportionally their audit fees and the opinion to get to the control is going to go up.

MS. VIRAG: We are going to go to break. When we come back, I will start with Ted and Lynn. Everyone can give thought to the question.

MR. RAY: Before you get up from your seats, one thing I neglected to mention in my opening remarks this morning is that we do have time set aside beginning at 5:00 o'clock for emerging issues, if there are any. I have not received any suggestions for any issues that we ought to discuss in that session to date, but if you have any you would like to discuss, please see me during one of the breaks and we can see if we can get that teed up.

With that, we do have a half an hour

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break. We'll see you back here at 11:00 o'clock. Thank you.

(Recess.)

MR. RAY: If everyone would please take your seats, we would like to resume the meeting.

I declare the break officially over and turn the floor back over to Sharon.

MS. VIRAG: I think we will start with Ted White.

MR. TED WHITE: I had a quick statement on the question. First, I agree with the statement. I agree with the approach. My single comment here is that I would urge the board and the staff to resist -- even strongly resist -- any approaches that would, under the guise of scaling an audit, come up with a two tiered process or anything that has lower standards just because a company is small.

I believe what Damon said is that size and complexity are two separate issues, and you can't assume because a smaller company is small, it is less complex and vice versa. Both of those concepts should be included in this standard, remain in it.

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And I'm a little bit worried -- I guess a lot worried -- about pressure on the PCAOB to scale an audit down, meaning giving lower standards to smaller companies. I think that's wrong. That's it. That's my statement.

MS. VIRAG: Bob Tarola?

MR. TAROLA: Thank you, Sharon. I think the concept around scaleability, looking at risks and focusing appropriately on those risks, allowing the company to show the auditor how they do control risk is the absolute right direction. I think it applies to all size companies.

I think it is an effectiveness improvement across-the-board that the focus on the higher level controls on the enterprise risk will allow the auditor, I believe, to more effectively conduct an audit, more effectively identify the areas where real work is needed to make sure that management is doing a proper job on serving its investors.

I think the trade-off between a better understanding of enterprise and high level risks will result in some conclusions that previous testing at

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lower levels may not be necessary. In my view, that's also an effectiveness conclusion and I'm supportive of where the board is going here.

I think, however, the perception that it's purely for efficiency is an incorrect perception. It is really an improvement in effectiveness.

MS. VIRAG: Other comments?

Craig Omtvedt.

MR. OMTVEDT: Just a couple of thoughts here and I will get back on my soapbox on 404 for a moment. I want to reiterate the point I made earlier this morning. I really truly don't believe that there's an audit process today that is effective in detecting fraud, and I think that there should be, and I believe that is the principal interest of the investment community.

I think what we have today is a process that -- again, as I said earlier -- I think assures the good people are getting it right. I would suggest to you that what has happened here is that in place of effective audit procedures for getting at fraud, we have substituted a 404 standard that says,

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well, if we do a lot to document all the controls at a grass roots level, then we really can be pretty well assured that we will not have fraud. I would suggest to you that the opposite is quite the case.

I think if you look at the body of evidence, it would say there has never been a major fraud as a result of poor control of inventories at a plant location or the potential is somebody wrote off 5 or 6 million dollars of inventory because they weren't determining obsolescence. I think, further, the problem we have here is because of the standard we have in 404 today, we have an issue in our public markets in that foreign investors don't want to issue here because of the expense and the difficulties associated with trying to comply with 404.

So as I look at the situation, I think that if we move to get stronger and better standards for detecting fraud, I believe that if we deal with the whole issue of 404 and scaling that to a standard that makes more sense, we then will do a great deal in resolving the disconnect we currently have between how the standards are working for large public

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companies and how we ultimately will deal with small companies.

Thanks.

MS. VIRAG: Lynn Turner?

MR. TURNER: First, let me correct the record that the reason companies aren't coming here has nothing to do with complexity. Two major Wall Street firms, Goldman Sachs and Thompson Financial in recent weeks have indicated that regulation has nothing whatsoever to do with that in this country.

Having said that --

MR. OMTVEDT: Excuse me, but I refute that for the record.

MR. SILVERS: Go call Goldman.

On the complexity issue, in a way, this ties back to what we talked about earlier in terms of translating what you think of the people at the top and the job they're doing into how far down you go and what you do, including not only in small companies but big companies.

And when you think back to a typical audit, probably most of us would assess things like

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PP&E additions and intercompany accounts as low risk. And yet those were the items that were actually manipulated at both Health South and WorldCom and we've heard discussions about accrued payroll and accrual for vacation allowance were two of the accounts manipulated at Qwest to turn around and make the numbers.

So one of the complexities that the standard really doesn't adequately address or get into is how is it that you translate -- how is it that you go about making that risk assessment and make sure that you don't make the same mistakes that others have made, that those type of things are automatically low risk. And I don't have to spend much time on them when, in fact, some of those accounts have turned out to be very, very problematic.

And I think there's very little -- actually, there's probably no discussion in the document, if you will, about the fact that you may have items that you typically would assess at low risk and most people would assess at low risk. And

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yet in reality, they turned out to be extremely high risk and been evident in multi-billion dollar misstatements that have cost investors tens of billions of dollars.

And somehow this document needs to come to grips with that issue and talk about the fact that, you know, just because you or I may think it is low risk doesn't necessarily mean it is. You need to be thinking about that and that's where in the O'Malley panel report, they did a nice job of saying that's where the auditor that's thinking about putting on that skeptical hat, and is that type of situation potentially existing here. You don't have that here, which, quite frankly, takes us back to repeating history again.

MR. OMTVEDT: I apologize for speaking out of turn here. But, Lynn, back to your point, I agree with your point. But the issue here isn't the absence of control, it is more a case of management override. And once you have management override or you have collusion to circumvent a control, then you killed the effectiveness of the controls that were

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there in the first place. And that's back to my point about we need better fraud detection methodologies in the audit process.

MR. TURNER: I think in a lot of cases that's true, Craig. But in the WorldCom case when you started to look at the intercompany accounts -- and Cynthia probably knows this better than me -- you didn't have intercompany accounts capturing the data in the way controls need to capture the data.

That was just not override. That was the type of systems and the information in a company that you didn't have especially in light of all the roll-ups and consolidation that occurred.

MS. VIRAG: Damon Silvers has his sign up. We'll move to him.

MR. SILVERS: Many years ago, I had the experience of sitting in a small room at the Securities and Exchange Commission without any windows.

(Laughter.)

NEW SPEAKER: That was special for you, Damon. There are only two of them, but they have

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very bright lights.

MR. SILVERS: That's right. I was sitting on John's side of the table, so to speak, in that room. Hopefully, John will stop me if I say anything I'm not supposed to. It was a long time ago.

And there was an individual on the other side of the table --

MR. TROTT: Stop.

MR. SILVERS: There was an individual on the other side of the table who neglected to ensure that his firm had counted the inventory in the warehouse. And that individual was crying. Turned out -- I think it wasn't his responsibility to see to it. But that failure to do so allowed other people to misrepresent what was in that warehouse, and there were serious consequences to the investors in that modestly sized public company.

That's why we need to have a standard here that will basically direct both companies and auditors to do their very, very best to figure out what's important and what isn't, and not presume that it isn't important if it turns out that it might well

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be.

Nobody wants to be in that room on that side of the table having that discussion, certainly not the investors who lost the money.

Now, the -- this is another one of these things -- there's a lot of people who paid a lot of money to get other people to assert nice finely published bound volumes that somehow the work of this board is imperiling the efforts -- the Congress of the United States protecting the investing public in the United States is somehow imperiling the national interest because Chinese parastatals and central Asian start-up companies feel leery about coming to our markets to issue their stock.

While I certainly understand that if you're someone like, say, Wilbur Ross, who has a large investment in Chinese parastatals which he would like to take public in our markets, you might be able to buy an infinite number of academics to buy that result.

I fail to see what anything like this has to do with the national interest, particularly, I

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find it offensive the suggestion that retired steel workers whom no one would lift a finger to protect when their jobs were going overseas ought to put their retirement assets at risk to subsidize the jobs of investment bankers.

I think that's precisely what is being put on the table here.

MS. VIRAG: Cynthia Cooper.

MS. COOPER: I want to follow up on what Craig and Lynn said about WorldCom. If you look at the WorldCom fraud, these entries were post-close on-top entries. Management closed the books and records at the end of the quarter. They said here is where we are. Here is what we told the analysts we were going to make this quarter. Then they booked these huge on-top post-close entries.

In the case of the external audit, Arthur Andersen did not have access to WorldCom's accounting system. They relied on management to provide them with the schedule they needed. They didn't go into the system and query for these on-top entries. If they had, the large entries would have fallen out.

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In the case of WorldCom, the other thing that went wrong is the external auditors really shared too much information in terms of their scope with management, so they lost the element of surprise.

What happened was when they told management we're coming in to test construction in progress and here's how we're going to test it, a lot of these entries were sitting in CIT. Management went in, moved the entries around in small dollar increments that would be less likely that the external auditors would detect it.

And the other thing that Andersen did was they relied heavily on analytical review. So they would come in each quarter and look at line costs as a percent of revenue and compare that with prior quarters and everybody was in line. It was flat at 42 percent. Andersen looked at it and said there are no anomalies, everybody looks good. They didn't compare it to a peer company like AT&T and others which I think is an excellent suggestion Craig mentioned. They did little substantive testing

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because they relied on the strength of internal controls.

For example, in the area of property, they only had six capital additions in the first half of the year and none in the second half of the year based, in my view, on over-reliance on internal controls.

So if any of you guys have questions you want to ask me, I'd be happy to answer them.

MR. RAY: I think this discussion about fraud is very enlightening. You will have a chance to talk about fraud this afternoon at our session. Maybe if we can -- I think we need to try to focus on these questions that we have teed up. I think this is a very important one to make sure we are heading in the right direction on the scale. If we could try to focus on this, that would be very helpful. Thanks.

MS. VIRAG: Ed Trott.

MR. TROTT: Why do I need this section in the document at all if I'm using a risk-based approach? Wouldn't that cover all these thoughts?

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Am I trying to send another message?

I don't even know why you have this section.

MS. VIRAG: Can we hear from other SAG members?

MR. OLSON: There's some hesitation by the staff to answer that, and let me tell you why I think that's the case. I have encouraged them -- there's not a word in the standard after thousands and thousands of hours, there isn't a word in that standard that has not been carefully thought through. And the real value, from our perspective, from this session, is to learn from this group what we have communicated. We are very interested in your response and I've encouraged our staff here to not get involved in a dialogue where here is what we meant to say.

That would, I think, diminish the value of this discussion. It is extraordinarily valuable to hear from you how you read it and especially where you find inconsistencies or that might be viewed as either an inconsistency or a duplication.

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I think that's why we're not giving this specific response to your question.

MS. VIRAG: John Morrissey?

MR. MORRISSEY: No. Thank you.

MS. VIRAG: Arnie?

MR. HANISH: I agree with Ed, actually. I'm questioning why it's entitled scaling the audit for smaller companies. I think if you look at paragraph 9, if you read it the way I read it, that would be all part of a top down risk-based approach. I don't think we want to lead any of the readers or any companies or any of the auditors to believe there should be a separate standard for smaller companies. I don't believe there should be a different standard for smaller companies. There should be one approach.

I might recommend we take out the header or the title as far as scaling the audit for smaller companies and try to incorporate and embed the principles under paragraph 9 and subsequent paragraphs throughout the entire document as opposed to trying to draw a distinction. There should not be a distinction, in my view.

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MS. VIRAG: John Morrissey.

MR. MORRISSEY: Thanks. I guess to answer at least from my view when I read through this section, I completely agree with Ed's thoughts as to why we need this. An appropriately risk-based approach, this should get swept up in that notion.

But I think what I have seen and heard in formal discussions anecdotally was that there was a notion that AS-2 was a one size fits all and the firms as they tried to implement this, had a level or standard that provided a certain degree of rigidity that made it difficult, particularly for companies that didn't have the same robust internal control environments that, say, a larger company might have.

So when I read this, I thought this was the attempt to try to reinforce the notion that one size doesn't necessarily fit all. And I thought in that context, it was helpful.

I didn't interpret this as a, we need a two-tiered standard that we need a big company audit standard and a small company audit standard. I thought it was to reinforce the notion -- at least

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that's the way I read it. When I looked at it as a preparer, that's my take away from reading this section. If that's the concern, I think the points should be taken under consideration by the staff as they craft the final document.

I don't think that was the intent. If people interpret it that way, I think that's probably the wrong interpretation.

MR. RAY: Kimberly Gavaletz.

MS. GAVALETZ: John, I concur with your last statement. You ought to look at how it is stated. If it came across as a multi-tiered approach, I don't believe that was the intent. Everything put in AS-5 -- and those who were in this body last year as I joined the body know I was against us doing anything. I thought we needed to maintain AS-2, continue to go forward, listen to the comments. I felt like -- as has been expressed by Ed and others in the room -- there was the flexibility in the standard to do all the things we talked about from the beginning.

I felt like we were getting a sufficient

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number of comments and I believe that's where the staff thought that some of these things needed to be addressed to answer where there was more work going on than needed to be done. Not to let there be less work, but to allow the people hung up on specific words to see their comments and to incorporate guidance that I felt was sufficient on its own into this standard being separate, which I also thought was sufficient.

That being said, we are at the point where we have something on -- out there, and I think it is there. It is trying to be clarifying. I do believe overall it might have been an overstep to give a new number to the standard. It is implying it is so much more drastically different, and I do believe it was to incorporate some of these subtleties that I believe were already in the document.

Relative to that, I think relative to size, the question that is up here, we already had the flexibility in there. I agree with John. But if that unintended consequence that people see the tiered approach, because I think in some cases

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smaller companies, you may have to do additional work in areas that you wouldn't have done because they were done a little differently.

So we are where we are. I think we have listened to folks. There was the cry for some clarification. The staff has answered that cry. We need to clean up any unintended consequences from that, but move forward without, you know, a major revamp of the activities.

I think that's actually what you presented to us, though it has been labeled in a much grander scale.

MS. VIRAG: We have about five, maybe 10 minutes left on this subject. I'm going to try to get everyone whose tent card is up. Joe Carcello?

MR. CARCELLO: I think in general, the standard is pretty well written. The one thing I would suggest for you to think about, though, is on paragraph 9, the note, footnote number 6, where you make specific reference to size cutoffs.

On the SEC advisory committee, on smaller public companies, I'm afraid that could be misused by

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people. I'm afraid people could look at that and say, well, you're below a certain size cutoff without really thinking through rigorously the issues of complexity. And it is very likely a company could be below those size cut-offs and be complex and really should have an audit scale up and vice versa.

And although the standard certainly talks about that, by putting in specific dollar amounts with the imprimatur of an SEC group, although this was privately funded, I think runs the risk of being potentially misused.

MS. VIRAG: Lynn Turner?

MR. TURNER: I agree with Ed's question and Arnie's answer. I think if you're really serious about a principle-based type of approach -- which I agree with -- I think you start taking yourself very much so into a rule-based approach when you start defining here's the size of companies, putting in numbers. There's no way at that point it isn't principle-based, it is rule-based, and you start to lose it.

I would suggest that a better way to deal

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with that would be right up front, lay out in bullet point, what your key principles or objectives that you are trying to get to which aren't there and I think should be in any principle-based standard.

Tell the auditors, these people around the table, what it is you expect them to achieve. You expect them, first bullet would be, to use risk-based approach that focuses on material items that are, in fact, considered to be the more risky.

Bullet 2, expect them to get enough knowledge about the business such that they can make decisions in light of industry and peer groups. They have to gain knowledge of the controls that are there and put in place.

The third bullet would be based on that, you expect them to scope the testing and perform enough testing so they get evidence from wherever, their own testing, or use others, but they've got to get sufficient testing to provide basis for telling the public whether those -- you know, those controls exist and are working with reasonable assurance.

The fourth bullet on reporting.

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Come back and tell -- here is the objective we expect you to achieve in reporting. This is another area where this is very much rule-based. You give the auditors one reason why is particular type report, you don't give them flexibility. You talk about giving them judgment, latitude to tell the public something about controls if they think there's something that needs to be.

Put those objectives right up front and lay those out. It gives you more flexibility in the later part of the document to have more room for judgment. They know what they have to come back and achieve. It increases your ability to use judgment but tells everybody what they have to get to and what they will be held accountable to at the end of the day.

When you get there, you don't need this two tiered standard which you have in this case, one for small, one for large.

I certainly encourage you to go down that path.

MS. VIRAG: Gaylen Hansen.

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MR. HANSEN: As I said earlier, as Arnie pointed out, I think maybe changing that title to make sure that people don't get misled, that the scaling related solely to small companies would be something to -- footnote 6, I don't understand what that did anyway. It is sitting there. Sort of gives you an idea of sizing. But how it translates to the standard, I'm not quite sure.

The only other point I had to make on this particular issue was I think the same thing could be said of the multi-location testing. At the point -- back on -- in AS-2, when the standard sort of said that you had to cover a larger portion, and then that's taken back, that's in the same boat with what Ed's talking about.

This is risk-based. You're going to make those decisions on all locations. Under that sort of principle-based approach, that wouldn't be any different than any other scaling decision.

MS. VIRAG: Bob Kueppers?

MR. KUEPPERS: I wanted to pick up on a comment Kimberly made about not needing to renumber

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the standard. I don't think anybody has picked on Ed yet. I think we should call this AS-2-R and I think it should be just fine.

MR. TROTT: Which firm are you with?

MR. KUEPPERS: One substantive comment. I hear the debate about the -- I don't believe this is two standards in one cover. I really don't. The question of whether or not you should call out or have separate importance to the smaller company, I think is one that is the result of all the sensitivity and the politically charged environment around this.

We know the SEC is determined not to exempt. We have to find a way to make sure the thousand companies that are not yet in the system have an audit approach that is AS-5 compliant at the end of the day.

The one thing this might provide, though, is a portal to plug in additional guidance at the small end of the spectrum. I'm not talking about size. I'm talking about complexity. I think that's the biggest driver. I think it might be helpful if

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all the audit firms that have not done one of these audits yet because their clients are in the non-accelerated filer category, additional guidance for getting it right at the less complex company level, this would be the place in the standard that guidance would sort of plug in.

I think that small business audit guide, even though in principle I'd love to have one thing and have the whole continuum be scaling. I think we need to provide extra help for a big part of the population that is not in the system under 404.

MS. VIRAG: Damon Silvers?

MR. SILVERS: First, I want to echo what Bob just said about the appropriateness of that kind of guidance for the non-accelerated filers. I think that most investors look at the non-accelerated filers and say we want the same principles to apply to everybody, but in real life, when people are doing things, it looks different when you talk about a company of 30 people than a company of 30,000 people. That's just a different thing. There ought to be some help to the firms and to the companies that

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are -- will be engaging in that. We believe it is important they engage in it. That kind of help would be a good thing.

The -- I also think the point -- I want to support the point John Morrissey made about why this section is in there. I think that it's -- while it is correct, Ed's analysis is correct at one level. Ed isn't generally correct at all.

But in this respect, there is a point to this which is about the fact that many people of good will in the preparer community have felt as though they've operated in an environment under AS-2 in which there's nobody listening to the realities of their business and the relative complexity or lack of complexity of their business.

I think it is important for the integrity of the whole process that those concerns be taken seriously and addressed. I think that's what this section tries to do. I think with some degree of success.

The issue that remains, in my opinion, about this section is the potential for the

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misunderstanding that this section constitutes, as I think Bob just said, two standards under one cover.

There's got to be absolutely no ambiguity about that question. It is one standard. Right. It provides -- allows the auditor of the mega company to think about the relative complexity of the mega company compared to other mega companies, but does not give any special breaks to the auditor of the small company in terms of the standard.

So I think to the extent that the title, for example, leaves any ambiguity, that title needs to be altered.

