

November 21, 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*

Dear Mr. Secretary:

The American Institute of Certified Public Accountants (“AICPA”) respectfully submits the following written comments on the Public Company Accounting Oversight Board’s (“PCAOB” or “Board”) proposed auditing standard (the proposed standard) governing the independent auditor’s attestation and reporting on management’s assessment of the effectiveness of internal control over financial reporting pursuant to Section 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002 (“the Act”). Our comments reflect our views as they pertain to audits of issuers subject to the Act and do not necessarily reflect our viewpoint for audits of nonissuers. The AICPA is the largest professional association of Certified Public Accountants in the United States, with more than 330,000 members in public practice, business, industry, government, and education.

Executive Summary

The AICPA has long supported reporting on the effectiveness of internal control over financial reporting by public companies accompanied by auditor attestation because effective internal control is a critical component of reliable financial reporting. We believe that this practice will lead to increased quality in the preparation of financial statements.

The AICPA recognizes the enormous effort put forth by the PCAOB members and staff to implement the provisions of the Act. Initially, a significant responsibility of the PCAOB will be to help restore public confidence in audited financial statements of public companies. The establishment and maintenance of high quality auditing and other professional standards is critical to that goal. The AICPA is committed to working cooperatively with the PCAOB in the continuous improvement of high quality audit standards.

We believe that incorporating our recommendations into the final standard will enhance auditors’ reports for users and also will significantly improve implementation of the requirements of the Act both by auditors and issuers. The following are among our more significant recommendations:

- **Retain the auditor’s option to express either a qualified opinion or an adverse opinion when there is a material weakness in internal control over financial reporting.** Reporting options provide better, more flexible disclosure and thus are more informative for users of the report. We believe reporting alternatives also are consistent with the Securities and Exchange Commission’s (“SEC”) reporting guidance for management.
- **Identify and communicate to the profession and to the public *all* areas where proposed requirements diverge from existing requirements in the Board’s interim standards.** Some significant changes have been made that relate to audit areas other than internal control over

financial reporting. These modifications are not discussed in the introductory material to the proposed standard and easily could be overlooked by auditors.

- **Require the auditor to assess the effectiveness of the audit committee within the consideration of the overall control environment instead of as a separate evaluation.** The audit committee is only one element of the control environment and its effectiveness should be assessed as part of the overall control environment. In addition, the criteria to assess this element of the control environment should be clarified and strengthened.
- **Change the requirement that the auditor, in performing walkthroughs, should trace *all* types of transactions and events, both recurring and unusual, from origination to reflection in the financial reports.** This requirement excludes any consideration of materiality, removes auditor judgment, and will be costly to implement with little incremental benefit. We believe that the auditor should perform independent walkthroughs for all the company's significant processes and for *significant* events and transactions.
- **Work in conjunction with the SEC to develop more definitive guidance about management's extent of testing.** Issuers appear to hold widely differing views about the extent of tests of controls that is appropriate to provide sufficient evidence to support management's assessment. We urge the PCAOB to coordinate with the SEC on the issuance of guidance on management's extent of testing.

Specific Recommendations

Forming an Opinion and Reporting

We strongly believe that the auditor should be permitted to express either a qualified opinion or an adverse opinion when there is a material weakness in internal control because these different reporting options are more informative for users of the auditor's report. We also believe that permitting these reporting options is consistent with the SEC's reporting guidance for management.

The SEC's release on the final rules implementing section 404 "preclude management from determining that a company's internal control over financial reporting is effective if it identifies one or more material weaknesses in the company's internal control over financial reporting." Footnote 72 at this sentence states that "this is consistent with interim attestation standards. See AT § 501." We agree with the above conclusion and with paragraph 37 of AT section 501 in the Board's interim standards which states:

. . . the presence of a material weakness will preclude the practitioner from concluding that the entity has effective internal control. However, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the practitioner may qualify his or her opinion (that is, express an opinion that internal control is effective "except for" the material weakness noted) or may express an adverse opinion.

Accordingly, we believe that the SEC's final rule does not preclude management's expression of a qualified "except for" conclusion about the effectiveness of its internal control over financial reporting, depending on the significance of the material weakness, consistent with the above guidance.

Alternative reporting options that are based on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria provide better, more flexible disclosure that is more informative for users of the report. In some circumstances, the auditor may conclude that the effect of one or more material weaknesses on the achievement of the objectives of the control criteria is pervasive enough that it renders internal control, taken as a whole, ineffective. An example of such a material weakness might be the existence of multiple material weaknesses in several different applications. In such circumstances, an adverse opinion that "internal control over financial reporting is

not effective in all material respects” is appropriate and communicates to users of the report the gravity of the effect of the material weakness on achieving the entity’s overall internal control objectives.

