

Law Offices  
ROBERT CHIRA & ASSOCIATES  
[www.robertchira.com](http://www.robertchira.com)

488 Madison Avenue, Suite 1100  
New York, N.Y. 10022  
Telephone: 212-826-7179  
Fax: 212-486-0701  
E-Mail: [rc@robertchira.com](mailto:rc@robertchira.com)

October 24, 2003

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

Re: PCAOB Rulemaking Docket No. 008:  
Proposed Auditing Standard-An Audit of Internal Control Over Financial Reporting

Dear Sir/Madam:

I am an attorney with no affiliation to any public accounting firm required to register with the Public Company Accounting Oversight Board (the "Board"). I commend the Board on its proposed standard relating to internal control over financial reporting, but offer the following comments on some of the questions posed in its Release No. 2003-017 dated October 7, 2003.

Question 1. Is it appropriate to refer to the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting as the audit of internal control over financial reporting?

Comment: No.

In proposing that an audit be made of internal control over financial reporting (hereafter such type of controls referred to simply as "internal accounting controls" or "internal controls"), the Board has interpreted relevant provisions of the Sarbanes-Oxley Act (hereafter the "Act") broadly and perhaps unnecessarily so at this point in time. It has also blurred the difference between an "attest" service and "attestation report" as compared to an "audit" and "audit report."

The Act contains two provisions concerning internal accounting controls: First, Section 103(a)(2)(A)(iii) provides that the Board include in auditing standards it adopts a requirement that the outside auditor “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) [of the Act]... Second, Section 404, entitled “*Managements’ Assessment of Internal Controls*,” and subsection (b) thereof, entitled “*Evaluation and Reporting*”, require the outside auditor to both “*attest to*” and “*report on*” “*the assessment made by management...*” It further provides that such attestation “be made in accordance with *attestation standards*” adopted by the Board. (Italics added).

An “attest” engagement” concerning matters other than the financial statements has traditionally been distinguished from an “audit” of the financial statements. The former usually refers to an engagement in which the auditor “expresses a conclusion about the reliability of a written assertion” made by others. See Statements on Standards for Attestation Engagements (“SSAE”) promulgated by the AICPA and codified as AT Section 100.01. Its standards further distinguish the attest function of an “audit of financial statements,” on the one hand, from those other kinds of “attest” services that provide “assurances on representations *other than historical financial statements and in forms other than the positive opinion*,” on the other hand. See Introduction to Attestation Standards. It makes clear that attesting to the effectiveness of internal controls is a typical example of such other “attest” services. A comparison of attestation standards and audit standards is set forth as Appendix A in AT Section 100.89.

The SEC has also traditionally distinguished between an “audit” which it has used to refer to an examination of the financial statements, on the one hand, and “performing other...attest services for the issuer,” on the other hand. See text and footnote 62 in Securities Act Release No. 8173, “Standards Relating to Listed Company Audit Committees”, dated January 8, 2003. Moreover, in its recent release adopting rules for management’s report on internal controls required by Section 404(a) of the Act, the SEC refers to the auditor’s report on management’s assessment required by Section 404(b) as an “attestation report” which is to be made in accordance with standards for “attestation engagements”. It has also amended Regulation S-X to define the term “attestation report.”. See Securities Act Release No. 8238 dated June 5, 2003 and Rules 210.1-02 and 210.2-02 of Regulation S-X.

Thus, to avoid confusion between the SEC’s rules and the Board’s standards, and to more closely follow the exact words used in Section 404(b) of the Act, the Board may wish to consider calling the auditor’s report an “attestation report” on management’s assessment of internal controls rather than referring to it as an “audit” of internal controls over financial reporting which results in an “audit report”.

The Board’s proposed standard explains in Paragraph 3 and footnote 3 that the terms “audit” and “attestation” “refer to the same professional service, one being the process and the other the result of that process.” I am not an accountant but believe that an “audit” of financial statements is a form of “attestation” and that the concept of “attestation” is almost indistinguishable from “auditing.” Both require an examination, testing, gathering of evidence

and opinion determining if managements' assertions are "fairly stated in all material respects" or "fairly presented." See AT Section 501, "Reporting on an Entity's Internal Control Over Financial Reporting" and AT Section 9501. However, attestation standards have traditionally been issued to "provide a framework for the attest function beyond historical financial statements." AT Section 100.89.