I also think with respect to the footnote issue and the issue of throwing numbers any place, there needs to be greater clarification that while certainly numbers like market cap and total revenue are relevant to the question of complexity, they're not determinative.

MR. COLMAN: I just want to support what was said by Bob and Damon, to be able to say there's a standard and a standard and scale it all the way down. That said, there's unique characteristics,

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having guidance -- I know it is here -- whether there's other guidance being worked on, I think could be helpful.

Specifically, though, I think we had a lengthy conversation about the risks of company level controls, and the degree of directness or indirectness, the risk of how much that would either drive no testing or the nature, time, and extent of the type of testing of process level controls.

I would ask that you take that conversation and marry it to what is in paragraph 12 about whether or not we are helping or hurting in some of that.

MS. VIRAG: The next subject is a discussion of the differences between management's evaluation process as management would follow it based on the SEC's proposed guidance and the process the auditor would follow under the board's proposed standard. The question is would management's process for evaluating its internal control under the SEC's proposed guidance and the process the auditor would follow under the board's proposed standard raise

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implementation difficulties for the auditors or management? If so, how can these difficulties be addressed or managed?

Howard Johnson?

MR. JOHNSON: Silence is golden on this. I haven't spoken to anything yet and I thought this might be a good one since there's a break in the action here. The interesting thing to me on this SEC is now for management to allow other forms besides testing of controls, following things like monitoring just daily interaction.

First of all, there's a lot of value to that. I think we hit on it this morning. Craig mentioned more than once that we have to get the auditors out of the box and do other things besides just appear to be too far down in the details.

And there's a lot of stuff you can do for monitoring of the control environment. You still need to take a look at it once in a while to make sure there isn't something that's changed significantly and also do things like analysis to see what's going on outside the bell-shaped curve, really

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weird stuff. Either too good to believe or just off.

Some of that stuff you get through doing things like monitoring. Not just testing.

So I kind of have to say I like the SEC's extra verbiage and allowance. I think from being down in the details, seeing what's happened both on management's side and public accounting's side, when I was with Lowe's, it is a big sigh of relief to have other options than doing testing to make sure the control environment is really what it appears to be.

MS. VIRAG: Kimberly Gavaletz?

MS. GAVALETZ: I would agree with Howard's comments relative to a broader spectrum of evidence that supports -- that management has a control environment. The one concern I still will echo to the group is keeping the ever increasing potential for divergence between what the SEC guidance is and what the PCAOB's.

This reconciliation going forward is something we're going to have to be very vigilant about. I applaud the SEC for keeping it sufficiently almost principles-based. I know there's a clamor for

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more detail from others. I would hesitate in telling people exactly how to do the things. I think you tried to do that. I hope we don't keep doing that. I think that gives more potential for things to diverge.

I would just lay out as an indirect answer to this, as we stand right now, there are kind of the right levels, but I see that it exists out there, there's the potential long term and we're going to get very -- to not let that occur and keep the reconciliation and test ourselves before either is released on making sure those are clear, so we don't confuse the management side of the things that are trying to implement. And then the external auditors who are trying to assess management and then getting things out of sync. We do have the potential for that.

MS. VIRAG: Randy Fletchall?

MR. FLETCHALL: There clearly are differences between the PCAOB's proposed standard and SEC's proposed guidance. But let's face it. Management is in a different place than auditors.

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They are there every day. They are running the company. It makes sense. One of the criticisms before was auditors were driving management to do things because there was only AS-2.

To the extent there are differences, that's probably good. A concern would be if there are so many differences that people can't communicate and we have gaps or duplication because as we manage these total costs down, I can go back to, Charles, what you said earlier, about your role as an audit committee member.

We think it is terribly, terribly important to make sure there is a thoughtful collaboration between management teams who we might have turned into auditors, let them manage, but take on the responsibility they have under 404 and certifications as Bob said to do what they do well. There is optionality, flexibility. All the effort might be reduced in some way, so what a management team chooses to do will have an effect on what an auditor does. What we are preaching to our people is a thoughtful collaboration, sharing of details,

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collectively management does its job, auditors do their job, and collectively it is done in the most efficient manner.

MS. VIRAG: Vin Colman?

MR. COLMAN: Just adding to that, we are doing the same thing. I think there should be differences. That's a good thing. I think it will affect the process for which there's been so much criticism, meaning to make sure you understand what has management done in their process before you start even the assessment that's in AS-5. Understand what they have done. How they support their assertion.

And it could assist in many aspects of AS-5 whether the nature, time, and extent of what you're going to do, your risk assessment, the use of work. Others, time -- there's a lot of areas that will affect.

We're going to educate our people to try to understand what management is doing first and engage in that rather than run first, decide what you're going to do, and figure out how you can reconcile back to management. That would be a bad process. I think everybody agrees with that. Some of this is like we talked about this morning around the implementation.

That said, there are a couple of areas where I do think it would be helpful to have just from an efficiency standpoint, whereby when the auditor comes in, they're speaking from the same song card. One was -- we touched upon before, the discussions around the entity level of control, the degree of precision in the PCAOB standard and the documentation that is in the SEC standards. Elements in both of them are very good. I think coming together would really help the process ultimately from both an effectiveness and an efficiency kind of standpoint.

Second, around the strong indicators of a material weakness. There's breakages between the two. I think some people could think there are subtle messages being sent through there. I'm not sure there are. I think it needs to be -- have collaboration about -- so that the management's trying to decide what are material weaknesses and

what an auditor is trying to decide. Quite frankly, they should be aligned.

MS. VIRAG: Leroy Dennis?

MR. DENNIS: I want to expand a little bit on what Vin said and what Lynn said earlier. Lynn talked about putting principles in the introductory part of AS-5.

I think having the same type of understanding of the SEC guidance would help to make sure the two standards are aligned at least in principle and would serve to eliminate any confusion that they are not.

MS. VIRAG: Bob Tarola.

MR. TAROLA: Thank you.

This one worries me.

I was glad to hear from Randy, Vin, and others words like collaboration, engagement, and sort of working together to identify the important risks and the way risks are mitigated. I think that's a healthy exchange that I don't think has existed to the degree necessary in the past, and I think this will drive that.

I further believe that the discussion of important risks should be held with the audit committee to make sure the management team and the outside auditor are in line -- or in alignment as to all of the important risks. And, in fact, how they're going to be -- how they are mitigated and how we will each do our job in making sure that we can provide a certification we have to provide.

The -- heretofore, there has been very little collaboration. It has been pretty much a gotcha situation. My hope is we can somehow avoid that and management teams and auditors could basically work together to protect investors by agreeing on important areas to review and complementing each other in some way toward achieving satisfaction that risks are appropriately mitigated.

MS. VIRAG: Jeff Steinhoff?

MR. STEINHOFF: I think it would be normal to have some differences in the way this is stated to the respective parties. Management has a much different responsibility than the auditor has. And it's important that management realize that it is the

one responsible for ensuring there be adequate controls. It is a fundamental management role.

It is not a process management should be going through to comply with what an auditor wants. It is good business practice. It helps protect the business as well as the shareholder. But it is a fundamental management responsibility.

So if that is always placed in mind, then the auditor's role is to provide a check over whether management is reasonably carrying out its responsibility and it shouldn't be the auditor driving management. And both parties should be really having a constant dialogue as to those things.

We have faced some of that at the federal government, where management just solely wants to find out what does the auditor think. So if the inspector general or GAO has issued a report, management will jump right on and report that as a weakness. They feel in some quarters as long as they have done that, they are compliant with the laws. That is very far from the truth.

They have a responsibility to assure on an

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ongoing basis that things are working well, and I think that it's all right for the language not to be exactly the same in every paragraph. And as long as there's a clear understanding, I think this can work well.

MS. VIRAG: Any other comments before we move on?

I think we're going to break for lunch at this point a few minutes early. If everybody could meet back here at 1:20 that would be great.

(Whereupon, at 11:51 a.m., the meeting was recessed, to reconvene at 1:20 p.m., this same day.)

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AFTERNOON SESSION

(1:20 p.m.)

MR. RAY: I would like to restart the meeting since most people are sitting down. If the remaining few could please take your seats, I will turn this back over to Sharon Virag to continue our discussion on internal control.

MS. VIRAG: The next topic for discussion is using the work of others. We have two questions. You can take them in any order you like.

First, does the proposed standard meet the objective of removing unnecessary barriers to using the work of others?

Does the proposed standard promote better integration of the audits?

Joe Carcello to start us off.

MR. CARCELLO: Since no one else wants to talk, I'll take the microphone.

Again, I think what you have here is reasonable in many ways. I guess the one concern I had is in AS-2, at least my read of AS-2, there was a clear demarcation in my mind between relying on the

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work of management and relying on the work of internal audit, particularly internal audit that follows the standards for the professional practice of internal auditing.

I thought that was a good demarcation. That seems to have gone away in AS-5.

In the discussion paper you gave us to prepare for today, you have a statement in there essentially focusing on competence and objectivity, which I agree is the focus. It is not on the job title. I agree clearly that is by far the least important. I don't know if I completely would ignore it. In my mind, job titles do matter somewhat because they create a mindset.

I think there is a fundamental difference in mindset between internal audits and management because they may involve compliance with a set of professional standards. When you rely on the work of internal audit, there's in many cases a set of professional standards, a certification, a code of ethics, a code of responsibility that those people in many cases have internalized and they're also bound

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to observe.

That's not necessarily the case when you rely on management. So I think kind of equating them is potentially dangerous.

I think the language that you had in AS-2 was in many ways better than what you have here.

MS. VIRAG: John Morrissey?

MR. MORRISSEY: I would like to -- first of all, I agree with everything Joe just said.

I think looking back on my days as an internal auditor, the internal audit function can be very, very valuable to an organization. As you mentioned, they have their own ethics requirements, professional standards; and in a properly structured, organized audit function where they report directly to the audit committee, they are in many ways accountable to the audit committee and investors directly.

I think this is something that really deserves serious attention and recognition that it's worth investing in an internal audit function from a public policy standpoint. And to elevate them --

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because they are different from management, they should be treated differently from management.

I think the opportunity within the standard to call them out and give them expert recognition when properly structured, when properly trained, when properly organized, provides an opportunity for management to invest in good internal controls at the most important level, and that's at the people level. I think if you look at this, you can't come out strong enough in order to encourage that, at least in my view.

MS. VIRAG: Gaylen Hansen.

MR. HANSEN: When it talks about whether the auditor accepts the testing of another individual, it needs -- I would hope that it would be a little bit more specific. It says some testing is required. Some testing seems a little vague to me in terms of the extent. I don't know if you want to get that cookbook-ish about it, but I think something more than "some" would be a good direction.

MS. VIRAG: Kimberly Gavaletz?

MS. GAVALETZ: One comment on the section

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that really started to deal with this, in removing the barriers to using the work of others where you address the principal evidence.

I just wanted to comment that I agree with eliminating the principal word and evidence because it is the right level of evidence you need for whatever is there. I think principal evidence, that goes along with everything was causing some behaviors, that meant you couldn't rely on the work of others to the extent if they had what they considered the principal evidence, you had to redo that particular work.

The importance is understanding the fidelity of the evidence, understanding the quality and qualifications of the person making that and the objectivity of the partner making those judgments.

I think you did help clarify some and remove barriers with how you addressed that particular area under principal evidence.

MS. VIRAG: Joe Carcello?

MR. CARCELLO: Let me respond and follow up on what Kimberly just said.

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I'm a little concerned with the principal evidence provision being eliminated. It's not necessarily that I think that the wording in AS-2 was necessarily right. Again, I always kind of go to the end point and worry about the potential consequences.

I asked some people this yesterday; let me pose this to the group. If management personnel appear objective and competent, could they gather the principal evidence, and not just for the audit of internal control but for the financial statement audit? That really worries me.

With the audit of internal control, if we do not get that right, that doesn't automatically mean there's a misstatement in the financial statements. But if there's a problem with the financial statements and we don't get it right, there's no backstop, no safety net. It is a change not just for ICFR but a change for the audit of the financial statements.

Here we're saying we can rely on management to essentially do the work to audit the financial statements if they appear objective and

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competent. If so, if that's true, what do we need the auditors for?

And roll back the clock to the late Nineties. Don't you think most everyone would have described Mr. Fastow and Mr. Sullivan as honest, as competent, if we were sitting here in 1998?

MS. VIRAG: Sam Ranzilla?

MR. RANZILLA: I'm not prepared to answer that question, Joe.

(Laughter.)

MR. RANZILLA: Hypothetical.

I'd like to address two things. One is the concept of principal evidence and, secondly, the proposed auditing standard on the use of the work of others.

With respect to principal evidence, I support the elimination of those words. My own belief is the elimination of those words doesn't do much, if anything; and if they were driving behavior that wasn't appropriate, which I think at best is anecdotal evidence, then I think that's fine.

There's been a notion of principal

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evidence in the auditing standards long before Auditing Standard No. 2; and it will continue to be one of the implicit standards in an auditor's ability to sign an auditor's report that says in my opinion -- not in the opinion of management, and not in the opinion of the internal auditors -- but in my opinion, these financial statements are blah, blah, blah, or this internal control is up or down.

So while I support the notion of removing the words "principal evidence," I don't think it's changed the auditor's responsibility with respect to its ultimate objective.

With respect to the use of the work of others, I don't support the issuance of standard number 6, if we're going down that path. I think that the board has made the appropriate changes through auditing standard number 5. If there were impediments to the issues that might have been leading to less than optimal use of others in an internal control audit, I think those have been amended; and that coupled with existing auditing standard number 65, I think is, in my belief, exactly

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where we want to be with respect to the integrated audit.

So I do not support the proposed standard.

MS. VIRAG: Lynn Turner?

MR. TURNER: Once again, I'd agree with those last comments of Sam.

I think the current standard that we've got up there is fine. If you decide to go to in the direction that you're headed, then I think you got to couple it with being transparent to investors. I think you need to first off clarify in the standard that takes any of the burden off the auditor to ensure they gain sufficient evidence that they themselves have enough that they can conclude, and that we're not going to hear cop-outs later on about "well, that was done by the internal auditors" or anything like that.

So I think you need to make it very clear. I would do that, once again, by going and laying the principles out right up front, in bullet form, and note that one the principles is you have to get enough evidence from the testing to form your own

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conclusion. You know -- at the end of the day I don't have a problem if people want to use internal audit. And pursuant to what John said, it is -- to the internal audit department, because we know we have some that are very good and some that are really lousy and some that are somewhere in between.

That's where I think the SAS 65 on use of specialists, as it exists, is already very good. It talks about those situations and how you have to deal with it. I don't see this as being an improvement on that. I don't know why you do it. That's why I agree with Sam.

But then I would come back and say in the report, if you're using someone else to do part of your work for you, I would like to know that as an investor. Just as we require the auditors to tell us if they're relying on work of others on the audits of the numbers in the balance sheet or income statement, and we note that, I think they should note that here, too, and give us a heads-up.

I can only think of one reason you wouldn't be able to tell us and that's not a good

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reason to leave it out in the first place.

MS. VIRAG: Damon Silvers?

MR. SILVERS: I think there's a principle here that the board ought to follow in relationship to these issues, which is the principle of the integrated audit. That the degree of reliance which an auditor can place on the work of others in the control audit ought to be conceptually the same degree of reliance an auditor is allowed to place on the work of others in the financial statement audit.

I don't know the terms of art that get you there, but I think that's the principle that you ought to be following.

I think that the creation of a separate standard on the work of others would suggest something else is going on; and so I don't believe that that's an appropriate thing to do.

And I believe, by the way, that this is an area where a great deal of danger lies. I would call the board's attention to the words of the statute, section 404 which -- an attestation as to the truth of the assessment by the independent auditor.

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That points at what's really going on which is the independent auditor is slapping their stationery on management's assessment. At that point, somebody is violating the statute.

And the -- more -- from law to real life, right? -- the risks that everyone involved in creating such a situation would bring upon themselves would be very dramatic, in relationship to the day when a large company would explode as the result of such a thing.

I can guarantee you if that were to happen, and if somebody cab walk into a courtroom with a defense lawyer and point to the standard, and state, "the standard allowed me to rely on the preparer; I should be able to walk out of this courtroom free of liability and not in handcuffs," I can guarantee you the judge will say that standard is inconsistent with the statute and whatever you say those words mean, they don't mean that.

It would be far better to get the words right in the first place.

MS. VIRAG: If there's no other thoughts

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on that -- Marty Singer?

MR. SINGER: I might have some confusion about this point. When I read it, I was a little confused. I'm a little confused by the discussion.

When we talk about the work of others, we had a discussion, I think two meetings ago, about whether there ought to be different standards for the work of specialists who were internal versus external. And it seemed that there was a potential of having some unnecessary barrier to having work done by, let's say, an internal tax specialist.

What I'm unclear on is, is there actually an objection here to having an outside audit firm rely on the work of others in the area of cycle counts of inventory, tax, or other preparation?

And, indeed, isn't one of the goals of Sarbanes-Oxley to impose a standard of excellence on your internal finance capabilities, so that more of this work is done internally?

It may be that there is liability in having an outside auditor rely on some of that work. On the other hand, it is a reasonable expectation

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that management develops its resources to accomplish this work.

I am really confused. I know Mark mentioned earlier he's reluctant to have people from the PCAOB comment on this; but I would actually like some helpful comments in this area about the degree to which we're discussing this.

I mean when we audit, for example, inventory, is there really a question about your public company auditor being able to rely on the work of others in cycle discounts? Or are we going to drive that level of work up to an outside vendor?

So I have perhaps some misunderstanding of this issue, and understanding the degree, but some of this discussion seems a little bit contrived as a real world problem, at least to me.

MR. RAY: Let me comment just very narrowly. I think your example was a good one. The cycle account example, as I read the standards currently, my reading is if the cycle accounts are done periodically throughout the year by internal auditors, the independent auditor may look at that

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work and evaluate it and decide whether they're going to use that work as it relates to the nature, time, and extent of work they need to do with regard to the existence of inventory.

I think if that work was done by somebody else, it's unclear as to whether the auditor would be able to use that work.

But I'd certainly welcome other views on that point under the existing standards again.

MR. OMTVEDT: May I offer you a perspective on that and stay with your cycle count example? At the end of the day, as a starting point, the cycle counting is part of our management controls just to be comfortable that our inventory systems are working.

I think one needs to differentiate between what's happening in the normal course of day-to-day activities versus perhaps a situation where we have the internal audit group going in to an audit on a management location to test the quality of the controls.

I think you really have three tiers here.

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The day-to-day activity, the -- separate to John's point earlier -- the independent assessment of those controls by a qualified internal audit group, and then whether or not the external auditors can place reliance on the work of the auditors.

I hope that helps.

MS. VIRAG: Lynn Turner, I think you're next.

MR. TURNER: The question that Martin poses here, though, is an interesting question. If you look at the companies that disclose material weaknesses after their first implementation of S-OX 404, including the external auditor requirement, about 95 percent of management certified that the controls were effective, right up to the last interim period before a control weakness was disclosed to the investors.

And so the question becomes, since that's almost the entire population, just 5 percent short, would you under this standard be permitted to rely upon that 95 percent of management that had it wrong right up to the very last quarter? And why would any

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auditor in their right mind be using that work by the management team, because presumably they were doing some testing or whatever to get to the certifications? And it absolutely fell miserably.

Why would you under any circumstance permit the auditors to rely upon it? That's why it comes back to what John so appropriately said, of it needs to be focused on an appropriately constructed and staffed internal audit team. And as Sam said, go back to the requirements that already exist or, are not always working, but seemed to have move us along out of the current SAS.

MS. VIRAG: Jeff Steinhoff?

MR. STEINHOFF: Of course, I guess I see this as part of the overall process one has for assessing risk. So I think the auditor would find out what management does on a day-to-day basis to assure itself it's running its business in the proper manner, as I mentioned prior to lunch, I view the internal control as management's responsibility, as to management's advantage that it does this well.

