November 12, 2003

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 2006-2803

Re: PCAOB Rulemaking Docket Matter No. 008

To the Public Company Accounting Oversight Board:

We are pleased to present our comments on *Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.*

Summary of Our Comments:

While we generally agree with most of the proposed standard, we take exception to the inference of "limited reliance" on internal audit for the internal control audit. This seems to be inconsistent with existing auditing literature, which provides for considerable reliance on internal audit for financial statement audits. We believe these elements will drive up the cost of the internal control audit, putting a substantial burden on medium-sized companies such as ours. Furthermore, we think that there is terminology in the proposed statement that needs clearer definition, and examples. Our detail comments follow.

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?*

   Yes.

2. *Should the auditor be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements?*

   Yes. Given the fact the two audits are integrated with each other, there is no other practical way to perform the internal control audit.

3. *Rather than requiring the auditor to also complete an audit of the financial statements, would an appropriate alternative be to require the auditor to perform work with regard to the financial statements comparable to that*

required to complete the financial statement audit?

No. Would be much too costly and difficult to coordinate.

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?*

   Not entirely.

   The proposed standard is very complex and involved. Being a medium-sized company, we are very concerned that the cost of the internal control audit will be excessive (both soft and hard dollars), and will be a significant burden to comply with. We are concerned that we will be held to the "highest bar", more appropriately fit for the largest of companies, who have the staff and resources to handle each element of the standard.

   Unfortunately, Appendix E, "Special Internal Control Over Financial Reporting Considerations for Small and Medium-Sized Companies", only addresses small companies. It does not discuss or give guidance for medium-sized companies such as ours. While this may be difficult to articulate, we do recommend that the Board take this into consideration and set forth how the internal control audit might differ for a medium-sized company. It may be helpful to mention the level of documentation required and the like.

5. *Should the Board, generally or in this proposed standard, specify the level of competence and training of the audit personnel that is necessary to perform specified auditing procedures effectively? For example, it would be inappropriate for a new, inexperienced auditor to have primary responsibility for conducting interviews of a company's senior management about possible fraud.*

   This seems to be adequately addressed in Paragraphs 30 and 31.

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?*

   Yes.

7. *Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation?*

   Yes.

8. *Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?*

We believe that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate. We can envision circumstances where the lack of documentation may not have any effect on internal controls over financial reporting.

9. *Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?*

Not entirely. We think the standard should mention that "walkthroughs" are often performed in connection with an audit of the financial statements, and therefore, are not always a "new" procedure for purposes of an internal control audit.

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

We believe that there are cases where the auditor can use (and perhaps rely on) walkthrough procedures performed by internal auditors.

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 some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?*

We believe the proposed standard generally allows "previous years" audit evidence to be considered in the current year's audit. We suggest that the Board consider giving more specific guidance in this regard. For instance, there may be certain accounts and disclosures where the auditor knows (from the audit of the financial statements) that no changes in internal controls have taken place in the current year.

12. *To what extent should the auditor be permitted or required to use the work of management and others?*

See responses to Questions 13 and 14.

13. *Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?*

No.

a. We would like to see a more precise definition of “control environment”.

b. We believe that more guidance is necessary to specifically define controls that have a “pervasive effect” on the financial statements. Paragraph 104 cites the example of information technology controls. However, we find it confusing when it is stated that “certain” information technology general controls have a pervasive affect. Our question is “which ones”?

   Lastly, auditors performing financial statement audits have usually relied on the work of internal auditors in the area of information technology general controls and other technology areas. Paragraph 104 and the example in Appendix B20-B23 suggests that auditors cannot rely on internal audit work for the internal control audit. We find it inconsistent that auditors can rely on internal audit in a pervasive area for the financial statement audit, but not for the internal control audit. We suggest that this be reconsidered. We also cannot understand why auditors have singled out information technology as an area for non-reliance.

c. Regarding Paragraph 105, we suggest that more definition be given to cases where the auditor is “limited” in using the results of testing performed by others. While we generally agree that higher risks are prevalent in (a) accounts involving significant judgments and estimates and (b) accounts where the risk of failure of controls is high, we also suggest that examples be given. In addition, we suggest that a definition be furnished for what it means to have “limited” use of testing by others in these situations.

14. *Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?*

We believe that the proposed standard does not place enough emphasis and preference on the work of internal auditors. We find a general inconsistency in the proposed standard and AU Sec. 322 “The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements”. The proposed standard seems to imply that reliance on the work of internal auditors should be significantly limited in audits of internal controls, whereas AU Sec. 322 permits greater reliance on internal audit in audits of financial statements. If the two audits are integrated, we believe the standards should be the same.

See our response to Question 13. We believe that Paragraph 104 of the proposed standard should not impose the requirement of non-reliance on the results of testing performed by internal audit in the 4 areas cited. As we have stated in our responses to Question 10 and 13, there may be cases where the auditor can significantly benefit and rely upon the work of internal auditors.

15. *Is the flexibility in determining the extent of reperformance of the work of others appropriate, or should the auditor be specifically required to reperform a certain level of work (for example, reperform tests of all significant accounts or reperform every test performed by others that the auditor intends to use)?*

We believe that flexibility in reperformance is especially important in cases where the auditor is relying on the work of the internal auditors.

16. *Is the requirement for the auditor to obtain the principle evidence, on an overall basis, through his or her own work the appropriate benchmark for the amount of work that is required to be performed by the auditor?*

No. We believe that existing auditing literature allows the auditor to place reliance on the work performed by internal auditors. This should be incorporated into the "benchmark".

17. *Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?*

The definitions seem appropriate.

18. *Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? Are there other specific examples that commenters could suggest that would provide further interpretive help?*

The examples in Appendix D are helpful.

19. *Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies?*

Yes.

20. *Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?*

No. The materiality considerations set forth in Paragraphs 21-23 cover this area adequately. To require the auditor to communicate every internal control deficiency would seem to go way beyond the spirit of the proposed standard. It would also put the auditor in the unenviable position of communicating all internal control deficiencies, including those cited by internal auditors and the like.

21. *Are the matters that the Board has classified as strong indicators that a material weakness in internal control exists appropriately classified as such?*

Yes.

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?*

Maybe. We raise the question as to whether there is an inherent conflict for the auditor, due to the fact that Audit Committee employs the auditor?

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

Yes.

24. *If the auditor concludes that ineffective audit committee oversight is a material weakness, rather than require the auditor to issue an adverse opinion with regard to the effectiveness of the internal control over financial reporting, should the standard require the auditor to withdraw from the audit engagement?*

No, unless such a weakness would cause the auditor to also withdraw from the audit of the financial statements.

25. *Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?*

Yes.

26. *Are there circumstances where a qualified "except for" conclusion would be appropriate?*

Yes, Example A-3 is a good use of an “except for” opinion.

27. *Do you agree with the position that when the auditor issues a nonstandard opinion, such as an adverse opinion, that the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting rather than to whether management's assessment is fairly stated?*

Yes.

28. *Should the Board provide specific guidance on independence and internal control-related non-audit services in the context of this proposed standard?*

See Question 29.

29. *Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client?*

We believe that this is adequately covered in Paragraphs 32 – 35. However, the last sentence of Paragraph 33 seems to imply that it is acceptable for the auditor to provide internal control related non-audit services, as long as such services are approved by the Audit Committee. This seems to conflict with the spirit of the independence rules set forth in the proposed standard. We think the Board needs to be clear on this issue.

30. *Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?*

Yes.

31. *Is the scope of the auditor's responsibility for quarterly disclosures about the internal control over financial reporting appropriate?*

Yes.

Cordially,

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