In view of this history and the confusion that might result from having Board standards using terminology that differs from both those customarily used and from those used in SEC's rules, it may be more appropriate (and practical) for the Board not to use the word "audit" or "audit report" when referring to the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting.

---

Question 6. Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective.

Comment: No.

Related to the use of terminology, and proceeding from it, the Board's proposed standard would require the auditor not only to evaluate management's assertion as to the effectiveness of internal controls, but also to independently determine, after obtaining direct evidence, that they are in fact effective. The Board asks if this scope of the audit is "appropriate."

It should be noted that historically there has been a distinction between the auditor directly expressing an opinion on the effectiveness of internal controls as compared to whether management's assessment of their effectiveness is fairly stated. See the AICPA standard in AT Section 501 (which the Board's standard would supercede). The difference is also highlighted, to some extent, by the General Accounting Office's May 20, 2003 comment letter to the AICPA's Auditing Standards Board ("ASB") on its exposure draft standard dated March 18, 2003. The GAO stated that although it believed in the value of an opinion on internal controls and has provided them for financial statement audits it conducts, it also pointed out: "Current guidance for audits of government agencies and programs requires auditor *reporting* on internal controls, *but not at the level of providing an opinion on internal control effectiveness.*" (Italics added).

Due to this historical background and traditional distinction, I believe it may be argued that at the time the Act was enacted Congress did not intend that an audit be conducted of the internal controls and that the auditor itself opine as to their effectiveness. If it did so intend one would have expected the Act expressly to so provide. Instead, it uses the words "attest to" and "report on" "*the assessment made by management*" and, further, that such attestation be made in

accordance with “attestation standards” adopted by the Board. (Italics added).

---

Question 11. Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use of the audit evidence obtained in previous years to support his or her current opinion on management’s assessment?

Comment: No.

The Board’s proposed standard requires testing of “all” relevant assertions concerning “all” significant accounts and “all” significant disclosures. This seems to adopt the ASB’s position concerning the extent of the controls to be tested in an audit of them as compared to one of the financial statements. Thus, in its March 18, 2003 exposure draft, the ASB contends that significantly greater testing is required when doing an audit of internal controls as compared to an audit of the financial statements, stating:

“6. The range of controls that need to be tested to express an opinion on internal control is *significantly broader* than that which may have been tested solely to express an opinion on financial statements. For example, [for the latter]...the auditor may elect to perform only substantive procedures rather than to perform tests of controls, or perform a mix of substantive procedures and tests of controls over some or all significant accounts, classes of transactions, and disclosures... For the purpose of expressing an opinion on internal control, the tests of controls should encompass significant controls related to all significant accounts, classes of transactions, and disclosures...” (Italics added).

(The Board has changed the ASB standard by requiring that all “relevant assertions” rather than “significant controls” be tested in the audit of internal control).

Such a significantly broader view of the controls to be tested, however, may be inconsistent with Section 103(a)(2)(A) (iii) of the Act which requires that the auditor’s report describe the “scope of the testing” of both controls and procedures, words that probably suggest a limitation was intended. The argument would be that if Congress intended that “all” significant assertions related to all significant accounts and disclosures be tested, it would not have used the words “scope of the testing”.

---

In view of the foregoing responses to Questions 1, 6 and 11, and for the reasons set forth below, I believe the Board should consider proposing a standard at this point in time which only

requires the auditor to examine “management’s assertion” of effectiveness and evaluate whether it is “fairly stated in all material respects”. To reach its conclusion, the amended standard would require the auditor to test “certain” controls and procedures but only to the extent necessary to gather evidence to corroborate or refute management’s assertion. I believe that such a standard would more closely follow the Act’s references in Section 404(b) to an “evaluation” of “the assessment made by management” and Section 103(a)(2)(A)(iii)’s requirement that the auditor’s report describe the “scope of the testing”.