Not to be compliant per se with

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Sarbanes-Oxley, but to run its business in an efficient, effective manner.

In looking at the proposed standard, it doesn't appear to me like the PCAOB is saying that the auditor doesn't have any responsibility here; they just take somebody else's work. I'm reading to it say that the auditor is, in fact, responsible no matter who does the work; and they don't share this responsibility.

And if you look at -- I forget the section it is -- section 9, the auditor must obtain sufficient, competent evidence.

If you go to 10-B, the auditor must evaluate the competence and objectivity of the individuals. It lays out risk factors considering the use of this other work.

If you go to paragraph 15, it appears really to be saying that largely we expect you, if you're using work, to be using the internal auditor's work.

So I guess I viewed this as a reasonable way to approach this and provide a framework to the

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auditor to consider a range of other work that may or may not be done. If the auditor went in and found that management did not have an internal audit function, management was not reviewing its own controls, or doing its cycle accounts, the auditor would consider the control environment not to be very good.

If the auditor found they were doing this, they would certainly factor that into what testing they may be doing. They may elect to observe a cycle account or two; but I don't see in the standard that it's really even implying that the auditor could just simply say -- you know -- Marty's having these cycle accounts, therefore I can rely on that.

I think the standard says I have to have competent evidence at the end, and I can go about having competent evidence in a variety of ways; and it's not saying I have to go count every cycle or inventory every item. But I have to use my professional judgment in considering risk in making that determination.

So that's -- I think this is really a

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reasonable approach to doing it; but it does not take the responsibility off the auditors or shareholders at all. At the end of the day.

MS. VIRAG: Marty Singer?

MR. SINGER: I agree with those last comments. I do want to comment on Lynn's statistics. We had this discussion before. It is not surprising after the implementation of Sarbanes-Oxley and 404, there were disagreements between management and outside auditors on what was acceptable. The game changed. There were new definitions of process. So these statistics are somewhat artifactual.

The other issue is, of course, a lot of these discrepancies revolved around the process associated with smaller companies, an issue this group is less and less sympathetic to, as you want to get rid of any sort of departure from one size fits all.

But the issue, of course, for smaller companies was the issue of materiality, another issue we discussed. I was talking to Vince earlier, and he mentioned this as an important issue. You have small

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companies with GAAP earnings near zero and, for example, in our case, we had a $50 million antenna business, $2 million inventory. $50,000 of discrepancy was a material weakness, because it wasn't mentioned against the asset that was important to shareholders, it was measured against GAAP. Okay? If we are losing a whole lot of money it would have been immaterial.

That was one of the delights of this whole process. There were definitions of material deficiencies or weaknesses that I think were somewhat artifactual; but again, I agree with these last comments. It doesn't suggest at all that the auditor abdicates responsibility. What it suggests is that you have learned competence on the part of management in these areas, not learned dependence.

And management has to be for improving its processes. Here it is like cycle counting and other audit practices.

MS. VIRAG: Vin Colman?

MR. COLMAN: You know, I just thought it has been mentioned a couple of times in the confusion

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about perhaps the paragraph on -- paragraph 9 which is sufficient competent evidential matter. Marty, your point, Sam raised, if standard number 6 is going to stay, to bring these concepts -- and Lynn brought this up -- I just thought it might be helpful to know what it says. It might help this conversation a little bit.

It basically says for assertions related to material financial statement, where a risk of material misstatement or degree of sub-activity involved in the evaluation of audit evidence is high, the auditor should perform sufficient procedures to fulfill the responsibilities described in earlier issuer opinion. In determining these procedures the auditor gives consideration to results of work, either test of controls or substantive tests performed by internal auditors, and those particular assertions, however, for such assertions, the conversion of internal work cannot alone reduce audit risk to an acceptable level to eliminate the necessity to perform tests of those assertions by the auditor.

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I think this is right on point to what is missing -- performance -- in AS-6 to clarify it. It is very subtle in paragraph 9, where you need to obviously have sufficient evidential matter to issue your opinion. This perhaps would clarify.

I think this is the point at when people are simply saying could you go back to what was in the old standards, I think that's what they mean by it. It would be a really helpful clarification.

MS. VIRAG: Damon Silvers?

MR. SILVERS: I think the issue facing the board is the question, not of whether or not we want to build internal competence within issuers; I think we all do. Marty's question is yes, we want competence here and want technical strength. But the dilemma that faces the board what is to do about essentially the fact that no matter how good you are as an internal auditor, you are not the independent auditor.

And how to guide the independent auditor in such a way that they can both make use of information that's generated from internal expertise

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without confusing this question as to who is independent and where the ultimate responsibility lies.

And that's a challenging task. It is why in my earlier comment, I said you need to keep your eye on the notion that there's a kind of -- there needs to be an integrated audit standard here, guided by the audit profession's sort of historical sense of how to do this in areas other than internal controls. I think that's the right way to think about it. I don't know what the words are that you need to write to implement that.

On the other hand, I think we need to be cautious about sort of assuming, for example, that all kinds of terrible things are happening around this -- different. For example, if you're dealing with companies that are not profitable, losing a lot of money, then you can easily measure materiality in that circumstance.

But my understanding is if it is a break-even kind of situation, that the materiality standards in terms of the company's finances, of what

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constitutes a material event, if I have a company with $200 million in revenue and it is break-even, profitability zero, that does not mean each coffee spoon is a material event. You look to other measures of materiality in that circumstance.

And I think that's sort of the way it is. Maybe somebody has the misfortune of dealing with people who don't know the standards. But that's how it is. And that kind of common sense stuff is the way this ought to be guided.

MS. VIRAG: Ed Trott.

MR. TROTT: Marty, let me say I think respectfully -- whatever that word is -- I think you are confused.

The fact that I hire a very competent tax person or a very competent inventory person who might be able to do a great job in preparing a financial statement or might be able to do a great job of having an internal control system that includes cycle count is one thing. But using the work of others I believe is -- the work of others in helping the auditor gather the evidence to be able to opine on

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either the financial statements or the system of internal control.

I think you've confused the need to increase the competence of the persons preparing the financial statements, the competence of the persons being part of the internal control system, and the role that the auditor has to play in their audit of either one of those in gathering evidence.

MS. VIRAG: Bob Tarola?

MR. TAROLA: Thank you, Sharon.

My concern here is the slippery slope concern. In my experience, anyway, I found that I generally got burned when I relied on someone else and didn't -- because they were a known expert, and because of that, I didn't do as much diligence as I might otherwise have.

I think it is proposed for external auditors to rely on the expertise of others, either inside the company or experts that the company engages, such as actuaries; but I think there has to be an air of caution. I think the words in the standards have that caution. So I didn't in my own

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thinking think it was a problem. I thought it was the right balance.

But I think I would like to see the diligence continue that the auditor as well as the financial statement preparer and certifier have -- do enough due diligence on the work of other parties to take responsibility for it.

MS. VIRAG: Arnie Hanish?

MR. HANISH: I guess I'm a little confused in listening to the dialogue. As I read the proposed standard, personally I'm rather comfortable with the way it is stated.

So I would support the board in its progress to using the work of others, especially as it relates to the opportunity to utilize the work of others to reduce the degree of testing as it relates to internal control testing by the auditors. And I think this is clearly one way where we can see some efficiencies and hopefully more effectiveness in the internal control process.

So I guess I'm a little confused as to where the tone and tenor of the discussion is headed.

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That's -- whether or not those of you that are sort of articulating some of the points are suggesting that we should throw this out? Or maybe I'm just misunderstanding the direction that is being taken here.

But I certainly support it and would hope we would embrace it as a step forward to be more efficient and effective at what we do in conducting the audits of internal control.

MS. VIRAG: Randy Fletchall?

MR. FLETCHALL: To that point, Arnie, I thought Ed said it very well, in terms of describing the difference between the preparer and auditor. I think the proposed changes, proposed standard to replace AS-2 does as said remove -- if there were barriers before, if there was a mindset one had of using the works of an internal qualified audit department, I applaud those changes. It is good to get rid of anything like that.

Where there is confusion, though, in the new proposed standard on using the work of others, this seeking out relevant activities of management

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would suggest there's something there besides the competence and objectivity and controls they have in place to prepare financial statements, and suggests there's something else out there.

Again we're chasing this Holy Grail. You would have considered those other things in making risk assessments to start with. I think it is promising there's something more there that we could take and use. Now in a bank situation you might have something -- you might have a credit review department.

But I think it promises maybe there's something else out there that management is doing that would constitute ^ designation alter ^ audit evidence, and I think as we look -- we are having trouble finding where that would be. That's where we are comfortable with the existing standard on using the work of others but the changes to AS-2 that remove any barriers that might have been in existence with respect to internal control.

MS. VIRAG: Unless there's more comments, I think this will wrap up the subject; and actually

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all of the five topics we have selected for discussion. Thank you. Do you want to slip one in on this topic? Joe Kellas?

MR. KELLAS: I was sort of waiting for the discussion on barriers to be ended and then take the final question. I'm not sure if you're wrapping up the barriers.

MS. VIRAG: I was going to wrap it all up. I thought we got through both of those. We would love to hear from you.

MR. KELLAS: One point on integration, maybe this is why not much has been said on it. It is not easy to answer on the back of the proposed draft because it depends on what is in the other standards in relation to risk assessment and so on.

When I read the draft standard, I noticed references to risk of material weaknesses; and so the language of risk assessment has been transplanted from assessing the risk of material misstatement to assessing the risk of material weakness.

Now, in simple terms, a material weakness is a state of affairs where the risk of material

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misstatement is too high to be acceptable.

So you now are talking about risks of a risk. And I just wondered how that integrates with what you have on the other side of the audit about risk assessments?

So that's where I would ask myself: Is there a true integration of the two standards; and is it a complication to be starting to talk about risks of material weakness as opposed to risks of material misstatement?

MS. VIRAG: Okay. At this time I would like to open it up for any other discussion points on auditing or on the proposals, analysis. We didn't scope the subjects, but if you have other comments you would like to make at this time please feel free.

Rebecca McEnally?

MS. McENALLY: Thank you. Just s very brief and a very general comment. A small proposal to think about here.

The discussion today has been quite interesting. I think it has been very helpful in identifying potential confusions, areas where

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misunderstanding could occur, with resulting audits that are less than we'd like them to be, and also difficulties in auditors working with managers at companies.

But I want to raise something slightly different. Lynn Turner raised an issue that I think characterizes a lot of issues in this particular area.

The audit of internal controls has been around forever. When I was teaching auditing decades ago -- not quite that long -- it was an issue. It was in the text. It was something we taught. Yet in practice, somehow, it was not at the top of the list in most audits.

What Lynn was really saying, I think -- and he will correct me if I'm wrong -- is that in the area, for example, of top-down, risk-based audits of controls, we haven't made all the progress we would like. We've been doing it for 20 years, but we're still seeing problems.

Perhaps -- and I hope it is certainly true -- we are seeing fewer problems than we would have

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seen six years ago. I do fervently believe that. But there are still problems.

I see this as an opportunity for us. The opportunity I see is that the PCAOB in its normal day-to-day operations and functioning has a vast amount of data. It has a lot of insight into what is going on in the audits; and it has an opportunity to move beyond the analyses that it is currently tasked with doing.

I would like to see these analyses where there are serious problems emerging, serious failures, certainly serious failures, but other problems as well, carried beyond the point of whether an auditor failed to pick up on a problem in revenue reporting, and whether that got corrected promptly and whether that problem appeared later.

I would rather see that, in addition to that, the whole process gets carried one more level, one more step.

Why did the auditor fail to pick up? Was -- and I -- at this point we get into touchy territory. I'll say a couple of words; you please

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fill in some more silently, please.

Was it a matter of competence? Was it a matter of experience? Were the incentives all wrong? Just exactly what was going wrong here?

Because until we approach that problem -- which is really basically an issue -- we're not going to know what we need to do to ultimately improve our standards and to make certain these things aren't happening, or at least to provide as much assurance as we can. We can't get to zero.

You have within the PCAOB I think the capability to do it; but it's my understanding that it's not going quite that fast.

Let me be quick to say before anybody gets excited here, I wouldn't -- I know what's going through the minds -- I would not want to see this as part of a criminal or civil proceeding. That's not the proper place. What we want is a learning process and, therefore, a revision to the work that we're doing, an improvement of the process and not primarily a fault-finding process.

So I would encourage the -- those in a

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position of authority to give some consideration to it.

Thank you.

MS. VIRAG: Cindy Richson?

MS. RICHSON: I have a question that is a follow-up to what several SAG meetings ago where the topic of limitation of liability provisions for auditors was discussed. This is actually a question I would like John White or Conrad Hewitt to address if they wouldn't mind.

I have heard and seen press accounts and references to speeches that the SEC was considering incorporating limitation of liability limitations into AS-2. I wonder if that's true. I would like to say for the record if that is true, which I hope it is not, that would be a significant detriment to the investing public and would significantly take away very important checks and balance in our existing system.

MR. HEWITT: Thank you for the question. I believe the SEC probably will not have anything like you described in the past. The SEC does

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exercise safe harbors in some of their rules such as the designated financial expert, which I was for three public companies. I was glad to see the safe harbor, as a person, that my liability would not exceed that of any other board member. I think that's the type of thing that should be exercised by the SEC.

We don't have any other plans to do things like that in AS-5.

MS. VIRAG: Jeff Carcello?

MR. CARCELLO: These are from the auditing standards committee of the auditing section of the IAAA. They forwarded me their comment letter and asked me to consider if there's anything I want to incorporate into my written comments.

One deals with a change in consideration of weaknesses; and the AS-2 had language "more than remote" and now the language has changed in the new standard to "reasonable possibility."

And the board may want to consider -- there is actually research on this -- as to how auditors operationalize these terms. And you may

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want to go back and look at a 1994 paper by Amir Hackenback and Mark Nelson. And the median probability that audit managers use for the term "remote" is 10 percent and the median probability that audit managers use for the term "reasonable possibility" is 60 percent.

That's a really big difference. Is that, in fact, what the board really wants to put in place if, in fact, audit managers are operationalizing it in that manner?

Now, they don't have to. One of the questions you might want to think about is, is it really appropriate to use the FAS 5 framework in the standard?

I know the first SAG meeting I came to I referenced that framework. I think somebody had a comment, something to the effect that it was garbage. And so you might want to think about whether, in fact, that's appropriate.

The second comment relates to a strong indicator of a material weakness being a lack of an independent audit committee. And you make it very

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clear in the exposure draft that pertains to companies where the listing standards would require an independent audit committee.

The question then I guess is even if you're not required to have an independent audit committee, the COSO framework when it talks about control environment, which is typically the framework that's going to be used, strongly emphasizes an independent board, an independent audit committee as a major feature of a control environment that's effective.

And maybe more importantly than that even, there's extensive research that finds an overwhelming direct relationship between independent directors and a lower incidence of both fraud and misstatements. I refer you to work by Patty LaChow in 1996, Mark Beasley in 1996, and David Farber in 2005.

MS. VIRAG: Damon Silvers?

MR. SILVERS: You know, to Cindy Richson's question and ^ Con's response, I want to add something that is very important here.

Everybody knows and it is appropriate that

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the SEC and the PCAOB interact a great deal on the issues that they mutually face. And that that occurs at the staff level, that occurs at the board level. That's fit and proper and healthy.

However, there is, I think, a constant danger given just the way the Sarbanes-Oxley Act is structured and the formal relationships that exist between the commission and board, there's a constant danger of inadvertently people at the Commission saying or doing things that might be perceived as undermining the autonomy and independence of the PCAOB.

I think from the investing public's perspective, this is exactly what we don't want to see. It doesn't do anyone any good when that happens. And it is not a question necessarily even of the reality but of the perception, what people hear, what people say.

I have been in public quite supportive of the outcomes that have occurred in the 404 area from both the PCAOB and the Commission as a general matter. And I hope that -- and I say that to sort of

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emphasize the respect I have for the Commission on many levels -- but I would give some advice to the folks from the Commission who are here which is keep in mind how important it is to reinforce the independence of this body here and how much responsibility rests on the Commission and its staff in relation to doing that, given the way the two institutions are structured and linked.

MS. VIRAG: Lynn Turner.

MR. TURNER: A broader overarching issue not only with internal control but the fraud stuff we'll get into later on, does come back and begs the question of, given what we're asking people to do in this top down risk-based area -- especially without additional guidance on certain procedures that people should be looking at doing, as Craig mentioned earlier -- is ultimately the question of do you have people doing the work that are capable of doing it and competent to do it?

And when you talk about making these risk assessments, you're talking about risk assessments that usually people with the type of experience that

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are sitting around the table here are used to making. Yet we know, 80 percent of the hours are still being spent by people with zero to five, zero to six years of experience. So while they're very sharp and bright and talented people, there's no way that they have the ability to turn around and go do those risk assessments.

I think you have to think about do you put something in here about the fact that these risk assessments have to be done at the partner level, because they just can't be done by the people down below. They don't have the experience. And history has shown us that we're missing them.

I still get back to, even notwithstanding that are they going to pick up on them, we now have an option scandal out there that's consumed well in excess of 200 companies, and there's probably many more out there that probably haven't disclosed it yet. Yet the auditors didn't pick up on that at all; and I suspect that it's because in part, whoever did make the risk assessment on those audits assessed the risk low. Yet we've seen some very, very significant

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restatements coming through; and each one of those have very serious consequences from a governance perspective.

How would you go in, for example, if you -- the recent court case on Tyson -- here's Tyson, a company that their board broke an agreement with the Delaware court they earlier entered into; they spring-loaded options, which the court has now said is inappropriate and raises the currently emerging issue for auditors given that current decision on spring-loading.

How could you even depend upon that board? Given that, how could you even do an audit at Tyson given that a number of those board members are still sitting there at the top?

And certainly those are all valid questions that have popped up in many of these major frauds. Yet this standard I don't think asks those tough questions and gives a response to them.

I think it is something you seriously have to consider: How do we get from where we are at to where we need to be on these?

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MS. VIRAG: I think with that we'll conclude our discussion today on the board's internal control proposals.

Is there one more? I beg your pardon.

MR. BECKER: To pick up on Lynn's point a little bit. This standard -- it strikes me -- places a huge premium on the capacity of the auditor, whoever that happens to be, for risk assessment; and I agree with Lynn's point that it does make a difference as to who is assessing the risk.

I also think, though, that there needs to be built into this safeguards with respect to the unapprehended risk, because it's the nature of humans that there's not just not going to be -- able to apprehend all the risks.

I worry a little bit that there is too much faith in the capacity of auditors to identify, both at the outset and as an audit develops, all the relevant risks, because we all get surprised. And we get surprised with sort of startling frequency.

What this standard seems to be, more than anything else, is all the things that auditors don't

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have to do compared with AS-2; and I just think it's important to address the issue of the limits of people's capacity to assess risk at the outset and then what procedures are built into the audit as a result.

MS. VIRAG: Thank you. For the record, that was David Becker speaking.

At this time I'm going to pause longer to see if anyone else would like to make another thought?

Dick Dietrich?

MR. DIETRICH: I would like to reinforce and amplify perhaps David's comments. There has been research done trying to see how well calibrated individuals are in assessing risk.

Some of the experiments go along the following way: Take an event that's going to occur two weeks ahead, for example. What do you think the high temperature is going to be two weeks from now? Don't tell me the number. Tell me a range where you think nine out of 10 times you'll be within that number.

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And it turns out that we horribly mis-estimate that tolerance.

So we might say 90 percent of the time the actual number is going to be within this range, and it turns out to be 60 percent of the time. It gets to this point of risk assessment.

And it turns out that that doesn't -- that does extend also to people with expertise. It takes a tremendous amount of expertise -- I think, to Lynn's point, it takes a considerable amount of experience in estimating risk probabilities here.

