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To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

SUBJECT: PCAOB Rulemaking Docket Matter No. 008

Via email: comments@PCAOB.org

Dear PCAOB Commissioners,

Both the PCAOB and the SEC should be commended on the comprehensive and rigorous efforts since the passage of the Sarbanes-Oxley Act to implement new rules and regulations to help rein in the abuse and greed that threatens Corporate America. Your approach thus far has been balanced and fair.

The subject of internal controls is an interesting one that unfortunately is probably not well understood by most investors. It is a topic that has not received an appropriate amount of attention over the past few years and one that is actually not as complex as some may make it appear.

Unfortunately, internal auditors and external auditors have made internal controls more complicated by engaging in a practice of "documenting controls" that provide very little value, meaning, or relevancy to the day-to-day operations or financial statement reporting integrity of an organization. They have done this because they needed to teach inexperienced staff members how to cost-effectively discharge their duties of evaluating a business process of which they have actually very little knowledge or comprehension. This effort to document controls served as an easy way out for the auditors. It ignores the need to assess risk and apply critical judgment to increasingly complex business processes.

Forgetting independence issues for a moment:

- Enron spent millions of dollars outsourcing internal audit work to Andersen,
- Tyco spent millions outsourcing internal audit work to PWC.
- Healthsouth spent millions outsourcing internal audit work to Ernst & Young.
- Adelphia spent millions outsourcing internal audit work to D&T.
- Levi Straus spent millions of dollars outsourcing internal audit work to KPMG

And what did they do? They exhaustively documented the existence of internal controls within critical business processes of which they had limited understanding. They deployed inexperienced, often straight out of college, staff members without adequate training or supervision to interview business process owners and to document the existence of controls. They tried to standardize complex business processes into forms and checklists that could be "leveraged" to staff apprentices. The economic needs to take this pressure are enormous. Staff members generated on average over \$175,000 a year in revenue and are paid but a fraction of what they produce. The economic model that each of the big-four firms is similar. Inexperienced staffs do the majority of the work and produce the majority of the revenue. Meanwhile partners and other "experienced" professionals are engaged to sell the work.

For the past twenty years or more the public accounting profession has aggressively strayed from their roots of providing independent, objective, audit opinions on financial reports to pursue lucrative consulting, tax, and internal audit related services. They traded their integrity and trust for growth and profits. They let down the shareholders and board members

who hired them as they succumbed to management's financial incentives.

In order to ensure the effectiveness of internal controls within a company the PCAOB needs to listen carefully to management and stockholders and not to the public accounting professionals who claim to be experts at internal control systems when they have recklessly managed an effective understanding of internal controls for the past twenty years. The purveyors of accounting solutions are motivated by a simple desire to enrich their private partnerships with wealth at the expense of Corporate America.

Business owners, managers and stockholders on the other hand have a vested interest in achieving sound systems of internal control. In a competitive business environment they need to have sound internal control systems in order to remain profitable and to attract capital investment for their endeavors.

Companies not only own and manage these systems, but they also work hard to design, improve, and enhance internal controls. Through this process individuals throughout an organization, not just in internal auditor, develop experience and knowledge critical to assessing and evaluating the effectiveness of internal controls.

In order to comply with the requirements of Section 404 management must be able to rely on both their internal auditors ability to help assess the internal control environment and the abilities of individuals throughout their organization in executing their responsibilities to maintain the internal control system within the organization. Therefore, in paragraph 108 of the proposed standard, the Board should specifically recognize the fact that: employees throughout an organization performing their daily activities and tasks are an integral part of the system of internal controls and that these individuals represent a valuable resource that organizations could and should call upon as they attempt to document, evaluate, and otherwise understand the existence of internal controls.

Paragraph 108 appears to limit an auditors ability to rely upon the work of others when clearly there are and should be instances when this is desirable. A professional and well-managed internal audit function is important but restricting an Auditor from relying upon work performed by other "non-internal audit" employees in documenting or testing internal controls may have other negative consequences that should be considered.

For example, Audit firms may suggest to management and the audit committee that the internal audit resources available to staff these engagements are not sufficient and therefore they, the external auditors, need to provide resources to "assist management in documenting internal controls." This scenario has already manifested itself in the marketplace as numerous companies have already engaged their independent auditors to "assist in the documentation of internal controls." The problem with this is that not only does it have the undesirable effect of compromising the auditor's independence, as discussed further below, but also it effectively provides the auditor with a license to violate other principles of independence.

Despite the SEC's own rules on Auditor Independence, current business practices clearly would suggest that the Big Four accounting firms are actively engaged in disguising non-audit related activities and more detailed control-related activities as permissible activities by billing them as part of the "documentation of internal controls for Sarbanes compliance. This is occurring at an account level throughout the country at numerous companies. Some firms are actively assisting clients in remediation of their internal controls around IT Systems, the Financial Statement Close Process, or other key business processes as part of the services that they cleverly call "audit related" or "documentation related."