Such an amended standard should significantly reduce the outside auditor’s work and fees, and thus significantly reduce the costs imposed on the approximately 15,000 large, medium-sized and small public companies affected by the Board’s standard. It would also allow the Board to proceed on a more cautious basis and discover over the next few years whether such an attestation standard has positive results before a more demanding one is adopted. Of course, such a decision is essentially a policy one and in its start up phase and in light of the horrendous audit failures that led to the Act’s enactment, the Board may decide it must impose the most stringent standard possible.

It should be noted, however, that the Board is not the only body that Congress has vested authority in, or responsibility for, improving internal controls over financial reporting. Management must not only report on the effectiveness of internal controls under Section 404(a) of the Act, but under Section 302 must also take responsibility for such controls and certify their conclusions as to their effectiveness. And, under Section 906 of the Act, there are criminal penalties attached to management’s knowingly false certification. Thus, the Board’s rules in this area should be considered in light of these other stringent requirements.

If, despite these new requirements imposed on management, the Board finds from experience that its attestation standard fails to improve internal accounting controls and the reliability of financial reporting, it will have sufficient reason and ample evidence to warrant the more rigorous standard of requiring an audit of internal accounting controls by the outside auditor with a direct expression of its opinion as to their effectiveness.

---

Question 4. Does the Board’s proposed standard give appropriate consideration to how internal control is implemented in, and how the audit of internal control over financial reporting should be conducted at, small and medium-sized issuers?

Comment: No.

While the Board states it is “sensitive” to its possible effects on such entities and recognizes that “one size does not fit all”, it does not give any *specific guidance* to how audits of internal accounting controls may be conducted for such smaller and medium-sized companies. For example, it could propose that “walkthroughs” of “significant processes” be required for only a *sample* rather than to “all” of them. It could also require the testing of controls of a

*sample* of “relevant assertions” for all significant accounts or disclosures rather than testing “all” such assertions for all such accounts and disclosures.

Without the Board providing specific guidance, the outside auditor of a small or medium-sized company will fear doing less than all “walkthroughs” and testing controls of “all” relevant assertions about “all” significant accounts and disclosures. Thus, the Board’s concerns that small and medium-sized companies not be subjected to the same extensive testing as larger companies will be ignored unless it gives guidance to the outside auditor to perform less.

---

Question 10. Is it appropriate to require that the walkthroughs be performed by the auditor himself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors or others?

Comment: No.

It is not appropriate for the Board to only permit such procedures to be performed by the outside auditor. If a company has a professional and independent audit staff it may be in a better position than the outside auditor to understand the internal accounting controls and how they perform. The central question is whether it would be “reasonable” for the outside auditor to rely upon the internal auditor staff. If that staff follows professional standards, such as the Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors (“IIA”), reports to the audit committee and is deemed independent of management, the outside auditor should be allowed to rely, to a significant extent, on “walkthroughs” already performed by it rather than re-doing its work. To determine what is “reasonable” reliance, the outside auditor could re-do a sample of those done by the internal staff. This position is consistent with the Board’s proposed standard in Paragraph 103 concerning relying on internal auditors for the tests of controls “to the greatest extent an auditor could use the work of others.”

---

Question 22. Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee’s oversight of the company’s external financial reporting and internal control over financial reporting?

And Question 23. Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee’s oversight?

Comment: No.

Such a requirement would reverse the “master-servant” relationship that should exist

between the audit committee as “master” and outside auditor as “servant” and is contrary to the objectives of the Act to strengthen the role of the former. I believe such a requirement would dilute the audit committee’s power and authority if it could be questioned and evaluated by the outside auditor it is supposed to supervise.

I also think it is impractical to require that the audit committee charged by Section 301 of the Act with responsibilities for hiring the outside auditor, approving of certain non-audit services, including tax services, it wishes to provide, retaining the sole authority to fire the auditor, and resolving disagreements between the auditor and management regarding financial reporting, be simultaneously evaluated by that auditor, particularly as to its effectiveness in overseeing such financial reporting.

In June 2002, a committee appointed by the New York Stock Exchange made a set of recommendations about improved corporate governance, stating with respect to the role of the audit committee:

“...the committee stands at the crucial intersection of management, independent auditors, internal auditors and the board of directors.”

In view of its significant and critical role, I would urge the Board to drop from its proposed standard any requirement that the auditor evaluate the audit committee’s effectiveness.

Respectfully submitted,

Robert Chira