MS. VIRAG: Okay. So that concludes our discussion on the board's internal control proposals.

We appreciate everybody's participation. I think that was extremely helpful for us. A lot of great comments. We really appreciate that.

As we mentioned in our briefing paper, the transcript of this part of the meeting will be included in the public comment file.

Having said that, we also encourage all of the SAG members, anyone in the audience or tuned in to the webcast to submit comment letters to the board

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if they want to provide additional insight on these or additional comments. The proposal period is open until the end of the day.

Thank you.

We'll reconvene at 2:50.

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AUDITING STANDARD No. 5 – AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS AND RELATED INDEPENDENCE RULE AND CONFORMING AMENDMENTS	PCAOB Release No. 2007-005 May 24, 2007 PCAOB Rulemaking Docket Matter No. 021

Summary: After public comment, the Public Company Accounting Oversight Board is adopting Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, as well as an independence rule and conforming amendments to the Board's auditing standards.

Board Contact: Sharon Virag, Associate Chief Auditor (202/207-9164)

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1. Introduction

In 2002, Congress passed the Sarbanes-Oxley Act (the "Act"), which, among other things, established new provisions related to internal control over financial reporting. Section 404 of the Act requires company management to assess and report on the effectiveness of the company's internal control. It also requires a company's independent auditor, registered with the Public Company Accounting Oversight Board ("PCAOB" or "Board"), to attest to management's disclosures regarding the effectiveness of its internal control. As directed by Sections 103 and 404 of the Act, the Board established a standard to govern the newly required audit by adopting Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("Auditing Standard No. 2").[1/] The

[1/] See PCAOB Release No. 2004-001 (March 9, 2004).

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Securities and Exchange Commission ("Commission" or "SEC") approved Auditing Standard No. 2 on June 17, 2004.[2/]

Since Auditing Standard No. 2 became effective, the Board has closely monitored the progress registered firms have made in implementing its requirements. The PCAOB's monitoring has included gathering information during inspections of registered public accounting firms; participating, along with the SEC, in two roundtable discussions with representatives of issuers, auditors, investor groups, and others; meeting with its Standing Advisory Group; receiving feedback from participants in the Board's Forums on Auditing in the Small Business Environment; and reviewing academic, government, and other reports and studies.

As a result of this monitoring, two basic propositions emerged.[3/] First, the audit of internal control over financial reporting has produced significant benefits, including an enhanced focus on corporate governance and controls and higher quality financial reporting. Second, these benefits have come at a significant cost. Costs have been greater than expected and, at times, the related effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.

As part of a four-point plan to improve implementation of the internal control requirements, the Board determined to amend Auditing Standard No. 2.[4/] On December 19, 2006, the Board proposed for comment a new standard on auditing internal control, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would replace Auditing Standard No. 2. The Board also proposed a related auditing standard, *Considering and Using the Work of Others in an*

[2/] See Securities Exchange Act Release No. 49884 (June 17, 2004).

[3/] See 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 (Dec. 19, 2006).

[4/] See PCAOB Press Release, "Board Announces Four-Point Plan to Improve Implementation of Internal Control Reporting Requirements" (May 17, 2006). The other aspects of the plan are: (1) reinforcing auditor efficiency through PCAOB inspections; (2) developing or facilitating development of implementation guidance for auditors of smaller public companies; and (3) continuing PCAOB Forums on Auditing in the Small Business Environment.

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Audit, an independence rule relating to the auditor's provision of internal control-related non-audit services, and conforming amendments to its auditing standards.[5/]

The Board issued these proposals with the primary objectives of focusing auditors on the most important matters in the audit of internal control over financial reporting and eliminating procedures that the Board believes are unnecessary to an effective audit of internal control. The proposals were designed to both increase the likelihood that material weaknesses in companies' internal control will be found before they cause material misstatement of the financial statements and steer the auditor away from procedures that are not necessary to achieve the intended benefits. The Board also sought to make the internal control audit more clearly scalable for smaller and less complex public companies and to make the text of the standard easier to understand. In formulating these proposals, the Board re-evaluated every significant aspect of Auditing Standard No. 2.

The Board received 175 comment letters on its proposals. The Board also discussed the proposals with its Standing Advisory Group on February 22, 2007.[6/] A large majority of commenters were generally supportive of the Board's proposals, particularly the top-down, risk-based approach and focus on the most important matters. Based on the comments received, the Board believes that the proposal achieves, in large part, the objectives the Board set out when deciding to amend Auditing Standard No. 2. Many commenters also offered suggestions to improve the final standard, which the Board has carefully analyzed.

In considering the comments received and formulating a final standard, the Board closely coordinated its work with the SEC, which proposed guidance for management on evaluating internal control at the same time that the Board issued its proposals.[7/] In addition to its role in implementing Section 404(a) of the Act, the SEC

[5/] See 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 (Dec. 19, 2006).

[6/] A transcript of the portion of the meeting that related to the proposals and an archived web cast of the entire meeting are available on the Board's Web site at http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2007/02-22/SAG_Transcript.pdf.

[7/] See Securities Exchange Act Release No. 54976 (Dec. 20, 2006).

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must approve new PCAOB auditing standards before they can become effective.[8/] On April 4, 2007, the Commission held a public meeting to discuss the Board's proposals and the coordination of those proposals with the Commission's proposed management guidance. At the meeting, the SEC staff provided the Commission its analysis of the public comments on the PCAOB's proposal and the proposed management guidance. The Commission endorsed the recommendations of its staff and directed its staff to focus its remaining work in four areas:

- "Aligning the PCAOB's new auditing standard … with the SEC's proposed new management guidance under Section 404, particularly with regard to prescriptive requirements, definitions, and terms";

- "Scaling the 404 audit to account for the particular facts and circumstances of companies, particularly smaller companies";

- "Encouraging auditors to use professional judgment in the 404 process, particularly in using risk-assessment"; and

- "Following a principles-based approach to determining when and to what extent the auditor can use the work of others."[9/]

After careful consideration of the comments it received and the input from the SEC, the Board has refined its proposals to provide additional clarity and further help auditors to focus on the most important matters. The Board has decided to adopt the revised standard on auditing internal control as Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("Auditing Standard No. 5"), to supersede Auditing Standard No. 2. The Board has also decided to adopt the independence rule and conforming amendments to the auditing standards.[10/]

8/ See Section 107 of the Act.

9/ See SEC Press Release, "SEC Commissioners Endorse Improved Sarbanes-Oxley Implementation To Ease Smaller Company Burdens, Focusing Effort On 'What Truly Matters'" (Apr. 4, 2007).

10/ As discussed below, the Board has determined not to adopt the proposed auditing standard on considering and using the work of others.

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2. Notable Areas of Change in the Final Standard

As stated above, the Board believes that the changes made to the proposal reflect refinements, rather than significant shifts in approach. This section describes the areas of change to the proposals that are most notable. Appendix 4 contains additional discussion of comments received on the proposals and the Board's response.

A. Alignment with management guidance

On December 20, 2006, the SEC issued proposed guidance to help management evaluate internal control for purposes of its annual assessment. In formulating a new standard on auditing internal control, the Board sought to describe an audit process that would be coordinated with management's evaluation process. Many commenters suggested, however, that the SEC's management guidance and the Board's standard should be more closely aligned.

After considering the comments in this area, the Board has decided to make changes that will improve the coordination between the SEC's management guidance and the Board's standard. In doing so, the Board has been mindful of the inherent differences in the roles of management and the auditor. Management's daily involvement with its internal control system provides it with knowledge and information that may influence its judgments about how best to evaluate internal control and the sufficiency of the evidence it needs for its annual assessment. Management also should be able to rely on self-assessment and, more generally, the monitoring component of internal control, provided the monitoring component is properly designed and operates effectively.

The auditor is required to provide an independent opinion on the effectiveness of the company's internal control over financial reporting. The auditor does not have the familiarity with the company's controls that management has and does not interact with or observe these controls with the same frequency as management. Therefore, the auditor cannot obtain sufficient evidence to support an opinion on the effectiveness of internal control based solely on observation of or interaction with the company's controls. Rather, the auditor needs to perform procedures such as inquiry, observation, and inspection of documents, or walkthroughs, which consist of a combination of those procedures, in order to fully understand and identify the likely sources of potential misstatements, while management might be aware of those risk areas on an on-going basis.

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The Board believes, however, that the general concepts necessary to an understanding of internal control should be described in the same way in the Board's standard and in the SEC's guidance. Accordingly, the Board has decided to use the same definition of material weakness in its standard that the SEC uses in its final management guidance and related rules. In addition, the Board is adopting the definition of significant deficiencies that the SEC has proposed. The final standard and final management guidance also describe the same indicators of a material weakness. In addition, as described more fully below, the final standard on auditing internal control uses the term "entity-level controls" instead of "company-level controls," which was used in the proposed standard, in order to use the same term as the SEC uses in its final management guidance.[11/] Auditing Standard No. 5's discussion of the effect of these controls is also consistent with the discussion of the same topic in the SEC's final guidance.

B. The top-down approach

The proposed standard on auditing internal control was structured around the top-down approach to identifying the most important controls to test. This approach follows the same principles that apply to the financial statement audit – the auditor determines the areas of focus through the identification of significant accounts and disclosures and relevant assertions. Under the proposed standard, the auditor would specifically identify major classes of transactions and significant processes before identifying the controls to test.

In response to comments about the level of detail in the requirements of the proposed standard, the Board has reconsidered whether the final standard should include the identification of major classes of transactions and significant processes as a specifically required step in the top-down approach. As a practical matter, the auditor will generally need to understand the company's processes to appropriately identify the correct controls to test. The Board believes, however, that specific requirements directing the auditor how to obtain that understanding are unnecessary and could contribute to a "checklist approach" to compliance, particularly for auditors who have a long-standing familiarity with the company. Accordingly, the Board has removed the requirements to identify major classes of transactions and significant processes from

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[11/] These terms were used interchangeably in the proposed standard and SEC's proposed management guidance and, for these purposes, they mean the same thing. See Securities Exchange Act Release No. 54976 (Dec. 20, 2006), at 12 fn. 29.

Public Company Accounting Oversight Board

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the final standard. While this should allow auditors to apply more professional judgment as they work through the top-down approach, the end point is the same as in the proposed standard – the requirement to test those controls that address the assessed risk of misstatement to each relevant assertion.[12/]

C. Emphasis on fraud controls

The proposed standard on auditing internal control discussed fraud controls and the auditor's procedures related to these controls among the testing concepts included near the end of the standard. Commenters suggested that the placement of the discussion, or the lack of specificity regarding the controls that should be deemed fraud controls, failed to properly emphasize these controls or provide auditors with sufficient direction on how to test fraud controls. In response, the Board has made several changes in the final standard.

First, the discussion of fraud risk and anti-fraud controls has been moved closer to the beginning of the standard to emphasize to auditors the relative importance of these matters in assessing risk throughout the top-down approach.[13/] Incorporating the auditor's fraud risk assessment – required in the financial statement audit – into the auditor's planning process for the audit of internal control should promote audit quality as well as better integration. While internal control cannot provide absolute assurance that fraud will be prevented or detected, these controls should help to reduce instances of fraud, and, therefore, a concerted focus on fraud controls in the internal control audit should enhance investor protection. Second, management fraud has also been identified in the final standard as an area of higher risk; accordingly, the auditor should focus more of his or her attention on this area.[14/] Finally, the standard, as adopted, provides additional guidance on the types of controls that might address fraud risk.[15/]

12/ See paragraph 21.

13/ See paragraphs 14 and 15.

14/ See paragraph 11.

15/ See paragraph 14.

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D. Entity-level controls

The proposed standard on auditing internal control emphasized entity-level controls because of their importance both to the auditor's ability to appropriately tailor the audit through a top-down approach – specifically by identifying and testing the most important controls – and to effective internal control. Additionally, the proposed standard emphasized that these controls might, depending on the circumstances, allow the auditor to reduce the testing of controls at the process level. Commenters suggested that the proposed standard did not provide enough direction on how entity-level controls can significantly reduce testing, and some suggested that controls that operate at the level of precision necessary to do so are uncommon. Many commenters suggested incorporating in the final standard the discussion of direct versus indirect entity-level controls that was included in the SEC's proposed management guidance.

The Board continues to believe that entity-level controls, depending on how they are designed and operate, can reduce the testing of other controls related to a relevant assertion. This is either because the entity-level control sufficiently addresses the risk related to the relevant assertion, or because the entity-level controls provide some assurance so that the testing of other controls related to that assertion can be reduced. In response to comments and in order to clarify these concepts, the Board included in the final standard a discussion of three broad categories of entity-level controls, which vary in nature and precision, along with an explanation of how each category might have a different effect on the performance of tests of other controls.[16/]

The final standard explains that some controls, such as certain control environment controls, have an important, but indirect effect, on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

The final standard explains that other entity-level controls may not operate at the level of precision necessary to eliminate the need for testing of other controls, but can reduce the required level of testing of other controls, sometimes substantially. This is

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[16/] See paragraph 23. The Board believes that expertise of auditors and companies in the area of entity-level controls will continue to evolve. For example, the Committee of Sponsoring Organizations of the Treadway Commission has begun a project on the monitoring component of internal control that may provide some guidance in this area.

because the auditor obtains some of the supporting evidence related to a control from an entity-level control and the remaining necessary evidence from the testing of the control at the process level. Controls that monitor the operation of other controls are the best example of these types of controls. These monitoring controls help provide assurance that the controls that address a particular risk are effective and, therefore, they can provide some evidence about the effectiveness of those lower-level controls, reducing the testing of those controls that otherwise would be necessary.

Lastly, the final standard explains that some entity-level controls might operate at a level of precision that, without the need for other controls, sufficiently addresses the risk of misstatement to a relevant assertion. If a control sufficiently addresses the risk in this manner, the auditor does not need to test other controls related to that risk.

E. Walkthroughs

The proposed standard on auditing internal control would have required auditors to perform a walkthrough of each significant process each year. This proposed requirement represented a change from Auditing Standard No. 2, which required a walkthrough of each major class of transactions within a significant process. Commenters were split on the question of whether the re-calibration from major class of transactions to significant process in the proposed standard would result in a reduction of effort. Some issuers and auditors suggested that walkthroughs are already being performed on significant processes, while other issuers and auditors commented that this proposed requirement would make a difference. A few commenters suggested that a walkthrough of each significant process was insufficient and would negatively affect audit quality, but many others stated that walkthroughs should not be required at all.

In evaluating these comments, the Board focused principally on the objectives it believes are achieved through a properly performed walkthrough. The Board firmly believes that those objectives should be met for the auditor to verify that he or she has a sufficient understanding of the points within the processes where misstatements could occur and to properly identify the controls to test.[17/] Procedures that fulfill those objectives also play an important role in the evaluation of the effectiveness of the design of the controls. The Board believes that, in some instances, the requirement to perform a walkthrough may have overshadowed the objectives it was meant to achieve. This may have resulted in some walkthroughs being performed to meet the requirement but failing to achieve the intended purpose.

[17/] See paragraph 34, which describes these objectives.

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The final standard, therefore, focuses specifically on achieving certain important objectives, and the performance requirement is based on fulfilling those objectives as they relate to the understanding of likely sources of misstatement and the selection of controls to test.[18/] While a walkthrough will frequently be the best way of attaining these goals, the auditor's focus should be on the objectives, not on the mechanics of the walkthrough. In some cases, other procedures may be equally or more effective means of achieving them.

F. Evaluation and communication of deficiencies

The proposed standard on auditing internal control required the auditor to evaluate the severity of identified control deficiencies to determine whether they are significant deficiencies or material weaknesses. It then required the auditor to communicate, in writing, to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The proposed standard defined "significant deficiency" as "a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected." The term "significant misstatement" was defined, in turn, to mean "a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

Commenters generally supported the proposed definition of the term "significant misstatement," though some were concerned that it was too subjective. Other commenters questioned whether the standard should include a definition of significant deficiency and a requirement to communicate significant deficiencies to the audit committee. At least one commenter suggested that the term be removed from the standard.

After considering these comments, the Board has determined to make changes to the definition of significant deficiency and related requirements.[19/] The Board

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[18/] See paragraph 34.

[19/] The Board also made minor changes to the definition of material weakness in order to use the same definition in the SEC's management guidance and related rule. In the final standard, material weakness is defined as "a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

continues to believe that the standard should require auditors to provide relevant information about important control deficiencies – even those less severe than a material weakness – to management and to the audit committee. The final standard, therefore, requires the auditor to consider and communicate any identified significant deficiencies to the audit committee. In order to emphasize that the auditor need not scope the audit to identify all significant deficiencies, however, the Board placed these provisions in the section of the final standard that describes communications requirements.[20/]

The relatively minor changes that the Board made to the definition of significant deficiency are also intended to focus the auditor on the communication requirement and away from scoping issues. The final definition is based on the proposed definition of "significant misstatement," which commenters generally supported, and is aligned with the SEC's proposed definition of the same term. Under the final standard, a significant deficiency is "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

G. Scaling the audit

The proposed standard on auditing internal control indicated that a company's size and complexity are important considerations and that the procedures an auditor should perform depend upon where along the size and complexity continuum a company falls. The proposed standard included a section on scaling the audit for smaller, less complex companies and would have required auditors to evaluate and document the effect of the company's size and complexity on the audit. This documentation requirement applied to audits of companies of all sizes. The proposed standard also included a list of the attributes of smaller, less complex companies and a description of how the auditor might tailor his or her procedures when these attributes

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[20/] See paragraph 80. The final standard also includes the proposed requirement for the auditor to communicate, in writing, to management, all deficiencies in internal control identified during the audit and inform the audit committee when such a communication has been made, and the proposed requirement to inform, when applicable, the board of directors of the auditor's conclusion that the audit committee's oversight is ineffective. See paragraphs 79 and 81. Some commenters believed that the requirement to communicate all identified deficiencies to management would result in an unnecessary administrative exercise. The Board continues to believe, however, that auditors should provide information about identified control deficiencies to management.

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are present. In general, commenters were supportive of the proposed standard's general approach to scalability, but had several recommendations for change.

Some commenters suggested that scalability should not be covered as a stand-alone discussion applicable only to smaller companies and that other companies, regardless of size, might have areas that are less complex. The Board agrees that the direction on scaling will be most effective if it is a natural extension of the risk-based approach and applicable to all companies. Consequently, the Board shortened the separate section on "scaling the audit," and incorporated a discussion of scaling concepts, similar to what was proposed, throughout the final standard. Specifically, notes to relevant paragraphs describe how to tailor the audit to the particular circumstances of a smaller, less complex company or unit. The Board also retained the list of attributes of smaller, less complex companies and acknowledged that, even within larger companies, some business units or processes may be less complex than others. Discussion of these attributes has been incorporated in the section on the auditor's planning procedures in the final standard.[21/] As described in the proposing release, the provisions on scalability in the final standard will form the basis for guidance on auditing internal control in smaller companies to be issued this year.

Several commenters, mostly auditors, suggested that the performance requirements that applied to all companies, including large, complex companies, would lead to unnecessary and costly documentation requirements. These commenters were particularly concerned about the requirement to document the effects of size and complexity on all aspects of the audit, even if a particular engagement could not be tailored as a result of these factors. After considering these comments, the Board agreed that this documentation requirement is not necessary to promote audit quality and, therefore, has not included it in the final standard.

H. Use of the work of others in an integrated audit

At the time the Board proposed Auditing Standard No. 5 for public comment, the Board also proposed an auditing standard entitled *Considering and Using the Work of Others in an Audit* that would have superseded the Board's interim standard AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("AU sec. 322"), and replaced the direction on using the work of others in an audit of internal control in Auditing Standard No. 2. As discussed in the proposing release, the Board had several objectives in proposing this standard. The first was to better integrate the financial statement audit and the audit of internal control by having

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[21/] See paragraph 9.

only one framework for using the work of others in both audits. Additionally, the Board wanted to encourage auditors to use the work of others to a greater extent when the work is performed by sufficiently competent and objective persons. Among other things, under the proposed standard, auditors would have been able to use the work of sufficiently competent and objective company personnel – not just internal auditors – and third parties working under the direction of management or the audit committee for purposes of the financial statement audit as well as the audit of internal control.