In other circumstances, the auditor may conclude that the effect of the material weakness on the achievement of the objectives of the control criteria is more isolated and does not result in ineffective internal control taken as a whole. An example of such a material weakness might be inadequate controls at a subsidiary that the company acquired in the last week of the year. In such circumstances, the auditor may determine that an adverse opinion is not appropriate, and perhaps potentially misleading, because the significance of the material weakness is not pervasive enough to warrant a conclusion that internal control, taken as a whole, is ineffective. In such circumstances, the auditor may determine that a qualified, “except for,” opinion, such as the following from paragraph 55 of AT section 501 in the Board’s interim standards, is more appropriate, and also more informative for users of the report, than a conclusion that “internal control is not effective”:

In our opinion, except for the effect of the material weakness described in the preceding paragraph on the achievement of the objectives of the control criteria, W Company has maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*identify criteria*].

In addition, we believe that the requirement always to express an adverse opinion when there is a material weakness places smaller companies at a disadvantage since smaller companies may be more predisposed to have specific material weaknesses that are not pervasive. In such circumstances we believe that a qualified “except for” report is more informative for investors.

We agree that when the auditor issues a non-standard opinion, such as a qualified or adverse opinion, the auditor’s opinion should speak directly to the effectiveness of the internal control rather than to whether management’s assertion about the effectiveness of internal control is fairly stated.

Process for Identifying and Communicating Changes to Various Interim Standards

We note areas where guidance in the Board’s interim standards has been modified in subtle but significant ways, particularly with regard to substantive procedures. For example, paragraph 138 states that “the auditor should perform substantive procedures *for all relevant assertions* [*italics added*] for all significant accounts and disclosures.” As additional examples, paragraph 141 states that “the auditor’s substantive procedures must include reconciling the financial statements to the accounting records;” and paragraph 140 states that “for significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.”

Our comment does not relate to the substance of the proposed changes, but to the process by which these proposed changes have been identified and communicated. We believe that proposed standards should identify and communicate to the profession and to the public how requirements diverge from existing requirements and how issuance of the standard would affect existing standards. The introductory discussion of the proposed standard appropriately focuses on reporting on internal control. However, it fails to mention other changes in auditing requirements, some of which auditors would consider to be significant. Furthermore, since some of these changes are only a sentence or two in a document that is over 100 pages in length, they easily could be overlooked.

Accordingly, we strongly urge the PCAOB to highlight in the final standard all such changes to existing requirements and describe how the issuance of this proposed standard affects the Board’s existing interim standards.

Evaluating the Effectiveness of the Audit Committee’s Oversight

We agree that the audit committee, which along with the board of directors comprises one of the factors of the control environment in the Committee of Sponsoring Organizations of the Treadway Commission's report, *Internal Control—Integrated Framework* (the COSO report), plays a significant role in the oversight of a company's internal control over financial reporting and in creating a positive "tone at the top." Accordingly, we believe that the auditor's responsibility to evaluate the control environment encompasses consideration of factors about the board of directors and the audit committee such as those outlined on pages 26 and 27 of the COSO report. Even though the auditor evaluates the control environment in its totality and does not separately conclude on any single element of the control environment, we do agree that the importance of those who govern is such that their overall ineffectiveness generally would lead to a conclusion that the control environment is ineffective. Therefore, we recommend that the proposed standard be revised to require the auditor to assess the audit committee's effectiveness as part of evaluating the company's overall control environment which includes those who govern. We also believe that it is the responsibility of the board of directors to evaluate the effectiveness of the overall board including the audit committee.

In order to achieve more consistent and effective assessment of the audit committee as part of the auditor's evaluation of the overall control environment, we also believe that the PCAOB should clarify and strengthen the guidance in paragraph 57. For example, some of the factors that the auditor would be required to assess in paragraph 57 of the proposed standard could be subject to inconsistent interpretation. Since the auditor does not have unfettered access to the audit committee, the auditor's ability to assess the committee's commitment of time to its activities or to internal control and to evaluate the involvement and interaction with external and internal auditors would be difficult and additionally may not be a meaningful measure of the audit committee's effectiveness. It presumes that levels of time and interaction are measurable when in reality each situation will call for different efforts and degrees of involvement. Therefore, to assess effectiveness against levels of time, effort, and interaction is neither appropriate nor effective.

In addition, in the first bullet of paragraph 57 or in paragraph 58, "independence" should be specifically defined so that everyone is using the same criteria to assess it. The second bullet of paragraph 57 should be clarified to identify potential written sources (for example, the charter) that would be expected to enumerate the audit committee's responsibilities. Finally, we believe that the audit committee's "compliance with applicable listing standards adopted pursuant to Section 301 of the Act" and "whether the committee includes one or more financial experts as described in Section 407 of the Act" (the fifth and sixth bullets) are matters for legal determination and outside the scope of the auditor's responsibility.