Audit Committees are being duped by their auditors and management as they believe they are buying one service when in fact the auditors are performing special projects for management that are only remotely related to the documentation of internal controls. In the current environment they (Audit Committees) should not be surprised to see that the nature of work performed varies significantly from what was presented to them in an audit committee meeting or represented to them in a letter of understanding by their external auditors. Audit Committees would be well advised to evaluate the actual work performed and scope of services for all projects they authorize that are not part of the financial audit and to possibly carefully scrutinize the scope of services now being billed as part of the financial audit.

The PCAOB should clearly articulate that public accounting firms cannot and should not be engaged to "assist audit clients in designing, implementing, assessing, or evaluating internal controls as a separate engagement independent of the financial audit." Performing these services in conjunction with a financial audit and an attestation of management's assertions on internal control should be permissible. But any other independent activity or engagement that is designed to assist a client in assessing or evaluating their internal control system should be specifically prohibited. Auditors should be placed on notice that internal controls is the responsibility of management and they should not act as special advisors on such topics except at a de minimis level.

Several of the large accounting firms have been engaged in providing their client's with templates or software packages that enable companies to document and evaluate internal controls. Because of the potential for perceived conflicts many

of these transactions have been performed through intermediaries or third parties. For instance, one major accounting firm has an agreement (possibly as a verbal amendment to an existing contract or otherwise) whereby they are entitled to certain discounts and incentives when they refer business to the software vendor. Another firm helped develop a conceptual architecture for other software vendors to employ. The resulting software products are now promoted to their audit and non-audit clients as Sarbanes-Oxley solutions.

Understanding the financial dealings or agreements behind these relationships is not a matter of public record – but it certainly raises significant questions as to what incentives exist for these firms to promote software products to their clients. Even if there is no remuneration, or other direct incentives, the public auditors objectivity will ultimately be compromised when they are called to attest to management's assertions on internal controls. Consider if you will a situation whereby a client spends \$250,000 with one of the "recommended providers" of software to assist in the documentation process. If the software doesn't do the job it was intended to do and the auditors recommended and promoted the solution or otherwise helped design the system, are they going to be objective in questioning management's evaluation of internal controls? Are they going to point out deficiencies in the client's new system? Probably not!

This raises another important point. Regardless of the fact that Auditors may be engaged in the practice of disguising inappropriate non-audit services as part of the "documentation of internal controls" effort, Auditors should not be engaged to assist in the documentation of internal controls. The proposed rule states in Paragraph 19:

For the auditor to satisfactorily complete an audit of internal control over financial reporting, management must do the following:C) Support its evaluation with sufficient evidence, including documentation, and...."

Paragraph 43 specifically outlines what an auditor might have to do to determine whether management's documentation provides reasonable assurance to support their assessment on internal controls. The Board appropriately defined some factors that the auditor should evaluate in assessing the quality of the documentation in supporting management's assertions. Since the Auditor is attesting to these assertions it seems to reason they should play a very limited and restricted role in devising any component that would be the subject on which management based their own evaluation and assessment.

Surely the auditor should not be engaged to assist the company in performing this documentation. Doing so, places the auditor in a position whereby they would have to assess the adequacy of internal documentation that they helped create. The result clearly places the auditor in a position of "auditing their own work." It also impairs their ability to provide impartial judgments on the quality of the documentation.

The rules are very clear on this point. In fact Grant Thornton, the fifth largest public accounting firm, arrived at this same conclusion and issued a press release on September 2nd 2003 stating that they would not provide services to document internal controls to their public audit clients. Meanwhile the Big Four firms have been deafly silent on this issue as they continue to deploy resources to their public audit clients to perform this and other non-audit related activities.

The existing rules seem to clearly prohibit this type of behavior; nevertheless the facts speak for themselves. The motivation of the Big Four to protect this will undoubtedly be disguised in their responses in the commentaries that will follow. A quick review of recent press releases forecasting record revenue for public accounting firms in fiscal year 2004 underscores the real motivation behind their complacency on these issues. In fact, the SEC and PCAOB should issue an immediate order clarifying this point otherwise the firms will continue to book revenue and claim ignorance of the blatant facts that Grant Thornton has clearly identified in their own reading of the rules.

Thank you for considering these comments to your important standard setting process. Some of the items brought forth point to larger issues of reform and/or are matters that may require further investigation on the part of the PCAOB. Ultimately, true reform will come when the large public accounting firms start to play by the rules that you have proposed and stop trying to find profitable loopholes whereby they can capitalize on the fear, uncertainty and doubt upon which they currently prey.

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