The Board received numerous comments on the proposed standard on using the work of others. Commenters generally indicated support for a single framework regarding the auditor's use of the work of others in an integrated audit. Some, however, suggested retaining existing AU sec. 322 as the basis for that single framework. They expressed the view that the objective of removing barriers to integration and using the work of others to the fullest extent appropriate could be achieved by retaining AU sec. 322 and going forward with the proposed removal of the "principal evidence" provision. At the same time, some other commenters suggested that the proposed standard did not go far enough in encouraging auditors to use the work of others.

After considering these comments, the Board continues to believe that a single framework for the auditor's use of the work of others is preferable to separate frameworks for the audit of internal control and the audit of financial statements. The factors used to determine whether and to what extent it is appropriate to use the work of others should be the same for both audits. At the same time, the Board agreed with those commenters who suggested that better integration of the audits could be achieved without replacing the existing auditing standard. The Board therefore has decided to retain AU sec. 322 for both audits and incorporate language into Auditing Standard No. 5 that establishes these integration concepts rather than adopt the proposed standard on considering and using the work of others.

Consistent with the proposal, however, Auditing Standard No. 5 allows the auditor to use the work of others to obtain evidence about the design and operating effectiveness of controls and eliminates the principal evidence provision. Recognizing that issuers might employ personnel other than internal auditors to perform activities relevant to management's assessment of internal control over financial reporting, the final standard allows the auditor to use the work of company personnel other than internal auditors, as well as third parties working under the direction of management or the audit committee.[22/]

[22/] See paragraph 17.

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In line with the overall risk-based approach to the audit of internal control over financial reporting, the extent to which the auditor may use the work of others depends, in part, on the risk associated with the control being tested. As the risk decreases, so does the need for the auditor to perform the work him or herself. The impact of the work of others on the auditor's work also depends on the relationship between the risk and the competence and objectivity of those who performed the work. As the risk decreases, the necessary level of competence and objectivity decreases as well.[23/] Likewise, in higher risk areas (for example, controls that address specific fraud risks), use of the work of others would be limited, if it could be used at all.

Finally, the Board understands that some of the work performed by others for the purposes of management's assessment of internal controls can be relevant to the audit of financial statements. Therefore, in an integrated audit, the final standard allows the auditor to use the work of these sufficiently competent and objective others – not just internal auditors – to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of financial statements.[24/] The Board believes that this provision will promote better integration of the audit of internal control with the audit of financial statements.

3. Rule 3525 – Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting

The Board also proposed a new rule related to the auditor's responsibilities when seeking audit committee pre-approval of internal control related non-audit services. As proposed, the rule required a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related non-audit services that are not otherwise prohibited by the Act or the rules of the SEC or the Board to: describe, in writing, to the audit committee the scope of the proposed service; discuss with the audit committee the potential effects of the proposed service on the firm's independence; and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee pre-approval to perform tax services for an audit client under PCAOB Rule 3524. Most commenters were supportive of the rule as proposed, though some offered

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[23/] See paragraph 18.

[24/] See paragraph 17.

suggestions about what should be included in the required communication. After considering the comments on the proposed rule, the Board has adopted it without change.

4. Conforming Amendments

As part of the proposal issued for public comment, the Board proposed amendments to certain of the Board's other auditing standards. Only one comment letter specifically addressed the proposed amendments. That letter expressed support for the amendments and suggested a few additional amendments that might be necessary. The Board has considered this comment and added these additional amendments, as well as others, as necessary based on the final standard.

5. Effective Date

The proposing release solicited commenters' feedback on how the Board could structure the effective date of the final requirements so as to best minimize disruption to ongoing audits, but make greater flexibility available to auditors as early as possible. Most commenters on this topic suggested making the final standard on auditing internal control effective as soon as possible in order to be available for 2007 audits.

The Board agrees that the improvements in Auditing Standard No. 5 should be available as soon as possible. Accordingly, the Board has determined that Auditing Standard No. 5, Rule 3525, and the conforming amendments will be effective, subject to approval by the SEC, for audits of fiscal years ending on or after November 15, 2007. Earlier adoption is permitted, however, at any point after SEC approval. Auditors who elect to comply with Auditing Standard No. 5 after SEC approval but before its effective date must also comply, at the same time, with Rule 3525 and other PCAOB standards as amended by this release.

Auditing Standard No. 2 will be superseded when Auditing Standard No. 5 becomes effective. Auditors who do not elect to comply with Auditing Standard No. 5 before that date (but after SEC approval) must continue to comply with Auditing Standard No. 2 until it is superseded. Such auditors should, however, apply the definition of "material weakness" contained in Auditing Standard No. 5, rather than the one contained in Auditing Standard No. 2. The SEC has adopted a rule to define the term "material weakness," and the definition in Auditing Standard No. 5 parallels the new SEC definition.

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On the 24th day of May, in the year 2007, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Secretary

May 24, 2007

APPENDIX 1 – Auditing Standard No. 5 – *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*

APPENDIX 2 – Rule 3525 – *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*

APPENDIX 3 – Conforming Amendments to PCAOB Auditing Standards

APPENDIX 4 – Additional Discussion of Comments and the Board's Response

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Appendix 1 – Auditing Standard

May 24, 2007
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Auditing Standard No. 5 –

An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

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APPENDICES

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Introduction

1. This standard establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of **management's assessment**[1/] of the effectiveness of **internal control over financial reporting** ("the audit of internal control over financial reporting") that is integrated with an audit of the financial statements.[2/]

2. Effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.[3/] If one or more **material weakness**es exist, the company's internal control over financial reporting cannot be considered effective.[4/]

3. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting. Because a company's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance[5/] about whether material weaknesses exist as of the date specified in management's assessment. A material weakness in internal control over

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[1/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[2/] This auditing standard supersedes Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements,* and is the standard on attestation engagements referred to in Section 404(b) of the Act. It also is the standard referred to in Section 103(a)(2)(A)(iii) of the Act.

[3/] See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f); Paragraph A5.

[4/] See Item 308 of Regulation S-K, 17 C.F.R. § 229.308.

[5/] See AU sec. 230, *Due Professional Care in the Performance of Work*, for further discussion of the concept of reasonable assurance in an audit.

financial reporting may exist even when financial statements are not materially misstated.

4. The general standards[6/] are applicable to an audit of internal control over financial reporting. Those standards require technical training and proficiency as an auditor, independence, and the exercise of due professional care, including professional skepticism. This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

5. The auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting.[7/]

Integrating the Audits

6. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.

7. In an integrated audit of internal control over financial reporting and the financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously –

6/ See AU sec. 150, *Generally Accepted Auditing Standards.*

7/ See Securities Exchange Act Rules 13a-15(c) and 15d-15(c), 17 C.F.R. §§ 240.13a-15(c) and 240.15d-15(c). SEC rules require management to base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework (also known as control criteria) established by a body or group that followed due-process procedures, including the broad distribution of the framework for public comment. For example, the report of the Committee of Sponsoring Organizations of the Treadway Commission (known as the COSO report) provides such a framework, as does the report published by the Financial Reporting Council, Internal Control Revised Guidance for Directors on the Combined Code, October 2005 (known as the Turnbull Report).

- To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end, and

- To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

8. Obtaining sufficient evidence to support control risk assessments of low for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements. (See Appendix B for additional direction on integration.)

Note: In some circumstances, particularly in some audits of smaller and less complex companies, the auditor might choose not to assess control risk as low for purposes of the audit of the financial statements. In such circumstances, the auditor's tests of the operating effectiveness of controls would be performed principally for the purpose of supporting his or her opinion on whether the company's internal control over financial reporting is effective as of year-end. The results of the auditor's financial statement auditing procedures also should inform his or her risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Planning the Audit

9. The auditor should properly plan the audit of internal control over financial reporting and properly supervise any assistants. When planning an integrated audit, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures –

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;

- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;

- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;

- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;

- The auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses;

- Control deficiencies previously communicated to the audit committee[8/] or management;

- Legal or regulatory matters of which the company is aware;

- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;

- Preliminary judgments about the effectiveness of internal control over financial reporting;

- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;

- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and

- The relative complexity of the company's operations.

  Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and

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[8/] If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Role of Risk Assessment

10. Risk assessment underlies the entire audit process described by this standard, including the determination of **significant accounts and disclosures** and **relevant assertion**s, the selection of controls to test, and the determination of the evidence necessary for a given control.

11. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

12. The complexity of the organization, business unit, or process, will play an important role in the auditor's risk assessment and the determination of the necessary procedures.

Scaling the Audit

13. The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its **control objective**s. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks. Scaling is most effective as a natural extension of the risk-based approach and applicable to the audits of all companies. Accordingly, a smaller, less complex company, or even a larger, less

complex company might achieve its control objectives differently than a more complex company.[9/]

Addressing the Risk of Fraud

14. When planning and performing the audit of internal control over financial reporting, the auditor should take into account the results of his or her fraud risk assessment.[10/] As part of identifying and testing entity-level controls, as discussed beginning at paragraph 22, and selecting other controls to test, as discussed beginning at paragraph 39, the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include –

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

15. If the auditor identifies deficiencies in controls designed to prevent or detect fraud during the audit of internal control over financial reporting, the auditor should take into

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[9/] The SEC Advisory Committee on Smaller Public Companies considered a company's size with respect to compliance with the internal control reporting provisions of the Act. See Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, Final Report, at p. 5 (April 23, 2006).

[10/] See paragraphs .19 through .42 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* regarding identifying risks that may result in material misstatement due to fraud.

account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit, as provided in AU sec. 316.44 and .45.

Using the Work of Others

16. The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* applies in an integrated audit of the financial statements and internal control over financial reporting.

17. For purposes of the audit of internal control, however, the auditor may use the work performed by, or receive direct assistance from, internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of internal control over financial reporting. In an integrated audit of internal control over financial reporting and the financial statements, the auditor also may use this work to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of the financial statements.

18. The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work. The auditor should apply paragraphs .09 through .11 of AU sec. 322 to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use.

> Note: For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding and knowledge that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the person's qualifications and ability to perform the work the auditor plans to use. To assess objectivity, the auditor should evaluate whether factors are present that either

inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the auditor plans to use.

Note: The auditor should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the auditor.

19. The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.

Materiality

20. In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements.[11/]

Using a Top-Down Approach

21. The auditor should use a top-down approach to the audit of internal control over financial reporting to select the controls to test. A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the **financial statements and related disclosures**. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those

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11/ See AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, which provides additional explanation of materiality.

controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

> Note: The top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the auditing procedures.

Identifying Entity-Level Controls

22. The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

23. Entity-level controls vary in nature and precision –

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.

- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

24. Entity-level controls include –

- Controls related to the control environment;
- Controls over management override;

  Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

- The company's risk assessment process;
- Centralized processing and controls, including shared service environments;
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

25. *Control Environment.* Because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company. As part of evaluating the control environment, the auditor should assess –

- Whether management's philosophy and operating style promote effective internal control over financial reporting;

- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and

- Whether the Board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

26. *Period-end Financial Reporting Process*. Because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following –

- Procedures used to enter transaction totals into the general ledger;

- Procedures related to the selection and application of accounting policies;

- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;

- Procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements; and

- Procedures for preparing annual and quarterly financial statements and related disclosures.

  Note: Because the annual period-end financial reporting process normally occurs after the "as-of" date of management's assessment, those controls usually cannot be tested until after the as-of date.

27. As part of evaluating the period-end financial reporting process, the auditor should assess –

- Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;

- The extent of information technology ("IT") involvement in the period-end financial reporting process;

- Who participates from management;

- The locations involved in the period-end financial reporting process;

- The types of adjusting and consolidating entries; and

- The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.

  Note: The auditor should obtain sufficient evidence of the effectiveness of those quarterly controls that are important to determining whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion as of the date of management's assessment. However, the auditor is not required to obtain sufficient evidence for each quarter individually.

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

28. The auditor should identify significant accounts and disclosures and their relevant assertions. Relevant assertions are those financial statement assertions that have a reasonable possibility of containing a misstatement that would cause the financial statements to be materially misstated. The financial statement assertions include[12/] –

- Existence or occurrence

- Completeness

- Valuation or allocation

- Rights and obligations

- Presentation and disclosure

[12/] See AU sec. 326, *Evidential Matter*, which provides additional information on financial statement assertions.

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Note: The auditor may base his or her work on assertions that differ from those in this standard if the auditor has selected and tested controls over the pertinent risks in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.

29. To identify significant accounts and disclosures and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include –

- Size and composition of the account;
- Susceptibility to misstatement due to errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;
- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- Existence of related party transactions in the account; and
- Changes from the prior period in account or disclosure characteristics.

30. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking

himself or herself "what could go wrong?" within a given significant account or disclosure.

31. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

> Note: In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts, disclosures and assertions that are not determined to be significant accounts and disclosures and relevant assertions.[13/]

32. The components of a potential significant account or disclosure might be subject to significantly differing risks. If so, different controls might be necessary to adequately address those risks.

33. When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements. Having made those determinations, the auditor should then apply the direction in Appendix B for multiple locations scoping decisions.

Understanding Likely Sources of Misstatement

34. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives –

[13/] This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (see AU sec. 312.39 for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed (see paragraph 61 and AU sec. 316.50 for further discussion about predictability of auditing procedures).

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;

- Verify that the auditor has identified the points within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material;

- Identify the controls that management has implemented to address these potential misstatements; and

- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.

35. Because of the degree of judgment required, the auditor should either perform the procedures that achieve the objectives in paragraph 34 himself or herself or supervise the work of others who provide direct assistance to the auditor, as described in AU sec. 322.

36. The auditor also should understand how IT affects the company's flow of transactions. The auditor should apply paragraphs .16 through .20, .30 through .32, and .77 through .79, of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, which discuss the effect of information technology on internal control over financial reporting and the risks to assess.

> Note: The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify significant accounts and disclosures and their relevant assertions, and the controls to test, as well as to assess risk and allocate audit effort as described by this standard.

37. *Performing Walkthroughs.* Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 34. In performing a walkthrough, the auditor follows a transaction from origination through the company's processes,

including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

38. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

Selecting Controls to Test

39. The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

40. There might be more than one control that addresses the assessed risk of misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

41. The decision as to whether a control should be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement to a given relevant assertion rather than on how the control is labeled (e.g., entity-level control, transaction-level control, control activity, monitoring control, **preventive control**, **detective control**).

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Testing Controls

Testing Design Effectiveness

42. The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

> Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, 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. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

43. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

44. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

> Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.

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45. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Relationship of Risk to the Evidence to be Obtained

46. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

> Note: Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

47. Factors that affect the risk associated with a control include –

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls, especially controls that monitor other controls;
- The nature of the control and the frequency with which it operates;

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- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);

- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;

- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and

  Note: A less complex company or business unit with simple business processes and centralized accounting operations might have 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 might 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.

- The complexity of the control and the significance of the judgments that must be made in connection with its operation.

  Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

48. When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

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Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.

49. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing may provide sufficient evidence in relation to the risk associated with the control.

Note: Walkthroughs usually consist of a combination of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control and might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough and the results of those procedures.

50. *Nature of Tests of Controls*. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

51. The nature of the tests of effectiveness that will provide competent evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls, might provide sufficient evidence about whether the control is effective.

52. *Timing of Tests of Controls*. Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the date of management's assessment provides more evidence than testing performed earlier in the year. The auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness.

53. Prior to the date specified in management's assessment, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment, the auditor should test the design and operating effectiveness of those superseded controls, as appropriate. (<u>See</u> additional direction on integration beginning at paragraph B1.)

54. *Extent of Tests of Controls*. The more extensively a control is tested, the greater the evidence obtained from that test.

55. *Roll-Forward Procedures.* When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

56. The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors –

- The specific control tested prior to the as-of date, including the risks associated with the control and the nature of the control, and the results of those tests;

- The sufficiency of the evidence of effectiveness obtained at an interim date;
- The length of the remaining period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.

Special Considerations for Subsequent Years' Audits

57. In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary. This decision-making process is described in paragraphs 46 through 56.

58. Factors that affect the risk associated with a control in subsequent years' audits include those in paragraph 47 and the following –

- The nature, timing, and extent of procedures performed in previous audits,
- The results of the previous years' testing of the control, and
- Whether there have been changes in the control or the process in which it operates since the previous audit.

59. After taking into account the risk factors identified in paragraphs 47 and 58, the additional information available in subsequent years' audits might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.

60. The auditor may also use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28.

61. In addition, the auditor should vary the nature, timing, and extent of testing of controls from year to year to introduce unpredictability into the testing and respond to changes in circumstances. For this reason, each year the auditor might test controls at a different interim period, increase or reduce the number and types of tests performed, or change the combination of procedures used.

Evaluating Identified Deficiencies

62. The auditor must evaluate the severity of each control **deficiency** that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.

63. The severity of a deficiency depends on –

- Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and

- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

64. The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.

65. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following –

- The nature of the financial statement accounts, disclosures, and assertions involved;

- The susceptibility of the related asset or liability to loss or fraud;

- The subjectivity, complexity, or extent of judgment required to determine the amount involved;

- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;

- The interaction of the deficiencies; and

- The possible future consequences of the deficiency.

Note: The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

Note: Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.

66. Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in controls include, but are not limited to, the following –

- The financial statement amounts or total of transactions exposed to the deficiency; and

- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

67. In evaluating the magnitude of the potential misstatement, the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the

probability of a small misstatement will be greater than the probability of a large misstatement.

68. The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.

Indicators of Material Weaknesses

69. Indicators of material weaknesses in internal control over financial reporting include –

- Identification of fraud, whether or not material, on the part of senior management;[14/]

- Restatement of previously issued financial statements to reflect the correction of a material misstatement;[15/]

- Identification by the auditor of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting; and

- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

70. When evaluating the severity of a deficiency, or combination of deficiencies, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable

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[14/] For the purpose of this indicator, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of the Act as well as any other members of senior management who play a significant role in the company's financial reporting process.

[15/] See Financial Accounting Standards Board Statement No. 154, *Accounting Changes and Error Corrections*, regarding the correction of a misstatement.

assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that a deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then the auditor should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

Wrapping-Up

Forming an Opinion

71. The auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies.

> Note: As part of this evaluation, the auditor should review reports issued during the year by internal audit (or similar functions) that address controls related to internal control over financial reporting and evaluate control deficiencies identified in those reports.

72. After forming an opinion on the effectiveness of the company's internal control over financial reporting, the auditor should evaluate the presentation of the elements that management is required, under the SEC's rules, to present in its annual report on internal control over financial reporting.[16/]

73. If the auditor determines that any required elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should follow the direction in paragraph C2.

[16/] See Item 308(a) of Regulations S-B and S-K, 17 C.F.R. §§ 228.308(a) and 229.308(a).

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74. The auditor may form an opinion on the effectiveness of internal control over financial reporting only when there have been no restrictions on the scope of the auditor's work. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement (see paragraphs C3 through C7).

Obtaining Written Representations

75. In an audit of internal control over financial reporting, the auditor should obtain written representations from management –

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;

b. Stating that management has performed an evaluation and made an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;

c. Stating that management did not use the auditor's procedures performed during the audits of internal control over financial reporting or the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting;

d. Stating management's conclusion, as set forth in its assessment, about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;

e. Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's evaluation, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;

f. Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;

g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraphs 77 and 79 have been resolved, and specifically identifying any that have not; and

h. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

76. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit. As discussed further in paragraph C3, when the scope of the audit is limited, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including those obtained in the audit of the company's financial statements.