As discussed above, the auditor does not have unlimited access to the audit committee. Therefore, if the PCAOB retains the requirement that the auditor make a separate evaluation of the audit committee, we recommend that the PCAOB require the auditor to obtain a written representation from the audit committee in order to facilitate the auditor's obtaining the additional evidence necessary to support this evaluation. At a minimum, such a letter must be signed by the chair of the audit committee. An audit committee's refusal to furnish written representations constitutes a scope limitation.

Because we agree that an effective audit committee is an important element of the control environment, we also believe that management should be required to assess the audit committee as part of its assessment of the overall control environment. Accordingly, the PCAOB should require that the auditor obtain from management its assessment of the audit committee and consider that assessment in forming the auditor's opinion.

Finally, in response to question 24, we strongly believe it would be a disservice to investors and to the public to require the auditor to withdraw from an audit engagement because the auditor has concluded that the audit committee is ineffective. The auditor always has the option to withdraw from an engagement. Requiring that action, however, does not appear to be in anyone's interest. The auditor could still express an unqualified opinion on the financial statements. Furthermore, the communication of the material weakness(es) that resulted in the adverse opinion is useful information to the public.

Walkthroughs

We believe walkthroughs have always been an important part of the auditor's evaluation of internal control. We therefore support the PCAOB's requirement that the auditor perform walkthroughs "for all of the company's significant processes."

However, the requirement that the auditor "should trace *all* types of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports" appears to be an additional requirement which is separate from the discussion of significant processes and which is unnecessarily onerous given that it potentially encompasses hundreds of immaterial types of transactions and events. As stated later in this letter in the discussion of the use of the term "all," a requirement related to all of a population by its nature excludes any consideration of materiality, removes auditor judgment, and will be costly to implement with little incremental benefit. We do not believe the auditor needs to walk through every immaterial or insignificant event and transaction within a significant process in order to identify risks that could create a material misstatement of the financial statements.

Furthermore, we do not believe the concept of significant processes that appears in paragraph 79 is consistent with that in paragraph 69. Paragraph 69 states that "the auditor should identify each significant process over each major class of transactions affecting significant accounts or groups of accounts." This suggests that the processes that are of concern to the auditor are those that are both significant and also are related to major classes of transactions affecting significant accounts or groups of accounts. We believe that this guidance is appropriate. The discussion of significant processes in paragraph 79, however, seems to have lost the notion of relatedness to major classes of transactions affecting significant accounts or groups of accounts. We believe that the guidance in paragraph 79 should be clarified and made consistent with that in paragraph 69.

In order to achieve the objectives described in paragraph 79, we believe that the auditor should perform independent walkthroughs for all the company's significant processes and for *significant* events and transactions. We do not believe the auditor should be required to perform independent walkthroughs for insignificant events and transactions.

Consideration of Management's Extent of Testing

There is considerable confusion among issuers about the extent of testing that management must perform in order to obtain sufficient evidence to support management's assessment. There appears to be a wide range of views among issuers as to what the appropriate levels of testing should be, including how monitoring controls and other aspects of the control environment affect the extent of testing. We believe that the PCAOB should work with the SEC to develop some definitive guidance for preparers. Furthermore, such guidance needs to make it clear that the auditor's testing cannot be used as the basis for management's assertion about the effectiveness of internal control.

In general, and as it relates to control activities in particular, we believe that management's extent of testing needs to be, *at a minimum*, at the same level as the auditor's in order for management to have sufficient evidence to provide a basis for its assessment. This concept needs to be applied on an overall basis. It should recognize that the controls tested and the nature of tests might differ, however, management's testing needs to provide the same level of reasonable assurance that is required of the auditor, and therefore the level of evidence to support management's assessment should be at least equal to the level of evidence obtained by the auditor.

Paragraph 125 of the proposed standard states:

Inadequate documentation of the design of controls and the absence of sufficient documented evidence to support management's assessment of the operating effectiveness of internal

control over financial reporting [italics added] also are internal control deficiencies. As with other internal control deficiencies, the auditor should evaluate these deficiencies as to their significance.

We believe that the above guidance should be expanded to address the extent of testing. We also believe that the proposed standard should require that the absence of sufficient evidence to support the responsible party's evaluation of the operating effectiveness of internal control constitutes either a significant deficiency or a material weakness because the monitoring component of internal control cannot be demonstrated in the absence of sufficient evidence to support management's assertion. Accordingly, we believe that the absence of sufficient evidence to support management's assessment should be added to the list of circumstances in paragraph 126 that is a strong indicator of a material weakness.

Considerations for Small and Medium-Sized Issuers

Page 6 of the introductory discussion in the proposed standard states:

The Board is sensitive to the possible effects of the proposed standard on small and medium-sized companies . . . For a smaller, less complex company, 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.

We agree with this statement because we believe that, *regardless of entity size and complexity*, the auditor should 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 entity's internal control. We are concerned, however, that the PCAOB's statement above will create an expectation among smaller issuers that the auditor should apply to audits of smaller entities a lower standard concerning sufficiency of evidence. Appendix E also appears to create a lower standard of internal control for smaller issuers that may be inappropriately interpreted by some as a justification for giving inadequate attention to their assessment of internal control.

