

Consultation Response



PROPOSED AUDITING STANDARD

AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS

PCAOB Rulemaking Docket Matter No. 008

Comments from ACCA

November 2003



Page 1

ACCA is the largest and fastest-growing international accountancy body. Over 300,000 students and members in 160 countries are served by more than 70 staffed offices and other centres.

ACCA's mission is to work in the public interest to provide quality professional opportunities to people of ability and application, to promote the highest ethical and governance standards and to be a leader in the development of the accountancy profession.

Further information on ACCA is available on ACCA's website, www.accaglobal.com



General Comments

ACCA is please to provide comments on 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* (the Proposed Standard).

PCAOB is currently issuing new standards while having established Interim Professional Auditing Standards in respect of auditing, attestation, quality control, ethics, and independence. These Interim Professional Auditing Standards are essentially those that were established by the American Institute of Certified Public Accountants (AICPA). ACCA considers that, to further its objectives over the longer term, it is vital that PCAOB develops new standards that promote consistent, high quality auditing around the world. To achieve this, we strongly encourage PCAOB to ensure that, wherever possible, it develops standards that are consistent with those of the International Auditing and Assurance Standards Board of the International Federation of Accountants. Global harmonisation of auditing standards of the highest quality is essential to the integrity and efficiency of capital markets and we encourage PCAOB to work closely with IAASB to achieve that end.



Our primary concern with the Proposed Standard is that its emphasis on requiring auditors to obtain direct evidence of the effectiveness of internal control, taken together with the extent of detailed requirements and guidance, may cause auditors to adopt a 'bottom up' rather than a 'top down' approach to their work. The 'bottom up' approach is neither effective nor efficient.

Corporate failures, such as Enron and WorldCom can be attributed to weaknesses in the control environment. The risk is that a 'bottom up' approach may mean that auditors pay insufficient attention to the control environment, which COSO rightly recognises as *'the foundation for all other components of internal control'*.

Companies already face cost increases relating to their own compliance with the Act. There is a risk that they will also experience both direct and indirect costs of auditor inefficiency that are greatly disproportionate to the benefit to their investors.

ACCA has a wide experience of auditing in many jurisdictions and we are aware of the fact that many will heed the words in the Proposed Standard that: *'the Board expects that the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control.'* Nevertheless, we perceive a significant risk that, particularly for larger enterprises, auditors will do too much work. If this happens, there is a risk that PCAOB standards themselves will be devalued. We urge PCAOB to address this perception problem aggressively to ensure that standards are seen as proportionate and cost effective as well as being of the highest quality.



Response to the Questions in the PCAOB's Request for Comments

- 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?

No. It would be better to retain the term 'audit' for the financial statement audit and to refer to the attestation as an attestation.

- 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. The Act does not anticipate that these engagements will be separate.

- 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?

We see no value in requiring equivalent work without actually reporting as the financial statement auditor.

- 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?

Yes. Much of the guidance is, however, given in Appendix E rather than in the main body of the Proposed Standard.

- 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.

Yes - generally. This is an area where the PCAOB should consider harmonisation with the IFAC standards on education and quality control.

- 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. It is important that the auditor does not simply rely on others throughout. In our general comments we have, however, drawn attention to the risk of auditors doing too much work because they perceive that obtaining direct evidence is emphasised.

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

Yes. Criteria are necessary and the provision of consistent criteria beneficial. We suggest, however, that the criteria in paragraphs 43 to 47 may be perceived as inflexible and that auditors might concentrate too much on documentation.

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

(a) Yes. This allows for the use of professional judgement.

(b) No.

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

No. Walkthroughs may be useful in some systems but provide little evidence of effectiveness. The 'controls' identified by walkthroughs are often no more than aspects of the accounting system which provide little mitigation of business risks.

- 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?

No. The auditor should use professional judgement to determine the extent to which he or she performs walkthroughs.

- 11 (a) 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 (b) every year or (c) may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

(a) Yes. We are concerned however that this will be perceived as requiring all low level controls to be tested.

(b) & (c) Although audit evidence may be obtained from work carried out in previous periods, the migration of that evidence to the current period is a complex matter of audit methodology which is rightly left to the judgement of the auditor.

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

This should be permitted as a matter for the judgement of the auditor.

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

No. We suggest that such material would be better presented as guidance and the decisions on reliance on the work of others left to the auditor.

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

Yes. Internal auditors play a vital role in many companies and it is appropriate that the independent auditor has the capacity to rely on their work.

- 15 (a) Is the flexibility in determining the extent of reperformance of the work of others appropriate, or (b) 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)?**

(a) Yes.

(b) No. This should be a matter of professional judgement.



- 16 Is the requirement for the auditor to obtain the principal 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. This should be a matter of professional judgement. A requirement in this regard would add substantially to the perception that the Proposed Standard is not cost effective.

- 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?**

Yes. Auditors need to focus on matters of significance and materiality. The definitions are one area where PCAOB should avoid issuing a Standard that is not easily reconcilable to the output of IAASB.

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

(a) Yes.

(b) We do not suggest any further examples.



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

Yes. The evaluation need not be extensive except where there is a potentially significant deficiency.

- 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?**

Yes. Trivial matters should, however, be excluded from such a requirement.

- 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?**

This is a difficult question. Theoretically the auditor’s relationship with the audit committee may preclude such an evaluation. Nevertheless, oversight exercised by the audit committee may in itself be important to internal control. On balance we suggest that there be no requirement to evaluate the effectiveness of oversight as a separate matter but that the impact of the work of the audit committee can be a factor that the auditor considers as part of his or her evaluation of the internal control environment at the highest levels.

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

See our answer above.

- 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?**

See our answer above.



- 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?**

No. The auditor should use professional judgement to determine whether an adverse conclusion is appropriate (see answer below).

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

Yes. In some circumstances, such an opinion will provide better information to users and this should, therefore, be a matter of professional judgement.

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

No. The Act is concerned with management's assessment. PCAOB should consider research of user understanding before moving towards a direct report.



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

No. Independence should be addressed in other pronouncements.

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

It would be appropriate to refer to the SEC independence rules.

- 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. In the case where a rule requires quarterly certifications of a different nature to annual certifications it is appropriate for the responsibility of the auditor also to differ.

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

Yes. Given the limited nature of quarterly certification we do not believe that more should be required.

TECH-CDR-349



1 The Association of Chartered Certified Accountants

29 Lincoln's Inn Fields London WC2A 3EE United Kingdom

tel: +44 (0)20 7396 7000 fax: +44 (0)20 7396 7070 www.accaglobal.com