77. AU sec. 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter.

Communicating Certain Matters

78. The auditor must communicate, in writing, to management and the audit committee all material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting.

79. If the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors.

80. The auditor also should consider whether there are any deficiencies, or combinations of deficiencies, that have been identified during the audit that are

significant deficiencies and must communicate such deficiencies, in writing, to the audit committee.

81. The auditor also should communicate to management, in writing, all deficiencies in internal control over financial reporting (i.e., those deficiencies in internal control over financial reporting that are of a lesser magnitude than material weaknesses) identified during the audit and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that has been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization.

82. The auditor is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the auditor communicates deficiencies in internal control over financial reporting of which he or she is aware.

83. Because the audit of internal control over financial reporting does not provide the auditor with assurance that he or she has identified all deficiencies less severe than a material weakness, the auditor should not issue a report stating that no such deficiencies were noted during the audit.

84. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. In such circumstances, the auditor must determine his or her responsibilities under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[17/]

Reporting on Internal Control

85. The auditor's report on the audit of internal control over financial reporting must include the following elements[18/] –

[17/] See 15 U.S.C. § 78j-1.

[18/] See Appendix C, which provides direction on modifications to the auditor's report that are required in certain circumstances.

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a. A title that includes the word *independent*;

b. A statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;

c. An identification of management's report on internal control;

d. A statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on his or her audit;

e. A definition of internal control over financial reporting as stated in paragraph A5;

f. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

g. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

h. A statement that an audit includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;

i. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;

j. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;

k. The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria;

l. The manual or printed signature of the auditor's firm;

m. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

n. The date of the audit report.

Separate or Combined Reports

86. The auditor may choose to issue a combined report (i.e., one report containing both an opinion on the financial statements and an opinion on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting.

87. The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8. We also have audited W Company's internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring*

Organizations of the Treadway Commission (COSO)."]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

[*Scope paragraph*]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria,* for *example, "criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

88. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph to the auditor's report on the financial statements –

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), W Company's internal control over financial reporting as of December 31, 20X8, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

The auditor also should add the following paragraph to the report on internal control over financial reporting –

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

Report Date

89. The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Because the auditor cannot audit internal control over financial reporting without also auditing the financial statements, the reports should be dated the same.

Material Weaknesses

90. Paragraphs 62 through 70 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement.[19/]

91. When expressing an adverse opinion on internal control over financial reporting because of a material weakness, the auditor's report must include –

[19/] See paragraph C3 for direction when the scope of the engagement has been limited.

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- The definition of a material weakness, as provided in paragraph A7.

- A statement that a material weakness has been identified and an identification of the material weakness described in management's assessment.

  Note: If the material weakness has not been included in management's assessment, the report should be modified to state that a material weakness has been identified but not included in management's assessment. Additionally, the auditor's report should include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. In this case, the auditor also should communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's assessment. If the material weakness has been included in management's assessment but the auditor concludes that the disclosure of the material weakness is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe the material weakness.

92. The auditor should determine the effect his or her adverse opinion on internal control has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements was affected by the adverse opinion on internal control over financial reporting.

> Note: If the auditor issues a separate report on internal control over financial reporting in this circumstance, the disclosure required by this paragraph may be combined with the report language described in paragraphs 88 and 91. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.

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Subsequent Events

93. Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors and obtain written representations from management relating to such matters, as described in paragraph 75h.

94. To obtain additional information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following –

- Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period,
- Independent auditor reports (if other than the auditor's) of deficiencies in internal control,
- Regulatory agency reports on the company's internal control over financial reporting, and
- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

95. The auditor might inquire about and examine other documents for the subsequent period. Paragraphs .01 through .09 of AU sec. 560, *Subsequent Events*, provide direction on subsequent events for a financial statement audit that also may be helpful to the auditor performing an audit of internal control over financial reporting.

96. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment, the auditor should issue an adverse opinion on internal control over financial reporting (and follow the direction in paragraph C2 if management's assessment states that internal control over financial reporting is effective). If the auditor is unable to determine the effect of the subsequent

event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim an opinion. As described in paragraph C13, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

97. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date and before issuance of the auditor's report. If a subsequent event of this type has a material effect on the company's internal control over financial reporting, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report.

98. After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

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APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows –

A2. A **control objective** provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant assertion and states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented or detected by controls on a timely basis.

A3. A **deficiency** in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

A4. **Financial statements and related disclosures** refers to a company's financial statements and notes to the financial statements as presented in accordance with generally accepted accounting principles ("GAAP"). References to financial statements and related disclosures do not extend to the preparation of management's discussion and analysis or other similar financial information presented outside a company's GAAP-basis financial statements and notes.

A5. **Internal control over financial reporting** is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that –

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.[1/]

Note: The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal control over financial reporting.

Note: Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

[1/] See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f).

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A6. **Management's assessment** is the assessment described in Item 308(a)(3) of Regulations S-B and S-K that is included in management's annual report on internal control over financial reporting.[2/]

A7. A **material weakness** is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

> Note: There is a **reasonable possibility** of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS 5").[3/]

A8. Controls over financial reporting may be **preventive controls** or **detective controls**. Effective internal control over financial reporting often includes a combination of preventive and detective controls.

- Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring.
- Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements.

A9. A **relevant assertion** is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

A10. An account or disclosure is a **significant account or disclosure** if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial

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[2/] See 17 C.F.R. §§ 228.308(a)(3) and 229.308(a)(3).

[3/] See FAS 5, paragraph 3.

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statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

A11. A **significant deficiency** is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

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APPENDIX B *– Special Topics*

Integration of Audits

B1. *Tests of Controls in an Audit of Internal Control.* The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole*.

B2. To express an opinion on internal control over financial reporting as of a point in time, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

B3. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on internal control over financial reporting, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

B4. *Tests of Controls in an Audit of Financial Statements.* To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

B5. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the company's internal control over financial reporting, as discussed in paragraph B2. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

B6. *Effect of Tests of Controls on Substantive Procedures.* If, during the audit of internal control over financial reporting, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

B7. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

B8. *Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls.* In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum –

- The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.

- Findings with respect to illegal acts and related party transactions.

- Indications of management bias in making accounting estimates and in selecting accounting principles.

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- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

B9. To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Multiple Locations Scoping Decisions

B10. In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk.

> Note: The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the company's consolidated financial statements.

B11. In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements. In lower-risk locations or business units, the auditor first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient evidence.

B12. In determining the locations or business units at which to perform tests of controls, the auditor may take into account work performed by others on behalf of management. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of locations or business units at which the auditor would otherwise need to perform auditing procedures.

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B13. The direction in paragraph 61 regarding special considerations for subsequent years' audits means that the auditor should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.

B14. *Special Situations.* The scope of the audit should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The direction in this multiple-locations discussion describes how to determine whether it is necessary to test controls at these entities or operations.

B15. For equity method investments, the scope of the audit should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The audit ordinarily would not extend to controls at the equity method investee.

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AU sec. 722, *Interim Financial Information*. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

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Use of Service Organizations

B17. AU sec. 324, *Service Organizations*, applies to the audit of financial statements of a company that obtains services from another organization that are part of the company's information system. The auditor may apply the relevant concepts described in AU sec. 324 to the audit of internal control over financial reporting.

B18. AU sec. 324.03 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, the auditor should include the activities of the service organization when determining the evidence required to support his or her opinion.

B19. AU sec. 324.07 through .16 describe the procedures that the auditor should perform with respect to the activities performed by the service organization. The procedures include –

a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and

b. Obtaining evidence that the controls that are relevant to the auditor's opinion are operating effectively.

B20. Evidence that the controls that are relevant to the auditor's opinion are operating effectively may be obtained by following the procedures described in AU sec. 324.12. These procedures include –

a. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in AU sec. 324.24b). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in AU sec. 324.24a) does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU sec. 324, the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

b. Performing tests of the user organization's controls over the activities of the service organization (e.g., testing the user organization's independent re-performance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).

c. Performing tests of controls at the service organization.

B21. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient evidence to support his or her opinion. In evaluating whether such a service auditor's report provides sufficient evidence, the auditor should assess the following factors –

- The time period covered by the tests of controls and its relation to the as-of date of management's assessment,

- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls, and

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- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements, as described in AU sec. 324.16.

B22. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures.

B23. In determining whether the service auditor's report provides sufficient evidence to support the auditor's opinion, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10a of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

B24. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.

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B25. The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors. As risk increases, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment,
- The significance of the activities of the service organization,
- Whether there are errors that have been identified in the service organization's processing, and
- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

B26. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures might include –

- Evaluating procedures performed by management and the results of those procedures.
- Contacting the service organization, through the user organization, to obtain specific information.
- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.
- Visiting the service organization and performing such procedures.

B27. The auditor should not refer to the service auditor's report when expressing an opinion on internal control over financial reporting.

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Benchmarking of Automated Controls

B28. Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.

B29. If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.

B30. The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

B31. To determine whether to use a benchmarking strategy, the auditor should assess the following risk factors. As these factors indicate lower risk, the control being evaluated might be well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated is less suited for benchmarking. These factors are –

- The extent to which the application control can be matched to a defined program within an application.
- The extent to which the application is stable (i.e., there are few changes from period to period).
- The availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed.)

B32. Benchmarking automated application controls can be especially effective for companies using purchased software when the possibility of program changes is remote – e.g., when the vendor does not allow access or modification to the source code.

B33. After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be reestablished. To determine when to reestablish a baseline, the auditor should evaluate the following factors –

- The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations.

- The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls.

- The nature and timing of other related tests.

- The consequences of errors associated with the application control that was benchmarked.

- Whether the control is sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

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APPENDIX C – *Special Reporting Situations*

Report Modifications

C1. The auditor should modify his or her report if any of the following conditions exist.

a. Elements of management's annual report on internal control are incomplete or improperly presented,

b. There is a restriction on the scope of the engagement,

c. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report,

d. There is other information contained in management's annual report on internal control over financial reporting, or

e. Management's annual certification pursuant to Section 302 of the Sarbanes-Oxley Act is misstated.

C2. *Elements of Management's Annual Report on Internal Control Over Financial Reporting Are Incomplete or Improperly Presented.* If the auditor determines that elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should modify his or her report to include an explanatory paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about a material weakness is not fairly presented in all material respects, the auditor should follow the direction in paragraph 91.

C3. *Scope Limitations*. The auditor can express an opinion on the company's internal control over financial reporting only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion states that the auditor does not express an opinion on the effectiveness of internal control over financial reporting.

C4. When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal control over financial reporting (paragraph 85 g, h, and i); to do so might overshadow the disclaimer.

C5. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report also should include –

- The definition of a material weakness, as provided in paragraph A7.

- A description of any material weaknesses identified in the company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraph 91.

C6. The auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

Note: In this case, in following the direction in paragraph 89 regarding dating the auditor's report, the report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

C7. If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the audit, the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

C8. *Opinions Based, in Part, on the Report of Another Auditor*. When another auditor has audited the financial statements and internal control over financial reporting of one

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or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion. AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements must participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

C9. When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by the other auditor. In these circumstances, the auditor's decision is based on factors analogous to those of the auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AU sec. 543.

C10. The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because management's assessment of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.[1/]

[1/] See paragraph B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

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C11. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion on the company's internal control over financial reporting, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinion.

C12. *Management's Annual Report on Internal Control Over Financial Reporting Containing Additional Information*. Management's annual report on internal control over financial reporting may contain information in addition to the elements described in paragraph 72 that are subject to the auditor's evaluation.

C13. If management's annual report on internal control over financial reporting could reasonably be viewed by users of the report as including such additional information, the auditor should disclaim an opinion on the information.

C14. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. AU sec. 317, *Illegal Acts by Clients* and Section 10A of the Securities Exchange Act of 1934 may also require the auditor to take additional action.[2/]

> Note: If management makes the types of disclosures described in paragraph C12 outside its annual report on internal control over financial reporting and includes them elsewhere within its annual report on the company's financial statements, the auditor would not need to disclaim an opinion. However, in that situation, the auditor's responsibilities are the same as those described in this paragraph if the auditor believes that the additional information contains a material misstatement of fact.

C15. *Management's Annual Certification Pursuant to Section 302 of the Sarbanes-Oxley Act is Misstated.* If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring

[2/] See 15 U.S.C. § 78j-1.

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during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[3/] the auditor should follow the communication responsibilities as described in AU sec. 722 *Interim Financial Information*, for any interim period. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in AU sec. 722, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Filings Under Federal Securities Statutes

C16. AU sec. 711, *Filings Under Federal Securities Statutes*, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should apply AU sec. 711 with respect to the auditor's report on internal control over financial reporting included in such filings. In addition, the auditor should extend the direction in AU sec. 711.10 to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements to matters that could have a material effect on internal control over financial reporting.

C17. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on internal control over financial reporting in the securities filing, the auditor's consent should clearly indicate that both the audit report on financial statements and the audit report on internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

[3/] See 17 C.F.R. §§ 240.13a-14(a) and 240.15d-14(a).

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Appendix 2

Rule 3525: Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting

In connection with seeking audit committee pre-approval to perform for an audit client any permissible non-audit service related to internal control over financial reporting, a registered public accounting firm shall –

(a) describe, in writing, to the audit committee of the issuer the scope of the service;

(b) discuss with the audit committee of the issuer the potential effects of the service on the independence of the firm; and

> Note: Independence requirements provide that an auditor is not independent of his or her audit client if the auditor is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Several principles guide the application of this general standard, including whether the auditor assumes a management role or audits his or her own work. Therefore, an auditor would not be independent if, for example, management had delegated its responsibility for internal control over financial reporting to the auditor or if the auditor had designed or implemented the audit client's internal control over financial reporting.

(c) document the substance of its discussion with the audit committee of the issuer.

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Appendix 3 – Conforming Amendments to PCAOB Auditing Standards

May 24, 2007

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Conforming Amendments to PCAOB Auditing Standards

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<u>Appendix 3</u>

Conforming Amendments to PCAOB Auditing Standards

<u>AU sec. 230, "Due Professional Care in the Performance of Work"</u>

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures," section 230, "Due Professional Care in the Performance of Work" (AU sec. 230, "Due Professional Care in the Performance of Work"), as amended, is amended as follows –

a. Paragraph .10 is replaced with –

The exercise of due professional care allows the auditor to obtain *reasonable assurance* about whether the financial statements are free of material misstatement, whether caused by error or fraud, or whether any material weaknesses exist as of the date of management's assessment. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Although not absolute assurance, reasonable assurance is a high level of assurance. Therefore, an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) may not detect a material weakness in internal control over financial reporting or a material misstatement to the financial statements.

b. The term "financial statements" within the first sentence of paragraph .13 is replaced with the term "financial statements or internal control over financial reporting."

c. The second sentence of paragraph .13 is replaced with –

Therefore, the subsequent discovery that either a material misstatement, whether from error or fraud, exists in the financial statements or a material weakness in internal control over financial reporting exists does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with the standards of the Public Company Accounting Oversight Board (United States).

AU sec. 310, "Appointment of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, is amended as follows –

a. The third bullet point of paragraph .06 is replaced with –

Management is responsible for establishing and maintaining effective internal control over financial reporting. If, in an integrated audit of financial statements and internal control over financial reporting, the auditor concludes that he or she cannot express an opinion on internal control over financial reporting because there has been a limitation on the scope of the audit, he or she should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

b. The eighth bullet point of paragraph .06 is amended as follows –

Under Integrated audit of financial statements and internal control over financial reporting, the last sub-bullet point is replaced with the following –

To the board of directors – any conclusion that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.

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Under Audit of financial statements, the last sub-bullet is replaced with the following –

> To the board of directors – if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the audit committee is ineffective, that conclusion.

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision" (AU sec. 311, "Planning and Supervision"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to paragraph 39 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 9 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), as amended, is amended as follows –

a. Within the note to paragraph 3, the reference to paragraphs 22-23 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 20 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. Within the note to paragraph 7, the reference to paragraphs 24-26 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 14-15 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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c. The note to paragraph 12 is replaced with –

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 9 and 20 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* regarding planning considerations and materiality, respectively.

d. Within the note to paragraph 18, the reference to Appendix B, *Additional Performance Requirements and Directions; Extent-of-Testing Examples* of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B10-B16 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

e. Within the note to paragraph 30, the reference to paragraphs 147-149 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 6-8 and paragraphs B1-B5 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards – 1983" (AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), is amended as follows –

Within the note to paragraph 1, the reference to paragraphs 98-103 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 52-53 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows –

The last sentence of paragraph 16 is replaced with –

> Furthermore, the predecessor auditor is not a specialist as defined in AU sec. 336, *Using the Work of a Specialist,* nor does the predecessor auditor's work constitute the work of others as described in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* or paragraphs 16-19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

<u>AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"</u>

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), is amended as follows –

Within the note to paragraph 1, the reference to paragraphs 24-26 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 14-15 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

<u>AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"</u>

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), as amended, is amended as follows –

a. The note to paragraph 2 is replaced with –

   Note: Refer to paragraph A9 of Appendix A, *Definitions,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* for the definition of a relevant assertion and paragraphs 28-33 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* for discussion of identifying relevant assertions.

b. Within the note to paragraph 9, the reference to Appendix B, *Additional Performance Requirements and Directions; Extent of Testing Examples,* of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B10-B16 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

c. The last sentence of paragraph 33 is deleted.

d. The note to paragraph 65 is deleted.

e. The note to paragraph 83 is deleted.

f. Within the note to paragraph 97, the reference to paragraphs 104-105 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 54 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

g. The appendix at paragraph 110 is deleted.

AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"

SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), is amended as follows –

a. Within the note to paragraph 1, the reference to paragraphs 108-126 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 16-19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The note to paragraph 20 is deleted.

c. Within the note to paragraph 22, the reference to paragraph 122 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 18-19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations" (AU sec. 324, "Service Organizations"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to Appendix B, *Additional Performance Requirements and Directions; Extent-of-Testing Examples,* of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B17-B27 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements"[1/]

AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements" is amended as follows –

a. The first bullet point before paragraph 1 is amended as follows –

The reference to paragraphs 207-214 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 78-84 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

[1/] When the Board adopted Auditing Standard No. 2, it superseded SAS No. 60 in the context of an integrated audit of financial statements and internal control over financial reporting by paragraphs 207-214 of Auditing Standard No. 2. See PCAOB Release No. 2004-008, *Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements"* (Sept. 15, 2004). As a result of superseding Auditing Standard No. 2, paragraphs 78-84 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* now supersede SAS No. 60 in the context of an integrated audit.

b. The first bullet point in paragraph 1 is replaced with –

A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

c. Paragraph 2 is replaced with –

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

d. The notes to paragraph 2 are deleted.

e. Paragraph 3 is replaced with –

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

> Note: There is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in paragraph 3 of Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*.
>
> Note: In evaluating whether a deficiency exists and whether deficiencies, either individually or in combination with other deficiencies, are material weaknesses, the auditor should follow the direction in paragraphs 62-70 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

f. Paragraph 5 is replaced with –

If oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that circumstance should be regarded as an indicator that a material weakness in internal control over financial reporting exists. Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight in an audit of only the financial statements, if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that information in writing to the board of directors.

g. The last sentence of paragraph 9 is replaced with –

In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph 2 of this standard.

<u>AU sec. 9325, "Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325"</u>

AU sec. 9325, "Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325" is amended as follows –

The note prior to paragraph 1 is replaced with –

Note: In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph 2 of this standard. Within the example report within paragraph 4 of the interpretation, the third sentence is replaced with the definition of a material weakness in paragraph A7 of Appendix A, *Definitions,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

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AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), is amended as follows –

The first sentence of paragraph 41 is replaced with –

Events and transactions that occur after the balance-sheet date but before the date of the auditor's report (for example, a sale of an investment shortly after the balance-sheet date), may provide audit evidence regarding management's fair value measurements as of the balance-sheet date [7/]

[7/] The auditor's consideration of a subsequent event or transaction, as contemplated in this paragraph, is a substantive test and thus differs from the review of subsequent events performed pursuant to section 560, *Subsequent Events*.