Appendix E focuses primarily on the lack of formality in implementing various components of internal control at smaller companies. While this may be valid, the examples that are given fail to describe sufficiently what kinds of controls are likely to be different in smaller issuers, and importantly, what kinds of compensating controls can smaller issuers implement to overcome potential control deficiencies. For example, paragraph E9 suggests that a "CFO's careful review of daily sales and key ratios might be just as effective in a small company as lower level control activities that might be found in a larger business." We do not believe that such a review is an adequate compensating control that would appropriately address all relevant financial statement assertions. Additionally, we believe the discussion throughout Appendix E substantially overemphasizes the benefits of direct interaction by senior management with employees in smaller entities as a compensating control.

Paragraph 27 states that:

. . . the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls related to all relevant financial statement assertions for all significant accounts and disclosures in the financial statements.

We believe that the above requirement or objective applies to small, medium-sized, and large issuers. It is important for the auditor to understand the difference of auditing internal control over financial reporting in a smaller less formal setting than a highly complex large organization. However, we believe the proposed guidance does not adequately emphasize that the auditor of small entities is still required to meet the objective of paragraph 27 and to evaluate design and operating effectiveness for all relevant assertions for all significant accounts and disclosures.

Finally, Appendix E provides *no* guidance on how the auditor might tailor his or her procedures for smaller issuers. Some examples of how this may be done and still meet the objective set forth in paragraph 27 would be helpful.

Safeguarding of Assets

The guidance in Appendix C of the proposed standard should be significantly enhanced. As currently written, it is not sufficient to answer the questions that are arising in practice about which controls over safeguarding of assets are within the scope of internal control over financial reporting, and which are not. Following are several examples where it would be difficult to conclude, using the guidance provided in Appendix C, that management or the auditor should be concerned about the effectiveness of the controls related to safeguarding the selected assets.

Retail Inventory Shrinkage. A retail client has made a cost-benefit decision not to install theft prevention techniques (for example, tagged clothing and security devices at entrances) in their retail stores. Actual shrinkage in each store ranges from 5-10 percent of inventory on a monthly basis. Are the controls related to theft prevention part of internal control over financial reporting? If so, does the lack of controls over inventory shrinkage represent a significant deficiency or a material weakness if management takes a quarterly physical inventory and properly records the shrinkage?

Music Piracy. The auditor has a client that produces music for sale on CDs. Customers copy the CDs and make them available over Internet sites that allow for file swapping. Technology exists that allows the CDs to be encrypted in such a way that they cannot be copied. Management makes a decision not to encrypt the CDs because they do not want to alienate their customers.

Does management's decision not to encrypt the CDs (and thus not protect the related asset – music) fall within internal control over financial reporting? If so, does it represent a significant deficiency or a material weakness?

Disaster Recovery. A client has made a cost-benefit decision not to provide controls for adequate disaster recovery. Is management's decision not to provide disaster recovery controls part of internal control over financial reporting? If so, does it represent a significant deficiency or a material weakness? If it is an internal control over financial reporting, how would management and the auditor test disaster recovery?

Insurance Underwriting. Do the controls over accepting risk and pricing an insurance policy fall into controls related to financial reporting? These controls affect the level of risk and therefore the balance sheet reserves required, however, the company has strong controls over setting loss reserves and those controls take into account the level of controls that exist over the underwriting process. Does the lack of such controls represent a significant deficiency or a material weakness?

We believe that none of the examples would be a significant deficiency or a material weakness. The definitions of both significant deficiency and material weakness require there be more than a remote likelihood that a misstatement of the annual or interim financial statements will not be prevented. In the retail and insurance underwriting examples, the company has a detective control (quarterly physical inventories, controls over setting loss reserves, and monthly bank reconciliations) to ensure that the financial statements are not misstated. The music piracy issue and the lack of a formal disaster recovery policy do not result in a misstatement of the financial statements.

Based on the proposed definitions, we do not believe an ineffectiveness issue could be raised in any of the above scenarios since an ineffective system of internal control results only when a material weakness exists, and in these cases no deficiency exists that could cause the financial statements to be misstated. If the PCAOB concludes that these types of controls *do* fall within the definition of internal control over financial reporting, and the lack of such controls results in an ineffective system of internal control over

financial reporting, we believe the PCAOB should modify its proposed definitions of internal control deficiency, significant deficiency, and material weakness to be consistent with that conclusion.

Service Organizations

We believe the PCAOB should revise the guidance on service organizations that appears in Appendix B of the proposed standard to clarify how it relates to the Board's existing interim standard, *Service Organizations*. Some of the guidance from the interim standard has been paraphrased or described using different wording. As a result, it is not clear whether the Board intended to change the interim standard and just omitted any mention of such changes from the introduction to the proposed rule (see our comment above entitled "Process for Identifying and Communicating Changes to Various Interim Standards"). In addition, we believe the Board should significantly enhance the guidance on what the auditor should do, and what management should do, when the company uses a service organization as part of its internal control.

