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Microsoft

November 21, 2003

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

RE: PCAOB Rulemaking Docket Matter No. 008

Ladies and Gentlemen:

Microsoft appreciates the opportunity to comment on the proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. We support independent auditor involvement in attesting and reporting on management's assessment of the effectiveness of internal control over financial reporting, but believe the proposal goes far beyond that envisioned under Section 404(b) of the Sarbanes-Oxley Act. In particular, we do not believe the proposed definitions of significant deficiency and material weakness are consistent with the definition of internal control over financial reporting, which is defined as "a process . . . to provide **reasonable** assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes . . ." [Emphasis added]. Given this inconsistency and the importance of full, thorough and careful consideration of this important point, Microsoft believes it is incumbent on the PCAOB to work with the SEC to extend the effective date of the internal reporting and disclosure requirements of Section 404 of the Sarbanes-Oxley Act until fiscal years ending on or after December 15, 2004 for companies that are accelerated filers. In addition, we believe certain aspects of the proposed Auditing Standard unnecessarily increase the cost of compliance and the requirement that the external auditors evaluate the effectiveness of the audit committee is undesirable for several reasons.

The proposed Auditing Standard defines a material weakness as "a significant deficiency that, by itself, or in combination with other significant deficiencies, results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected". The definition of significant deficiency also includes the term "remote likelihood" and the proposed Auditing Standard indicates that it has the same meaning as the term "remote" as used in FAS No. 5. Based on this guidance, the definition of a material weakness can be understood to mean "a significant deficiency that, . . . results in more than a slight chance that a material misstatement of the annual or interim financial statements will not be prevented or detected". We believe this is a significant change from the current definition of material weakness included in

Statements on Standards for Attestation Engagements No. 10. SSAE No. 10 says that a material weakness is "a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions".

Given that the both the proposed Auditing Standard and SSAE No. 10 describe internal control over financial reporting as a process providing reasonable assurance, we are having difficulty understanding why the proposed Auditing Standard contains such a significant change in the definition of a material weakness, from a "relatively low level" to "slight chance" that a material misstatement will not be prevented or detected. This is an especially pressing issue for Microsoft, as we have a June 30 fiscal year-end and are currently in the midst of our internal control assessment, documentation and test work. As indicated in SEC Release No. 33-8238, SSAE No. 10 is the standard applicable on a transition basis for attestations required under Section 404 of the Sarbanes-Oxley Act and we believe it is only fair that the effective date of the internal reporting and disclosure requirements of Section 404 be extended so that sufficient time is available for companies to understand the final Auditing Standard and properly apply it. This includes executing tests of critical quarter-end controls, which we do not believe the proposed Auditing Standard provides sufficient time to complete given the compressed timeframe from a final rule to the currently proposed effective date. Microsoft recommends an effective date of fiscal years ending on or after December 15, 2004 for companies that are accelerated filers.

We also have concerns with certain aspects of the proposed Auditing Standard which we believe unnecessarily increase the cost of compliance, such as the limited level of reliance that the external auditors can place on the work of the internal auditors, the prohibition against external auditors relying on evidence obtained in prior years, and the lack of reliance on mitigating controls that would prevent material misstatements. As drafted, the proposed Auditing Standard seems to equate management testing with that of internal auditors and appears to ignore the unique role of the internal audit function which is implicit in Statement of Auditing Standards No. 65 and reinforced by standards of the Institute of Internal Auditors. In fact, a decrease on the reliance of the work of internal auditors could reduce external auditors' assimilation of internal auditors' considerable knowledge and understanding of an entity's internal controls. The prohibition against rotation of testing ignores the fact that many controls are substantially unchanged from year to year and that they can be validated through sufficient evidence gathering during the planning stage of an audit. We also believe that internal control over financial reporting is a network of controls with multiple levels and that the existence of mitigating or compensating controls should be taken into account.

Finally, we believe the requirement that the external auditors evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is undesirable for several reasons. First, we question whether external auditors have the necessary expertise to evaluate the dynamic nature of an audit committee's roles and responsibilities. We agree that external auditors should consider the role of the audit committee as part of the overall control environment, but requiring the external auditors to evaluate the effectiveness of the audit committee is unwarranted given that a properly functioning audit committee is comprised of individuals with broader expertise than external auditors. Second, having the external auditors evaluate the audit committee risks compromising the quality of the audit committee's oversight of the external auditors. Having the audit committee evaluated by those whom it employs could influence a committee's willingness to assertively manage the external auditor. Third, this requirement would significantly invade the roles and responsibilities of the board of directors by potentially elevating the external auditor's assessment of certain matters over that of the board of directors, with the effect that the external auditors' determinations would supersede that of the board.

If you have any questions, please call me at (425) 722-6514.

Sincerely,

Scott Di Valerio
Vice President, Corporate Controller