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), is amended as follows –

The note to paragraph 11 is replaced with –

Note: When performing an integrated audit of financial statements and internal control over financial reporting, paragraph 39 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* states "[t]he auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if there are relevant assertions related to the company's investment in derivatives and securities, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and service organizations whose services are part of the entity's information system.

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows –

a. Within the note to paragraph 5, the reference to paragraphs 142-144 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 75-77 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The second sentence of paragraph 9 is replaced with –

   Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the representations should be made as of the date of the auditor's report.

AU sec. 9337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337"

AU sec. 9337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337" is amended as follows –

a. The last sentence of paragraph 4 is replaced with –

   What is the relationship between the effective date of the lawyer's response and the date of the auditor's report?

b. Paragraph 5 is replaced with –

   Interpretation – Section 560.10 through .12 indicates that the auditor is concerned with events, which may require adjustment to, or disclosure in, the financial statements, occurring through the date of his or her report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the date of the auditor's report

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as is practicable in the circumstances. Consequently, specifying the effective date of the lawyer's response to reasonably approximate the expected date of the auditor's report will in most instances obviate the need for an updated response from the lawyer.

AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows –

The second sentence of paragraph 2 is replaced with –

The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), is amended as follows –

a. Subparagraph c. of paragraph 10 is replaced with –

c. Review subsequent events or transactions occurring prior to the date of the auditor's report.

b. Paragraph 13 is replaced with –

Review subsequent events or transactions. Events or transactions sometimes occur subsequent to the date of the balance sheet, but prior to the date of the auditor's report, that are important in identifying and evaluating the reasonableness of accounting estimates or key factors or assumptions used in the preparation of the estimate. In such circumstances, an evaluation of the estimate or of a key factor or assumption may be minimized or unnecessary as the event or transaction can be used by the auditor in evaluating their reasonableness.

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AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees"), as amended, is amended as follows –

Within footnote 1 to paragraph 1, the reference to PCAOB Auditing Standard No. 2 is replaced with a reference to PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508, "Reports on Audited Financial Statements"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to paragraphs 162-199 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 85-98 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* and Appendix C, *Special Reporting Situations,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. The sentence that reads "In addition, see Appendix A, *Illustrative Reports on Internal Control Over Financial Reporting,* of PCAOB Auditing Standard No. 2, which includes an illustrative combined audit report and examples of separate reports," is replaced with, "In addition, see paragraphs 86-88 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* which includes an illustrative combined audit report."

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 530, "Dating of the Independent Auditor's Report" (AU sec. 530, "Dating of the Independent Auditor's Report"), as amended, is amended as follows –

a. Paragraph .01 is replaced with –

The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Paragraph .05 describes the procedure to be followed when a subsequent event occurring after the report date is disclosed in the financial statements.

> Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same date.
>
> Note: If the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion on the financial statements, then the auditor's report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

b. Paragraph .05 is replaced with –

The independent auditor has two methods for dating the report when a subsequent event disclosed in the financial statements occurs after the auditor has obtained sufficient competent evidence on which to base his or her opinion, but before the issuance of the related financial statements. The auditor may use "dual dating," for example, "February 16, 20__, except for Note __, as to which the date is March 1, 20__," or may date the report as of the later date. In the former instance, the responsibility for events occurring subsequent to the original report date is limited to the specific event referred to in the note (or otherwise disclosed). In the latter instance, the independent auditor's responsibility for subsequent events extends to the later report date and, accordingly, the procedures outlined in section 560.12 generally should be extended to that date.

c. Within the heading before paragraph .03, the reference to "completion of field work" is replaced with "the date of the independent auditor's report."

<u>AU sec. 543, "Part of Audit Performed by Other Independent Auditors"</u>

SAS No. 1, "Codification of Auditing Standards and Procedures," section 543, "Part of Audit Performed by Other Independent Auditors" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), as amended, is amended as follows –

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Within the note to paragraph .01, the reference to paragraphs 182-185 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs C8-C11 of Appendix C, *Special Reporting Situations,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 560, "Subsequent Events"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 560, "Subsequent Events" (AU sec. 560, "Subsequent Events"), as amended, is amended as follows –

a. Within the note to paragraph .01, the reference to paragraphs 186-189 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 93-97 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The second sentence of paragraph .12 is replaced with –

These procedures should be performed at or near the date of the auditor's report.

AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report" (AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"), as amended, is amended as follows –

Within the note to paragraph .01, the reference to paragraph 197 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 98 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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AU sec. 711, "Filings Under Federal Securities Statutes"

SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), is amended as follows –

a. Within the note to paragraph 2, the reference to paragraphs 198-199 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs C16-C17 of Appendix C, *Special Reporting Situations,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The third sentence of paragraph 10 is replaced with –

The likelihood that the auditor will discover subsequent events necessarily decreases following the date of the auditor's report, and, as a practical matter, after that time the independent auditor may rely, for the most part, on inquiries of responsible officials and employees.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), is amended as follows –

a. The following is inserted after the first sentence of paragraph 3 –

The SEC also requires management, with the participation of the principal executive and financial officers (the certifying officers) to make certain quarterly and annual certifications with respect to the company's internal control over financial reporting.[2/]

[2/] See Section 302 of the Sarbanes-Oxley Act of 2002, and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), (17 C.F.R. § 240.13a-14a or 17 C.F.R. § 240.15d-14a), whichever applies.

b. The note to paragraph 3 is deleted.

c. The following is added to the end of paragraph 7 –

Likewise, the auditor's responsibility as it relates to management's quarterly certifications on internal control over financial reporting is different from the auditor's responsibility as it relates to management's annual assessment of internal control over financial reporting. The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

Note: The auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting take effect beginning with the first quarter after the company's first annual assessment of internal control over financial reporting as described in Item 308(a)(3) of Regulations S-B and S-K.

d. The following lettered section is added to the end of paragraph 18 –

g. Evaluating management's quarterly certifications about internal control over financial reporting by performing the following procedures –

- Inquiring of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information;

- Evaluating the implications of misstatements identified by the auditor as part of the auditor's other interim review procedures as they relate to effective internal control over financial reporting; and

- Determining, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

e. Paragraph 29 is replaced with –

As a result of conducting a review of interim financial information, the accountant may become aware of matters that cause him or her to believe that –

a. material modification should be made to the interim financial information for it to conform with generally accepted accounting principles;

b. modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies; and

c. the entity filed the Form 10-Q or Form 10-QSB before the completion of the review.

In such circumstances, the accountant should communicate the matter(s) to the appropriate level of management as soon as practicable.

f. Paragraph 32 is replaced with –

If the auditor becomes aware of information indicating that fraud or an illegal act has or may have occurred, the auditor must also determine his or her responsibilities under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[1/]

[1/] See 15 U.S.C. § 78j-1

g. Within paragraph 33, the third sentence is replaced with –

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

Auditing Standard No. 3, *Audit Documentation*

Auditing Standard No. 3, *Audit Documentation* is amended as follows –

Within footnote 2 to paragraph 6, the reference to paragraphs 68-70 of Auditing Standard No. 2 is replaced with a reference to paragraphs 28-33 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* is amended as follows –

a. Within note 1 to paragraph 1, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. Within paragraph 2, the two references to Auditing Standard No. 2 are replaced with references to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

c. Within the note to paragraph 2, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

d. Within paragraph 4, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control*

Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

e. Paragraph 9 is replaced with –

The terms *internal control over financial reporting*, *deficiency*, *significant deficiency*, and *material weakness* have the same meanings as the definitions of those terms in Appendix A, *Definitions,* of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

f. The first sentence of paragraph 10 is replaced with –

Paragraph 5 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* states "[t]he auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting."

g. Within the note to paragraph 10, the reference to Auditing Standard No. 2 in the first sentence is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and the last sentence is amended as follows –

More information about the COSO framework is included within the COSO report.

h. Paragraph 11 is replaced with –

The terms *relevant assertion* and *control objective* have the same meaning as the definitions of those terms in Appendix A, *Definitions,* of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

i. Paragraph 13 is replaced with –

In an audit of internal control over financial reporting, the auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.[2/]

[2/] See paragraph 42 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

j. Within the note to paragraph 17, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

k. Within note 2 to paragraph 18, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

l. Within paragraph 21, the last sentence is deleted.

m. Within paragraph 23, the reference to paragraphs 22 and 23 of Auditing Standard No. 2 is replaced with a reference to paragraph 20 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Additionally, the second sentence is deleted.

n. Within paragraph 24, the reference to paragraph 39 of Auditing Standard No. 2 is replaced with a reference to paragraph 9 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

o. Within paragraph 25, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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p. Within the note to paragraph 25, the two references to Auditing Standard No. 2 are replaced with references to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

q. Within subparagraph a. of paragraph 26, the reference to paragraphs 47 through 51 of Auditing Standard No. 2 is replaced with a reference to paragraphs 22-27 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

r. Subparagraph b. of paragraph 26 is replaced with –

Perform the procedures described in paragraphs 34-38 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* for those transactions that are directly affected by controls specifically identified by management as addressing the material weakness.

s. The note to subparagraph b. of paragraph 26 is deleted.

t. Within paragraph 27, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

u. The note to paragraph 28 is deleted.

v. Within paragraph 31, the reference to paragraphs 88 through 91 of Auditing Standard No. 2 is replaced with a reference to paragraphs 42-43 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

w. Paragraph 32 is replaced with –

Consistent with the direction in paragraphs 44-45 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* the auditor should test the operating effectiveness of a specified control by determining whether the specified control operated as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively. In determining the nature, timing, and extent of tests of controls, the auditor should apply paragraphs 50-54 of Auditing Standard No. 5.

x. Paragraph 33 is replaced with –

The auditor should perform tests of the specified controls over a period of time that is adequate to determine whether, as of the date specified in management's assertion, the controls necessary for achieving the stated control objective are operating effectively. The timing of the auditor's tests should vary with the risk associated with the control being tested. For example, a transaction-based, daily reconciliation generally would permit the auditor to obtain sufficient evidence as to its operating effectiveness in a shorter period of time than a pervasive, entity-level control, such as any of those described in paragraphs 22-24 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Additionally, the auditor typically will be able to obtain sufficient evidence as to the operating effectiveness of controls over the company's period-end financial reporting process only by testing those controls in connection with a period-end.

y. Within paragraph 35, the reference to paragraphs B1 through B13 of Appendix B of Auditing Standard No. 2 is replaced with a reference to paragraphs B10-B16 of Appendix B, *Special Topics,* of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

z. Within paragraph 36, the reference to paragraphs 109 through 115 and 117 through 125 of Auditing Standard No. 2 is replaced with a reference to paragraphs 16-19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

aa. The second sentence of paragraph 37 is replaced with –

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Therefore, if the auditor has been engaged to report on more than one material weakness or on more than one stated control objective, the auditor must evaluate whether he or she has obtained sufficient evidence that the control objectives related to each of the material weaknesses identified in management's assertion are achieved.

bb. The first two sentences of paragraph 38 are replaced with –

Paragraphs 18-19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* should be applied in the context of the engagement to report on whether a previously reported material weakness continues to exist.

cc. The note to paragraph 38 is deleted.

dd. The note to paragraph 39 is deleted.

ee. Paragraph 42 is replaced with –

Management may conclude that a previously reported material weakness no longer exists because its severity has been sufficiently reduced such that it is no longer a material weakness.

ff. Subparagraph f. of paragraph 44 is replaced with –

Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a misstatement in the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting and that has occurred or come to management's attention since the date of management's most recent annual assessment of internal control over financial reporting.

gg. Within the note to subparagraph b. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

hh. Within the note to subparagraph l. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

ii. Within the note to the second bullet point of subparagraph o. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

jj. Within paragraph 52, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

kk. Within paragraph 63, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29-32 of AU sec. 722, *Interim Financial Information*.

ll. Within paragraph 64, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29-32 of AU sec. 722, *Interim Financial Information*.

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Appendix 4

Additional Discussion of Comments and the Board's Response

As discussed in the first part of the Board's release, on December 19, 2006, the Board proposed for comment a new standard on auditing internal control, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would replace Auditing Standard No. 2, a related auditing standard, *Considering and Using the Work of Others in an Audit*, an independence rule relating to the auditor's provision of internal control-related non-audit services, and certain amendments to its auditing standards. The Board received 175 comment letters on its proposals and feedback from the Board's Standing Advisory Group.

Notable changes that the Board made in finalizing its proposals in response to comments are described in the first part of the Board's release. This appendix contains a further discussion of comments received on the proposals and the Board's response.

1. Alignment of Board's Internal Control Auditing Standard and the SEC's Guidance to Management

Many commenters suggested that the SEC's guidance to management and the Board's auditing standard should be more closely aligned. The commenters appeared to hold different opinions, however, about what alignment should mean in this context. Some commenters suggested that the most important issue was the need to use the same definitions of important terms in both documents. Some focused on perceived differences in scope, testing, and documentation requirements, while others suggested that the tone of the two documents was different and that the Board's proposals were more prescriptive. A few commenters suggested that the standard on auditing internal control should merely refer to the SEC management guidance without providing additional direction to the auditor.

As discussed more fully in the first part of this release, in formulating a new standard on auditing internal control, the Board intended to describe an audit process that would be coordinated with management's evaluation process. After considering the comments in this area, the Board made several changes, described in the first part of this release, that improve coordination while recognizing the inherent differences in the roles of management and the independent auditor under Section 404. The Board also adopted, as proposed, the final standard without a requirement for the auditor to perform an evaluation of management's assessment process. Commenters generally supported this aspect of the proposal, which was intended to respond to concerns that the requirements of Auditing Standard No. 2 had become *de facto* guidance for management's process. The absence of this requirement in the final standard should also allow for improved coordination between management and the auditor.

2. Level of Prescriptive Detail

Some commenters suggested that there remained too many instances of the use of the terms "should" and "must" in the proposed standard and that this might drive excessive documentation and possibly unnecessary work. The Board's Rule 3101 describes the level of responsibility that these imperatives impose on auditors when used in PCAOB standards, and the Board uses these terms in its standards to clearly convey its expectations. In response to these comments, the Board analyzed each requirement in the proposed standard to determine whether more reliance could be placed on general principles rather than detailed requirements. Where appropriate, the Board made modifications to make the final standard more principles-based. As discussed more fully in the first part of this release, areas in which changes were made include the focus on fulfilling the objectives of a walkthrough and in the description of the top-down approach. Some of these changes also contributed to better coordination with the SEC's guidance for management.

In addition, several commenters expressed concern over the creation of presumptively mandatory responsibilities related to efficiency concepts. The example cited most often was the note to paragraph 3 of the proposed standard on auditing internal control, which stated –

> Note: The auditor should select for testing only those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to a given relevant assertion that could result in a material misstatement to the company's financial statements.

Commenters suggested that because of this requirement for the auditor to select "only those controls that are important" for testing, an auditor would have violated the Board's standards if he or she tested even one control that was later shown to be not important. Commenters believed that this would undermine audit effectiveness and recommended removal of such statements.

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One of the objectives of the revised standard is to encourage auditors to focus on those areas that present the greatest risk of allowing a material misstatement in the financial statements. However, the Board agrees that its standards should not define a ceiling or maximum amount of work which the auditor may not exceed. While this statement (and others like it) in the proposed standard was not intended to imply that the Board would, with hindsight, suggest that an auditor violated the standard through testing of a control that was later determined to be not important to the audit, the Board has removed the note to paragraph 3 in response to these comments. Similar statements throughout the standard have also either been removed or modified.

3. Walkthroughs

The proposed standard required that the auditor perform a walkthrough of each significant process each year and allowed the auditor to use others, such as management personnel and internal auditors, to directly assist the auditor in this work. The proposed standard also indicated that the walkthrough provides audit evidence but did not prescribe further requirements regarding the circumstances in which a walkthrough might provide the auditor with sufficient evidence of operating effectiveness for a particular control. The proposing release, however, noted that a walkthrough could be sufficient for some low-risk controls in subsequent years.

As discussed in the first part of this release, the Board received a significant number of comments on this topic. While several commenters expressed support for the importance of the walkthrough to audit quality, many commenters suggested that the proposed provisions in this area were more prescriptive than necessary, and suggested risk concepts as a way to add flexibility. While these commenters acknowledged the value of a walkthrough and its importance to the evaluation of design effectiveness, many stated that the requirement to perform a walkthrough in an area that is either low-risk, not complex, or unchanged appears inconsistent with the other areas in the proposed standard that rely upon auditor judgment to a much greater extent.

Use of others in achieving the objectives of a walkthrough

Commenters supported allowing the auditor to use others to provide the auditor with direct assistance, particularly in low-risk areas, with only a few commenters believing that this change could jeopardize the quality of the audit. In addition, many commenters believed that the standard should allow full use of the work of others in performing walkthroughs, although some commenters strongly disagreed with this point.

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As discussed in the first part of this release, the final standard focuses the auditor on achieving four objectives related to the identification of where within the company's processes misstatements could arise, rather than specifically on performing walkthroughs. Due to the importance of achieving these objectives to the auditor's conclusion about internal control, the Board believes that allowing the use of the work of others to a greater extent than what was proposed would not provide the auditor with an adequate understanding of the relevant risks and the related controls. Therefore, similar to the proposed standard, Auditing Standard No. 5 allows the auditor to use the work of others in achieving the objectives of a walkthrough, but only as direct assistance. That is, the auditor will be required to supervise, review, evaluate, and test the work performed by others.[1/]

Using walkthroughs to test operating effectiveness

On the subject of using walkthroughs to test operating effectiveness, commenters suggested that walkthroughs can provide sufficient evidence of operating effectiveness, but held different views about situations in which this would be the case. Some commenters supported the use of walkthroughs in low-risk areas, while others focused on whether the control itself should be low-risk. Several commenters suggested that a walkthrough could provide sufficient evidence of operating effectiveness for lower-risk controls but only when entity-level controls are strong. Almost all commenters agreed that the proposed standard focused on the appropriate conditions for using such an approach – specifically, when risk is low, when past audits indicate effective design and operation of the control, and when no changes have been made to the control or process in which the control resides.

After considering these comments, the Board has decided that the risk-based approach that is described in the final standard is the appropriate framework for determining the evidence necessary to support the auditor's opinion. Therefore, Auditing Standard No. 5 articulates the principle that performance of a walkthrough might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthroughs and the results of the procedures performed.[2/] The Board believes that establishing more detailed requirements in this area is not necessary, because application of the general

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[1/] See paragraph 27 of AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.*

[2/] See paragraph 49.

principle in the standard will depend on the particular facts and circumstances presented.

4. Assessing Risk

The Board's May 16, 2005 guidance emphasized the importance of risk assessment in the audit of internal control, and that element of the guidance was incorporated and enhanced in the proposed standard. The proposed standard required risk assessment at each of the decision points in a top-down approach, including the auditor's identification of significant accounts and disclosures and their relevant assertions. The proposed standard also required an assessment of risk at the individual control level, and required that the auditor determine the evidence necessary for a given control based on this risk assessment.

The Board received many comments on the risk assessment provisions in the proposed standard. Comments on the proposed risk assessment approach were generally supportive, with some commenters suggesting ways for improving the risk assessment emphasis in the standard. Many commenters discussed the requirement in the proposed standard for the auditor to assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result for each control the auditor selected for testing. Commenters suggested that this requirement conflicted with both current practice and the requirements within the interim standards for the financial statement audit, which involve risk assessment at the financial statement assertion level. These commenters believed that this requirement would result in risk assessments at both the assertion level and the individual control level and suggested that assessing (and documenting) risk at the relevant assertion level is sufficiently precise to drive appropriate audits. Furthermore, they believed that a specific requirement to assess risk at the individual control level and its associated documentation requirement would be unnecessary.