Use of "All"

The proposed auditing standard significantly increases various requirements for auditors to perform a procedure for "all" of a specific item. By its nature, a requirement related to all of a population excludes any consideration of materiality, removes auditor judgment, and will be costly to implement. Consideration must be given to whether the benefits to be achieved outweigh the cost of such requirements. In addition, we are concerned that in some instances the proposed guidance is establishing a threshold for the auditor that may be unachievable because the auditor's testing is generally selective. Requiring the auditor to perform a procedure for "all" of a population also inappropriately removes the auditor's ability to apply his or her professional judgment to the unique facts and circumstances of an audit engagement. The following are examples of paragraphs where we believe the word "all" (identified in boldface italics) needs to be reconsidered to ensure the requirements do not exceed the benefits obtained and result in the auditor performing procedures that would not result in discovery of material weakness in internal control over financial reporting.

79. In a walkthrough, the auditor should trace ***all*** types of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports. (Also see the discussion of walkthroughs earlier in this letter)
114. As part of this evaluation, the auditor should review ***all*** reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address controls related to internal control over financial reporting and evaluate any internal control deficiencies identified in those reports.
191. In addition, the auditor should communicate to management, in writing, ***all*** deficiencies in internal control over financial reporting (that is, 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. (Also see our response to question number 20)

Indicators of Material Weakness

We agree with the guidance in paragraph 126 of the proposed standard that a restatement of previously issued financial statements to reflect the correction of a misstatement is at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting existed at that time. However, the subsequent discovery of a material misstatement of the financial statements, or of a material weakness in internal control, is not, in and of itself, evidence of (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 PCAOB standards. Given the inherent limitation of an audit as described in

paragraph 15 of the proposed standard, absolute assurance is not possible. Therefore, we believe the proposed standard should include the following statement: "Since the practitioner's opinion on internal control is based on the concept of obtaining reasonable assurance, the practitioner is not an insurer and his or her report does not constitute a guarantee."

Effective Date

We understand that the PCAOB's effective date for the proposed standard is based on the date established by the Securities and Exchange Commission for implementation by registrants of its final 404 rule.

Nonetheless, we do not believe it is realistic to require implementation by accelerated filers of the internal control reporting and disclosure requirements of Section 404 of the Act for fiscal years ending in June, July, or August of 2004. Under the best of circumstances, we do not believe this proposed standard can be issued as a final document before early 2004. Since management as well as auditors are looking to this guidance to undertake what is a significant new approach to the audits of public companies, we do not believe that a time frame that is less than six months is sufficient to implement these requirements. In addition to the lack of final guidance, many implementation questions will need to be addressed by both management and the auditor. Time will be required to surface, resolve, and provide guidance on these issues. Accordingly, we believe that the effective date should be extended to audits of financial statements for fiscal years ending on or after September 15, 2004.

Authoritative Appendices

The Statement of Authority at the beginning of the proposed standard states that "appendices to the Board's standards are an integral part of the standard and carry the same authoritative weight as the body of the standard." We believe that the PCAOB should clarify whether this statement applies to the appendices in the Board's interim transitional standards.

We also recommend that the PCAOB clarify whether examples in the appendices are intended to establish requirements, or to provide illustrative guidance to be used by the auditor in making judgments about similar circumstances. For example, paragraph D3 states: "The following examples illustrate how to evaluate the significance of internal control deficiencies in various situations. These examples are for illustrative purposes only." However, each of the scenarios in Appendix D has a conclusion that states, "based only on these facts, the auditor *should determine* that this deficiency represents a significant deficiency [material weakness] for the following reasons" (italics added). The "should determine" language is inconsistent with the statement in paragraph D3 that the examples are for illustrative purposes only.

Responses to Questions

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?**

It is appropriate to refer to the auditor's attestation as an audit. The auditor's objective is to express an opinion on management's assertion about the effectiveness of internal control over financial reporting, just as the auditor's objective in an audit of the financial statements is to express an opinion on the financial statements. The level of assurance provided by the auditor's opinion is the same for either engagement. The requirement to obtain sufficient competent audit evidence to support the opinion is the same for either engagement. Only the subject matter on which the opinion is expressed is different.

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?

We agree that for public company audits, the auditor should be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements.

The applicability of the proposed standard and the continuing applicability of AT section 501 needs to be clarified. The first sentence of paragraph 2, on its own, does not appear to be correct since not all companies subject to the reporting requirements of the Securities Exchange Act of 1934 are required to report on internal control over financial reporting. Furthermore, footnote 1 states that "this standard supersedes AT section 501 as it relates to performing an audit of the design and operating effectiveness of internal control over financial reporting." Does that mean that AT section 501 is superseded, or that it is superseded only with respect to some guidance? Should public companies not subject to section 404 of the Sarbanes-Oxley Act but that voluntarily wish to obtain an auditor attestation of internal control use the proposed standard or AT section 501?

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. Requiring something less would be difficult to define and would result in significant inconsistencies in practice for public company audits. We also agree that the audit of internal control and the audit of financial statements should be completed as of the same date.

Question regarding the costs and benefits of internal control:

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?

See comment above entitled "Considerations for Small and Medium-Sized Issuers."

Question regarding the audit of internal control over financial reporting:

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.

The PCAOB's interim standards require that the person or persons performing the engagement have adequate technical training and proficiency as an auditor (or in the attest function) and adequate knowledge of the subject matter, and that work is to be properly supervised. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312.17), further states:

Whenever the auditor has concluded that there is significant risk of material misstatement of the financial statements, the auditor should consider this conclusion in determining the nature, timing, or extent of procedures; assigning staff; or requiring appropriate levels of supervision. The knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the level of risk for the engagement. Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and the conduct of the engagement.

We believe the existing interim standards are adequate. We do not believe that it is realistic to mandate levels of experience for the performance of specific procedures because development of personnel does not progress on a uniform timetable. We believe appropriate judgment needs to be made around staffing assignments and it would be inappropriate to specify the level of staff for specific audit procedures.

Questions regarding evaluation of management's assessment:

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, we believe that for public companies it is appropriate that the scope of the audit requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is designed and operating effectively, as stated in paragraph 5 of the proposed standard.

We also believe that the auditor's opinion in report Examples A-1 and A-6 should run directly to the effectiveness of internal control over financial reporting rather than to management's assessment both to be consistent with the scope paragraph in those reports and to eliminate any confusion that the auditor is expressing an opinion on the effectiveness of internal control over financial reporting. Accordingly, we believe that report element "i" in paragraph 153 should be changed to read "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" so that it is consistent with report element "h."

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

Yes. It is appropriate to provide criteria. However, we believe the Board needs to clarify paragraph B-3 of the proposed standard. Does the guidance in B-3 mean that management would not be required to have controls documented at locations or business units that are not able to create, either individually or in the aggregate, a material misstatement? We believe that management should have at least a minimum level of documentation of controls at these locations or business units consistent with the requirement that registrants must maintain adequate books and records.

We also believe more guidance is needed in the area of documentation of locations or business units that individually are insignificant but when aggregated could result in a material misstatement. We believe management should be required to document all significant controls at these locations as it relates to the significant accounts at the consolidated financial levels. Without appropriate documentation, we do not believe management can demonstrate adequate company wide controls since documentation of controls is a foundation of company wide controls.

Further, as part of providing criteria that auditors should use to evaluate the adequacy of management's documentation, we believe that the Board, in conjunction with the SEC, should address the matter of management's level of documentation and retention of documentation as well as the auditor's documentation of the entity's systems and controls.

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 do not believe inadequate documentation should automatically rise to the level of a significant deficiency or a material weakness. The effect of inadequate documentation is a judgmental matter to be

considered in the auditor's evaluation of internal control over financial reporting.

Paragraph 46 states that "in evaluating the deficiency as to its significance, the auditor should determine whether management can demonstrate the monitoring component of internal control over financial reporting in the absence of documentation." This language suggests that there are ways in which management can demonstrate the monitoring component in the absence of documentation of controls. We believe there needs to be clarification around this statement and if this statement is retained, examples of how management would do this should be provided. We believe that documentation provides the foundation for the entity's evaluation of and monitoring of the effective operation of controls.

Questions regarding obtaining an understanding of internal control over financial reporting:

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

See comment above entitled "Walkthroughs."

Question regarding testing operating effectiveness:

- 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 that the auditor needs to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year. Reliance on prior year work is inappropriate.

We do not, however, believe that this requirement is clearly stated in the proposed standard. Paragraph 101 of the proposed standard states:

Each year the auditor must obtain sufficient evidence about whether the company's internal control over financial reporting, including the controls for all internal control components, is operating effectively. The auditor also should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances. For example, each year the auditor might test the controls at a different interim period; increase or reduce the number and types of tests performed; or change the combination of procedures used.

We believe that the guidance in the above paragraph does not make it clear that the auditor is required to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year, without using some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment. The guidance in the proposed standard should be stated as explicitly as question 11 so that it is clear to auditors.

Questions regarding using the work of management and others:

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

Allowing the auditor to rely on certain testing performed by management should be permitted but not required. It should be based on the auditor's judgment of the competence and objectivity of those performing the work, and subject to the overall requirement that the auditor should obtain the principal evidence for the opinion.

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

Paragraph 104 of the proposed standard states that areas in which the auditor should not use the work of others includes "controls that have a pervasive effect on the financial statements, such as certain information technology general controls on which the operating effectiveness of other controls depend." Internal auditors in many companies possess both the skills and the objectivity to perform tests of IT general controls very effectively. We believe that to prohibit using the work of such professionals altogether would result in a costly redundancy of work effort between the company and the auditor that provides no benefit. Accordingly, we strongly believe that controls that have a pervasive effect on the financial statements, such as IT general controls, should be included among the areas of controls discussed in paragraph 105 where the auditor's use of the results of procedures performed by others should be limited, but not prohibited.

With regard to the areas in which the work of others should be limited (paragraph 105), we believe the PCAOB should provide additional guidance to clarify the meaning of "limited."

In paragraph 106, the phrase "without specific limitation" does not clearly communicate what level of auditor involvement is appropriate in areas such as controls over routine processing of significant accounts and disclosures. Does this imply the auditor would not necessarily be required to do some testing of each control in this category? We believe that the auditor needs to perform some tests in the areas described in paragraph 106 because it is inappropriate to rely exclusively on the results of tests performed by others. See also our response to question 15.

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 do believe that the proposed standard gives appropriate recognition to the work of internal auditors in paragraph 108. The guidance in paragraph 108 supports our response to question 13 as it relates to using the results of tests of IT general controls performed by 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)?

Paragraph 107 states that if the auditor intends to use the work of others, "the auditor should reperform some of the tests of controls originally performed by others." We believe more guidance is needed here to indicate if reperformance must be done at each individual control level, the account balance level, or just on an overall basis.

In addition, it is not clear whether the guidance in paragraph 107 is intended to apply to both paragraphs 105 and 106 or only to paragraph 105.

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?

Yes, the requirement in paragraph 109 that “the auditor must perform enough of the testing himself or herself so that the auditor’s own work provides the principal evidence for the auditor’s opinion” is an appropriate benchmark for the amount of work that is required to be performed by the auditor. However, we believe the following guidance should be added to paragraph 109: “Because controls over certain areas are not always susceptible to mathematical measurement, the auditor will need to apply judgment to determine that he or she has obtained the principal evidence from his or her own testing.”

Questions regarding evaluating results:

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?

We recognize how difficult it is to develop a meaningful definition of internal control deficiency that can be understood and applied consistently. The AICPA’s Auditing Standards Board task force spent significant time in its own deliberations on this subject. We believe the definitions included in the proposed standard provide a reasonable level of clarity that would provide a more consistent application. However, we believe by including the probability concept of “remote” in the definition of significant deficiency, the PCAOB has lowered the threshold and as a result will increase the number of deficiencies that will be classified as significant deficiencies. Although the number of deficiencies is not of major concern to us, what does concern us is that the number may ultimately dilute the importance of significant deficiencies and, as a result, cause management, audit committees, boards of directors, and others to view this category as irrelevant or unimportant. At the same time, requiring unresolved significant deficiencies to be strong indicators of a material weakness would capture significant deficiencies when the likelihood of a misstatement is slightly more than remote (for example, a 5-8 percent likelihood) and the amount of misstatement is slightly more than inconsequential (for example, more than 1 percent). Doing so seems inappropriate and could result in adopting controls that far exceed the benefit. We believe the Board needs to evaluate if it intended to have these consequences when applying the proposed definitions and consider removing the concept of “remote” from the definition.

We also note that in the report Examples A-2 and A-3, the definition of significant deficiency in the explanatory paragraphs includes only the part of the definition that states that “a significant deficiency is an internal control deficiency that adversely affects the company’s ability to initiate, record, process, and report external financial data reliably in accordance with generally accepted accounting principles.” We do not believe that this definition will be meaningful to users of the report since it does not communicate anything about the materiality or the likelihood of the deficiency, in contrast to the definition of material weakness.

In addition, we think the Board should change the definition of significant deficiency to read “A significant deficiency *is*” rather than “A significant deficiency *could be*” so that the construction is parallel to the definition of material weakness. Finally, we believe the Board should drop the words “in amount” following “more than inconsequential,” since we believe the determination of what is “more than inconsequential,” just as well as what is “material,” could involve qualitative as well as quantitative considerations.

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?

We believe the examples are helpful in providing some clarity around the application of the definition. However, they are reasonably straightforward (black and white) situations. The difficulty will come in the gray areas. Additional examples should be provided where deficiencies would not meet the threshold of “more than remote” and less obvious examples and conclusions are needed.

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

Yes. Once the auditor becomes aware of an internal control deficiency, the auditor needs to evaluate whether it is a significant deficiency or a material weakness.

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?

We believe it is appropriate to require the auditor to communicate to management all deficiencies in internal control (that is, those deficiencies that are of a lesser magnitude than significant deficiencies) that were identified by the auditor during the audit.

However, paragraph 191 goes beyond communication of deficiencies identified by the auditor and includes all deficiencies identified by management, internal auditors, or others. In large multi-national companies this could amount to hundreds, even thousands, of comments that do not reach the level of significant deficiency and would create a level of effort that would far exceed the benefits. We believe that management should be expected to be responsible for accumulating these comments as part of its overall monitoring function. It is inappropriate for the auditor to play this role.

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

As stated earlier, we believe that the absence of sufficient evidence to support the responsible party's evaluation of the operating effectiveness of internal control would result in a strong indicator of material weakness. We believe that this matter should be added to the list in paragraph 126 and deleted from paragraph 125.

While we agree that an ineffective regulatory compliance function may result in a material misstatement in the financial statements, there are many aspects of the function that by themselves may be ineffective without affecting the financial statements. Singling out the entire function will lead to confusion regarding whether the regulatory process falls within the definition of internal control over financial reporting. We believe each deficiency within the regulatory function first needs to be evaluated to determine if it applies to internal control over financial reporting. If it does, then it should be evaluated to determine whether it is a significant deficiency or a material weakness.

We agree fraud on the part of senior management is a serious issue, however, we do not believe it is the responsibility of the auditor to identify fraud of any magnitude. We also do not believe that fraud of any magnitude would necessarily constitute a significant deficiency or a material weakness, particularly in situations where the company's controls uncovered the issue. We also do not believe that the auditor should be required to consider issues that occur outside the company's environment such as filing a false tax return.

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?

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

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 comment above entitled "Evaluating the Effectiveness of the Audit Committee's Oversight."

Questions regarding forming an opinion and reporting:

- 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?**
- 26. Are there circumstances where a qualified "except for" conclusion would be appropriate?**
- 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 the internal control over financial reporting rather than to whether management's assessment is fairly stated?**

See comment above entitled "Forming an Opinion and Reporting."

Questions regarding auditor independence:

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

No. We do not believe that this proposed standard is the appropriate place for guidance on independence and internal control-related non-audit services.

- 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 the non-audit services currently prohibited for audits of issuers are appropriate and that no additional rules are necessary.

Questions regarding auditor's responsibilities with regard to management's certifications:

- 30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?**
- 31. Is the scope of the auditor's responsibility for quarterly disclosures about the internal control over financial reporting appropriate?**

As in financial statement reporting, we believe differing levels of responsibility are appropriate.

We believe paragraphs 8 and 9 of the proposed standard may imply that the auditor is obligated to identify deficiencies that could result in a misstatement to interim financial statements. We do not believe that an auditor should be required to plan his or her annual audit of internal control to consider materiality or tolerable errors at the materiality level of the interim financial statement. Therefore, we believe the PCAOB needs to be explicit that this is not required or state what they believe is required relative to the existing model (that is, SAS 100).

In addition, we believe that the language in the second bullet of paragraph 186 should be changed from "whether significant changes in internal control over financial reporting may introduce significant deficiencies or material weaknesses in the design of internal control over financial reporting" to "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" to

conform to wording in the SEC's final 404 rule. We do not believe that the auditor's responsibility should be extended beyond that required for management.

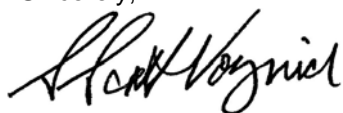
Finally, we believe the auditor evaluation responsibilities described in paragraphs 185 through 189 should not be required until the first quarter after the company's issuance of its first annual 404 report.

Additional/Editorial Comments

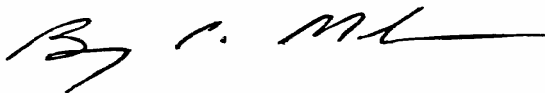
1. The proposed standard should include guidance on the work that is required of the auditor to determine whether an identified deficiency in one interim period has been corrected in a subsequent interim period. Since the auditor has no responsibility to do testing on a quarterly basis, what would be the basis for the auditor to conclude that the control is now designed and operating effectively?
2. In regard to paragraph B15 of the proposed standard, we believe that the internal control of all equity investees should be excluded from the company's evaluation of internal control over financial reporting, except with regard to controls over accounting for these investments in accordance with generally accepted accounting principles. Therefore, we believe the word "ordinarily" should be eliminated from the statement that "the evaluation *ordinarily* [italics added] would not extend to controls at the equity method investee." However, if it is not eliminated, we believe an example should be provided of a situation where the evaluation of the company's internal control would extend to controls at an equity method investee.
3. In paragraph 2, change the beginning of the fourth sentence to either "the audit firm that audits" or "the auditor who audits."
4. Although we agree with the statement, the last sentence of paragraph 11 seems misplaced.
5. Although we agree with the statement, the last sentence of paragraph 36 seems off point in that it doesn't tie back to the discussion of professional skepticism.

Thank you for the opportunity to comment on this proposed standard. We would be pleased to meet with PCAOB members and staff to discuss our comments.

Sincerely,



S. Scott Voynich, CPA
Chairman of the Board



Barry C. Melancon, CPA
President and CEO