



SOCIETY OF CORPORATE COMPLIANCE AND ETHICS

February 21, 2007

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 021

Dear Sir/Madam:

The purpose of this letter is to suggest revisions to the Proposed Auditing Standard – “An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements” which is intended to supersede PCAOB Auditing Standard No. 2, “An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements.”

At the outset we would note that we support the general theme of the changes proposed by the PCAOB. However, we would like to suggest several minor modifications intended to further promote appropriate control practices in organizations. All suggested changes to the document relate to Paragraph 79.

A. Auditor Evaluation of Audit Committee

Paragraph 79 relating to **Strong Indicators of Material Weaknesses** suggests that one of the indicators of a material weakness in internal control over financial reporting is “[i]neffective oversight of the company’s external financial reporting and internal control over financial reporting by the company’s audit committee.” This section goes on to state in part that:

“The aspects of the audit committee’s effectiveness that are important may vary considerably with the circumstances. The auditor should focus on factors related to the effectiveness of the audit committee’s oversight of the company’s external financial reporting and internal control over financial reporting, such as the independence of the audit committee members from management, the clarity with which the audit committee’s responsibilities are articulated (e.g. in the audit committee’s charter), and how well the audit committee and management understand those responsibilities. The auditor might also consider the audit committee’s involvement and interaction with key members of financial management, including the chief financial officer and chief accounting officer. The auditor also might evaluate whether the committee raises and pursues appropriate questions with management and the auditor, including questions that

indicate an understanding of the critical accounting policies and judgmental accounting estimates, and the committee's responsiveness to issues raised by the auditor."

The adoption of this standard will set a minimum threshold for auditor inquiry and evaluation and as a result also drive organizational behavior. While we believe that those factors specifically identified in the paragraph are appropriate, it is our view that the foregoing paragraph should be expanded to include additional factors which the auditor should consider when assessing the audit committee's effectiveness. Moreover, we think the PCAOB should expand the list of persons whose interaction and involvement with the audit committee should be evaluated by the auditor. These concerns are expressed in more detail below.

- 1. Assessing Audit Committee Effectiveness.** We believe that any new standard should explicitly include at least two additional factors related to the evaluation of audit committee effectiveness.

The first factor relates to the composition of the audit committee. The accuracy of an organization's financial reporting is dependent upon much more than the effectiveness of the finance and accounting functions. Many other functions may have information which directly impact the accuracy of financial reporting. Principal among these other functions are compliance, legal and operations. In order to function effectively, an audit committee must be composed of a diverse group of persons who have the breadth of relevant knowledge and experience to accurately oversee the organizations activities and assess the effectiveness of managements control activities. This expertise should include not only financial/accounting expertise (as is required by Sarbanes-Oxley), but relevant business, audit and compliance related expertise as well. Particularly in industries which are subject to extensive and complicated regulation, the vulnerability to fraud and internal control weaknesses that could result in a material misstatement of the organizations financial position depends substantially on the tone that the board and management set with respect to compliance as well as the effectiveness of controls designed to mitigate regulatory risks. Much of the conduct which precipitated the corporate scandals that spawned Sarbanes-Oxley as well as changes to the Organizational Sentencing Guidelines, were failures that might have been prevented if the organization's activities had included appropriately structured and effectively implemented compliance programs. These programs are more likely to exist in organizations where the audit committee has appropriate expertise. Consequently, we would suggest the addition of a factor that reads "the relevant expertise of the audit committee members (e.g. audit, compliance, industry expertise, etc.)".

The second factor relates to the adequacy of the audit committee oversight. As noted above, inadequate oversight by the audit committee was a direct contributing factor to many of the corporate scandals. In order to function effectively, the audit committee must devote appropriate time and resources to its

work, consistent with the size and complexity of the organization as well as the complexity of the regulatory environment(s) in which it operates. Consequently, we would suggest an additional factor that reads “whether the audit committee activities (including scope of responsibility and frequency and duration of meetings) provide adequate oversight given the regulatory environment and the size and complexity of the organization”.

2. **List of Persons Who Interact with Audit Committee.** Paragraph 79 states in part that “[t]he auditor also might consider the audit committee’s ... interaction with key members of management including the chief financial officer and chief accounting officer.” While these two individuals are essential to the list of persons whose interaction the auditors must evaluate, there is other management in organizations who have direct responsibility for functions or processes that, while not purely financial, can clearly and directly result in failures (or the prevention thereof) that could lead to a material misstatement of the organizations financial reports. Because the proposed standard will set a minimum threshold for auditor inquiry, we believe the list of positions specifically enumerated should be expanded to include the “chief compliance officer, chief legal officer, and chief operating officer” in addition to the chief financial officer and chief accounting officer. Generally, we would expect the auditor’s inquiry to extend beyond this group. However, we believe that these five positions should be a minimum standard.

B. Complex Entities in Highly Regulated Industries

The last section of Paragraph 79 reads as follows:

“For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of an ineffective regulatory compliance function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.” (emphasis added)

We have two concerns regarding the forgoing language.

The first concern is use of the word function rather than “program.” This sentence implies that the auditor should be focused on the effectiveness of the people who staff the compliance department (i.e., function) rather than on whether the program is effective. While an effective function is frequently, perhaps even typically, associated with an effective program, the two are not synonymous. For example, it is possible to have a very competent, professional compliance function which has developed a state of the art compliance program, but have that program periodically or regularly ignored by management and/or the board. Such was the case in many of the corporate scandals and more recently in organizations wrestling with stock option back-dating issues. Moreover, we believe that this provision as written, unintentionally sends the message that it is the compliance department (function)

rather than management that is responsible for compliance. Clearly that is not the case. While it is the job of the compliance function to provide an organization with the tools, processes, procedures and other components necessary for an effective compliance program, it is the job of the board and management to ensure that the program is effectively implemented. Given the foregoing, we believe the word "function" should be replaced with the word "program".

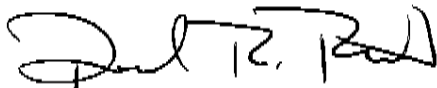
We are also concerned that the use of the word "solely" may inappropriately de-emphasize the importance of the auditors work in this area. The consequences of non-compliance, particularly in entities operating in highly regulated industries, can be organizationally devastating. Cancellation of government or other contracts, exclusion from participation in government contracts, penalties and fines (or the real risk of any of the foregoing) can all have a material impact on the accuracy of an entity's financial reporting. Consequently we would suggest that this subparagraph be rewritten to read as follows:

"For complex entities in highly regulated industries, an ineffective regulatory compliance program. This relates to those aspects of an ineffective regulatory compliance program in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting." (emphasis added)

Finally, we would note that we believe that the changes we have proposed would enhance the effectiveness of the audit process. Moreover, we believe that such provisions would promote the public policy initiatives – contained in Sarbanes-Oxley legislation, recent amendments to the Federal Organizational Sentencing Guidelines and elsewhere – designed to improve the culture of compliance in organizations and encourage the implementation of effective compliance programs.

We would welcome the opportunity to discuss these comments and proposals with the PCAOB or its representatives. If you have questions regarding these proposals, please contact me at 415-438-5579.

Sincerely,



Daniel R. Roach
President, Health Care Compliance Association
Co-Chair, Society of Corporate Compliance & Ethics