After considering these comments, the Board continues to believe that the auditor may vary the nature, timing, and extent of testing based on the assessed risk related to a control. Making this assessment a presumptively mandatory requirement, as it was in the proposed standard, however, does not appear necessary to achieve the intended benefits of varied testing based on the risk associated with a control. Auditing Standard No. 5, therefore, requires the auditor to assess the risk related to the relevant assertion, but not the risk at the individual control level. The standard permits the auditor to consider the risk at the control level, however, and alter the nature, timing, and extent of testing accordingly.

Several commenters expressed concern about the advisability of taking a risk-based approach and the adequacy of the Board's interim standards regarding risk assessment. These commenters suggested that auditors have frequently been unsuccessful at applying a risk-based approach to the financial statement audit in the past.

The Board has found the arguments for a more principles-based approach to internal control auditing convincing, and the principle that the auditor should vary the testing to respond to the risk is one of the most important in the standard. Early implementation of Auditing Standard No. 2 demonstrated that, when internal control is audited without adequate consideration of risk, the areas that pose the greatest danger of material misstatement may be obscured or lost. The emphasis on risk, therefore, drives an audit that is more effective and focused. While the Board believes that auditors can appropriately assess risk based on the interim auditing standards, it has committed to examining the existing standards in this area to see where improvements can be made. This is currently one of the Board's standard setting priorities.

5. Evaluation of Deficiencies

The Board received a substantial number of comments on the topic of evaluating deficiencies, including comments on the proposed definitions of material weakness and significant deficiency, the "strong indicators" of a material weakness, and the requirement to evaluate all identified deficiencies. While a number of commenters stated that auditors do identify material weaknesses in the absence of an actual material misstatement, some noted that, in many cases, material weaknesses are identified only when material misstatements are discovered. Several commenters suggested that the proposed standard, with its focus on using a top-down approach and scoping to identify material weaknesses, would allow auditors to do a more thorough review of the most important controls with less effort expended on reviewing lower risk controls. These commenters often stated that this approach should increase the likelihood of the auditor detecting material weaknesses before a material misstatement occurs.

Definition of a material weakness

The proposed standard retained the basic framework in Auditing Standard No. 2 that described material weaknesses by reference to the likelihood and magnitude of a potential misstatement. While the Board believed that framework to be sound, it made an effort to clarify the definition in the proposed standard by replacing the reference to

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"more than remote likelihood" with "reasonable possibility." Financial Accounting Standards Board ("FASB") Statement No. 5 describes the likelihood of a future event occurring as "probable," "reasonably possible," or "remote." The definition in Auditing Standard No. 2 referred to a "more than remote" likelihood of a misstatement occurring. In accordance with FASB Statement No. 5, the likelihood of an event is "more than remote" when it is either "reasonably possible" or "probable."

As the Board noted in the proposing release, however, some auditors and issuers have misunderstood the term "more than remote" to mean something significantly less likely than a reasonable possibility. This, in turn, could have caused these issuers and auditors to evaluate the likelihood of a misstatement at a much lower threshold than the Board intended. Because the term "more than remote" could have resulted in auditors and issuers evaluating likelihood at a more stringent level than originally intended, the Board proposed changing the definition to refer to a "reasonable possibility."

Commenters on this change were split between those that felt the change would reduce unnecessary effort spent on identifying and analyzing deficiencies, and those who believed it would not. Several commenters noted that the replacement of the term "more than remote likelihood" with the term "reasonable possibility" does not raise the auditor's threshold for classifying deficiencies. According to those commenters, the change simply attempts to align the description of the threshold for identifying deficiencies with previous guidance issued by the PCAOB. The Board continues to believe that the proposed definition – as well as Auditing Standard No. 2 – established an appropriate threshold for the likelihood part of the definition of material weakness. While the Board agrees that, as a definitional matter, "reasonable possibility" and "more than remote" describe the same threshold, it believes that "reasonable possibility" describes that threshold more appropriately and clearly, and will therefore avoid the misunderstanding of the threshold created by the way it was described in Auditing Standard No. 2. As a result, it retained that term in the final definition in the standard.

In addition, some commenters noted that the definitions of material weakness and significant deficiency in the proposed standard, like the definitions in Auditing Standard No. 2, referred to the likelihood of a material misstatement in both the interim and annual financial statements. Most of these commenters suggested that the Board remove the term "interim" from the definitions of material weakness and significant deficiency because, according to the commenters, it causes confusion when scoping the audit of internal control and unnecessarily complicates the evaluation of deficiencies, particularly in the absence of guidance from the SEC and FASB regarding interim materiality. Some commenters, however, said that the Board should not remove the term "interim" from the definitions because the evaluation of deficiencies should be performed to consider the effectiveness of internal control for both the interim and annual financial statements. After carefully considering these comments, and in order to use the same definition that the SEC uses in its guidance to management, the Board determined to retain the reference to interim financial statements in the final definition of material weakness.[3/]

Indicators of a material weakness

The proposed standard described circumstances that should be regarded as strong indicators of a material weakness in internal control. The proposing release noted that the identification of one of these strong indicators should bias the auditor toward a conclusion that a material weakness exists but does not require the auditor to reach that conclusion. Under the proposal, the auditor could determine that these circumstances do not rise to the level of a material weakness, and in some cases, are not deficiencies at all.

Many commenters supported the proposed changes from Auditing Standard No. 2 relating to strong indicators, agreeing that, by allowing greater use of professional judgment in this area, practice will improve. A few commenters stated that these changes may lead to some inconsistency in practice, but consistent with other commenters, they still supported the use of greater professional judgment in the evaluation of deficiencies. At least one commenter suggested that several of the strong indicators were not indicators of a material weakness but should be, under all circumstances, a material weakness. A few commenters also suggested that the list of strong indicators in Auditing Standard No. 2 actually stifles the auditor's judgment to the point that auditors fail to identify material weaknesses that exist because the deficiency is not on the list of strong indicators. These commenters suggested that removing the list of strong indicators entirely would be best.

[3/] The provisions in the final standard relating to significant deficiencies are discussed in the first part of this release. As discussed in the first part of this release, the Board also made minor wording changes to the definition of material weakness in order to use the same definition as the SEC in its guidance to management and related rules.

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The Board believes that auditor judgment is imperative in determining whether a deficiency is a material weakness and that the standard should encourage auditors to use that judgment. At the same time, the Board continues to believe that highlighting certain circumstances that are indicative of a material weakness provides practical information about the application of the standard. As a result, the Board has included this information in the final standard but has taken a more principles-based approach. Additionally, the Board has coordinated with the SEC so that the indicators in the auditing standard parallel those in the SEC's management guidance.

Rather than referring to "strong indicators," the final standard refers simply to "indicators" of material weakness.[4/] The standard also makes clear that the list of indicators is not exhaustive and should not be used as a checklist. Specifically, under the final standard, the presence of one of the indicators does not mandate a conclusion that a material weakness exists. At the same time, a deficiency that is not a listed indicator may be a material weakness.

The Board did not adopt as indicators in the final standard certain proposed strong indicators. The Board believes, as at least one commenter suggested, that some of these proposed strong indicators are better characterized as material weaknesses rather than as indicators of a material weakness.[5/] Including them in the list of

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4/ The Board included as an indicator the proposed standard's requirement to determine the level of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. In the proposal, if the auditor determined that a deficiency would prevent prudent officials from concluding that they have such reasonable assurance, the auditor was required to deem the deficiency to be at least a significant deficiency. Under the final standard, if the auditor determines that a deficiency might prevent prudent officials from concluding that they have such reasonable assurance, this circumstance is an indicator of material weakness.

5/ One such proposed strong indicator was an ineffective control environment. Under the proposal, indicators of an ineffective control environment included identification of fraud on the part of senior management and significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after some reasonable period of time. The final standard includes the identification of fraud on the part of senior management as an indicator of a material weakness. In order to simplify the list and make it more principles-based, as

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indicators, as adopted, would therefore be inconsistent with the degree of judgment required to evaluate whether an indicator of a material weakness is, under particular facts and circumstances, a material weakness.

Requirement to evaluate all identified deficiencies

The proposed standard required the auditor to evaluate the severity of each control deficiency that comes to his or her attention. The same provision in the proposed standard made clear, however, that the auditor need not scope the audit to find control deficiencies that are less severe than material weaknesses. A few commenters believed that this requirement is not necessary and suggested that an acceptable alternative would be for the auditor to verify that management has evaluated all deficiencies.

The Board continues to believe that the auditor needs to evaluate all deficiencies that come to his or her attention. Without such an evaluation, there would not be a sufficient basis for the auditor's opinion.

6. Additional Scoping and Materiality Issues

The proposed standard clarified that the auditor should plan and perform the audit of internal control using the same materiality measures used to plan and perform the audit of the annual financial statements. This direction was intended to address concerns that auditors have interpreted Auditing Standard No. 2 as directing them to search for potential defects in internal control at a lower materiality level than that used in the audit of the annual financial statements.

The Board received many comments on materiality and scoping, and a large portion of the commenters expressed support for the proposed standard's approach. Some commenters, however, recommended providing clear quantitative guidelines for calculating materiality. Other commenters expressed concern about such an approach, fearing that material areas would be inappropriately excluded from the audit scope. Finally, some commenters suggested that the Board should provide additional guidance on scoping and extent of control testing decisions, such as guidance on sample sizes

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well as to align it with the SEC management guidance, however, the Board did not include significant deficiencies that remain uncorrected as an indicator in the final standard.

related to testing of high-risk controls versus low-risk controls or more specific guidance on the scope of the internal control audit for entities with multiple locations.[6/]

After considering these comments, the Board has determined to adopt its discussion of materiality in the internal control audit as proposed. The Board believes that the auditing standard on internal control is an inappropriate place to redefine or refine the meaning of materiality, which is a long-established concept in the federal securities laws. With respect to requests for more specific guidance on scoping or extent of testing issues, the Board has, as discussed in the first part of this release, endeavored to adopt a standard that relies more on general principles than detailed requirements. Accordingly, the Board believes that auditors should make specific determinations of how to comply with the general scoping and testing requirements in the standard using professional judgment in the particular circumstances presented.

7. Scaling the Audit for Smaller Companies

As discussed in the first part of this release, the Board received many comments on the proposed section on scaling the audit from commenters with a variety of perspectives. The comments covered a wide range of issues. In addition to the matters discussed in the first part of this release, commenters suggested:

- That the proposed section on scalability should be focused more closely on how complexity relates to a risk-based audit;
- That the proposed standard did not provide sufficient flexibility for smaller companies and that the standard should provide for more "credit" for control testing based on work done as part of the financial statement audit;
- That the resulting costs of these proposed changes would need to be studied for several years to determine if they are appropriate;

[6/] The proposed standard focused on the auditor's assessment of risk of material misstatement and how the auditor could carry that assessment process into the scoping of a multi-location audit. Commenters were very supportive of the Board's approach in this area and, consequently, the Board has determined to adopt these provisions as proposed.

- That the attributes of smaller, less complex companies that were included in the proposed standard were appropriate and that the tailoring directions for auditors were adequate;

- That some of the attributes of smaller, less complex companies that might allow the auditor to tailor the audit might be, instead, risk factors that require more testing;

- That the emphasis on entity-level controls might not be appropriate; and

- That the Board's project to develop guidance on auditing internal control in smaller public companies is necessary.

As discussed in the first part of this release, the Board made several changes in response to comments in the final standard. The new standard provides direction on how to tailor internal control audits to fit the size and complexity of the company being audited. It does so by including notes throughout the standard on how to apply the principles in the standard to smaller, less complex companies, and by including a discussion of the relevant attributes of smaller, less complex companies as well as less complex units of larger companies. The Board believes that the final standard appropriately considers the circumstances of smaller and less complex public companies (and other companies with less complex business units) while requiring a high-quality audit regardless of company size or complexity. The planned guidance on this topic will provide additional practical information for auditors of smaller companies.

8. Information Technology Principles

In gaining an understanding of the effect of information technology ("IT") on internal control over financial reporting and the risks the auditor should assess, the proposed standard directed the auditor to apply guidance in AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*. Additionally, the proposed standard included a discussion of IT operations at smaller and less complex companies. A number of commenters discussed the importance of IT risks to determining the scope of the audit and recommended that the final standard include additional guidance on how the risk assessment related to IT is incorporated in the audit of internal control.

In response to these comments, the Board included in Auditing Standard No. 5 a note to paragraph 36 that clarifies that the identification of risks and controls within IT should not be a separate evaluation but, rather, an integral part of the auditor's top-down risk assessment, including identification of significant accounts and disclosures and their relevant assertions, as well as the controls to test.

9. Roll-forward Procedures

The proposed standard discussed the procedures the auditor should perform to obtain additional evidence concerning the operation of the control when the auditor reports on the effectiveness of the control "as of" a specific date, but has tested the effectiveness of the control at an interim date. The Board received a few comments on this topic, mainly from auditors. The comments were consistent in their view that the proposed standard improperly implies, by using the expression "if any" in relation to additional evidence the auditor is required to obtain, that the auditor may not need to do any roll-forward work. Commenters suggested that such an approach would be inconsistent with paragraph .99 of AU sec. 319 and suggested that the words "if any" be removed from the final standard. The Board believes that its standard should be consistent with AU sec. 319.99 in that the auditor should perform some level of roll-forward procedures. Consequently, the Board removed the words "if any" from the relevant paragraphs of Auditing Standard No. 5 to correct the inconsistency. The Board also noted that, in some circumstances, inquiry alone might be a sufficient roll-forward procedure.

10. Cumulative Knowledge and Rotation

The proposed standard on auditing internal control allowed the auditor to incorporate knowledge from previous years' audits into his or her decision making process for determining the nature, timing, and extent of testing necessary. The section in the proposed standard on special considerations for subsequent years' audits built upon the risk-based framework in the proposed standard for determining the nature, timing and extent of testing by describing certain additional factors for the auditor to evaluate in subsequent years. These factors included the results of prior years' testing and any change that may have taken place in the controls or the business since that testing was performed. This section retained the requirement in Auditing Standard No. 2 that each control deemed important to the auditor's conclusion be tested every year, but allowed for a reduction in testing when the additional risk factors indicated that the risk was lower than in the past.

Many commenters strongly supported these provisions as proposed. Many investors, in particular, stated that while they supported the proposed approach, they would not be supportive of rotation of control testing over a multiple-year period. These

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commenters were generally concerned that rotation of control testing would negatively affect audit quality. Among supporters of the approach in the proposed standard, several requested further clarification in the standard or additional guidance on how this approach should affect the level of testing.

Many issuers suggested that the standard should allow for full rotation – which exempts some important controls from testing each year – of at least controls in low-risk areas. Other commenters recommended that all controls should be tested on a multi-year rotating basis. These comments often focused on the fact that while the proposed standard required the auditor to evaluate whether there had been any relevant changes since the control was tested, it still required testing at some level even when there had been no change. These commenters considered this requirement to be unnecessary.

The Board shares the concern that multi-year rotation of control testing would not provide sufficient evidence for the auditor's opinion on internal control effectiveness, which is required by the Act to be issued each year. In the financial statement audit, control testing plays a supporting role – to the extent that controls have been tested and are effective, the auditor can reduce the level of (but not eliminate) the necessary substantive testing. In contrast, in the internal control audit, control testing does not play a supporting role but is the sole basis for the auditor's opinion. Additionally, even if the design of the control and its related process does not change from the prior year, it is not possible to assess the control's operating effectiveness without performing some level of testing. For these reasons, rotation is not a viable option in the audit of internal control.

Instead, the approach described in the proposed standard has been clarified in the final standard and continues to focus the auditor on relevant changes since a particular control was last tested, as many commenters suggested. Under this approach, the auditor would consider, in addition to the risk factors described in the standard that are always relevant to determining the nature, timing, and extent of testing, whether there has been a change in the controls or in the business that might necessitate a change in controls; the nature, timing, and extent of procedures performed in previous audits; and the results of the previous years' testing of the control.[7/] After taking into account these additional factors, the additional information in subsequent years' audits might permit the auditor to assess risk as lower than in the initial year and, thus, might permit the auditor to reduce testing.

[7/] See paragraph 55.

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This treatment of cumulative knowledge is analogous to the roll-forward provisions in the final standard. In the case of subsequent years, the auditor, in essence, rolls forward the prior years' testing when the control was found to be effective in the past and no change has occurred (or would have been expected to occur due to changes in the environment or process that contains the control). Because the auditor might be able to assess the risk lower in the subsequent years, a walkthrough, or equivalent procedures, might be sufficient for low-risk controls. This approach appropriately factors in the effect of cumulative knowledge, while maintaining audit quality and providing a sufficient basis for the auditor's opinion.

11. Reporting the Results of the Audit

In the proposed standard, the Board attempted to address concerns that the separate opinion on management's assessment required by Auditing Standard No. 2 contributed to the complexity of the standard and caused confusion regarding the scope of the auditor's work.[8/] Accordingly, to emphasize the proper scope of the audit and to simplify the reporting, the proposed standard required that the auditor express only one opinion on internal control – a statement of the auditor's opinion on the effectiveness of the company's internal control over financial reporting. The proposal eliminated the separate opinion on management's assessment because it was redundant of the opinion on internal control itself and because the opinion on the effectiveness of controls more clearly conveys the same information – specifically, whether the company's internal control is effective.

Many commenters agreed with the Board that eliminating the separate opinion on management's assessment would reduce confusion and clarify the reporting. Some commenters, however, suggested that the Board should instead require only an opinion on management's assessment. These commenters expressed their belief that the Act requires only that the auditor review management's assessment process and not the company's internal control. Additionally, a few commenters expressed confusion about why the proposed standard continued to reference an audit of management's assessment in paragraph 1 of the proposed standard and the auditor's report.

[8/] Although Auditing Standard No. 2 requires the auditor to evaluate management's process, the auditor's opinion on management's assessment is not an opinion on management's internal control evaluation process. Rather, it is the auditor's opinion on whether management's statements about the effectiveness of the company's internal controls are fairly stated.

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The Board has determined, after considering these comments, to adopt the provision requiring only an opinion on internal control.[9/] The Board continues to believe that the overall scope of the audit that was described by Auditing Standard No. 2 and the proposed standard is correct; that is, to attest to and report on management's assessment, as required by Section 404(b) of the Act, the auditor must test controls directly to determine whether they are effective.[10/] Accordingly, paragraphs 1 and 2 of the proposed standard provided that the auditor audits management's assessment – the statement in management's annual report about whether internal control is effective – by auditing whether that statement is correct – that is, whether internal control is, in fact, effective. The final standard similarly makes this clear. In response to commenters, however, the Board has clarified the auditor's report so that it will consistently refer to the required audit as the audit of internal control.

12. Implementation

Some commenters urged the Board to focus on implementation issues after it adopts a final standard, and noted that effective implementation by the Board is crucial to the internal control reporting process. Some of these commenters focused on the inspections process, which they suggested is key to promoting audit efficiency. Some stated that auditors would be unlikely to change their audit approach until they are confident that the inspections will be similarly focused. The Board is committed to effective monitoring of firms' compliance with the new standard and will continue to promote proper implementation through other means, including the Board's Forums on Auditing in the Small Business Environment and guidance for auditors of smaller companies.

[9/] The SEC has adopted changes to its rules that require the auditor to express an opinion directly on internal control.

[10/] In addition, Section 103 of the Act requires the Board's standard on auditing internal control to include "testing of the internal control structure and procedures of the issuer …." Under Section 103, the Board's standard also must require the auditor to present in the audit report, among other things, "an evaluation of whether such internal control structure and procedures … provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles …."