26 February 2007

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

Dear Sirs

PCAOB RULEMAKING DOCKET MATTER NO. 021

PCAOB Release No. 2006-007 issued on 19 December 2006 invited interested parties to submit written comments to the Board.

Whilst Vodafone agrees that there have been benefits derived from the application of s404 of the Sarbanes-Oxley Act, we have some concerns in relation to the costs of compliance. This is measured in terms of the initial implementation, the ongoing overhead and the increase in audit fees. We welcome the Board's stated intention to drive a more efficient, risk-based audit approach. We also support the reconsideration of associated areas as set out in the overall proposal. Our primary concerns relate to how the proposals will be applied in practice.

Having considered the detailed proposal, we have a number of comments, each of which is cross referenced to the relevant sections in the PCAOB Release.

A. Focusing the audit on the matters most important to Internal Control

1. Directing the Auditor's Attention Towards the Most Important Controls

We agree that, to date, the emphasis on detailed, process-level aspects of internal controls has been disproportionate to the actual risk. Clear focus should be on 'what can really go wrong'.

Question 1: Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?

Having learned from the experiences of some US companies which had an earlier compliance date, Vodafone designed its s404 methodology based on a top down risk-based approach. We have identified Company Level Controls, Reporting Controls and other Key Controls at in-scope locations.

Whilst the new standard describes this concept, it does not give a particularly clear picture of how it should be applied in practice. Further, there is a close link between the application of a top-down risk-based approach and the identification of in-scope locations. Using the proposed standard, we believe there will continue to be discussion and debate with external auditors in relation to what should be included in scope.

Vodafone Group Services Limited
Group Finance
Vodafone House, The Connection, Newbury, Berkshire RG14 2FN, England
T +44 (0)1635 33251 F +44 (0)1635 www.vodafone.com

M 07747 790247
T 01635 673522
linda.lewis@vodafone.com

Question 2: Does the proposed standard place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud?

In our view, adequate focus is placed on the importance of identifying and testing controls designed to prevent or detect fraud.

Question 3: Will the top-down approach better focus the auditor's attention on the most important controls?

The guidance is clear and, if applied logically, will focus audit attention on the most important controls. However there remains the risk that client and auditor may not agree on the extent to which the use of top-down risk based controls identification should reduce lower level 'transaction' testing.

Question 4: Does the proposed standard adequately articulate the appropriate consideration of company-level controls and their effect on the auditor's work, including adequate description of when the testing of other controls can be reduced or eliminated?

Whilst the principle is explained, the practical application is not clearly set out. There is currently a strong desire to attach numbers to areas such as testing coverage, to gain comfort that management and the external auditor has done sufficient work. In order to generate efficiencies, external auditors will need to move away from this and we are unclear at this stage about how will they come to terms with the relative 'significance' of higher level controls, especially when the 'coverage' of each can not easily be quantified.

2. Emphasising the Importance of Risk Assessment

Question 5: Does the proposed standard appropriately incorporate risk assessment, including in the description of the relationship between the level of risk and the necessary evidence?

The discrimination between smaller and larger companies tends to cloud the matter. An alternative approach would be to determine scoping based on in-depth risk assessment (focus on 'what could really go wrong'), with all in-scope areas requiring a 'standard' level of evidence.

Question 6: Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?

In our experience, the results of walkthroughs are a very strong indicator of the overall effectiveness of the control environment and, if done properly, it is extremely uncommon for exceptions to be noted in subsequent operational effectiveness testing.

Further, we believe that for such lower risk controls, it is hard to justify a need for auditor testing at all. Failure in such controls could not result in a reasonable probability of a material misstatement. The auditor should be able to place reliance on management activity.

3. Revising the Definitions of Significant Deficiency and Material Weakness

Question 7: Is the proposed definition of "significant" sufficiently descriptive to be applied in practice? Does it appropriately describe the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency?

In the proposal, 'significant' is defined to be "less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting." If applied in practice, it should result in better focus during the audit.

Question 8: Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or the auditor? How could the proposed standard on auditing *internal control further encourage auditors to appropriately identify material weaknesses when an actual material misstatement has not occurred?*

In conducting a top-down risk-based s404 audit, the auditor has the opportunity to identify material weaknesses when an actual misstatement has not occurred.

Question 9: Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analysing deficiencies that do not present a reasonable probability of material misstatement to the financial statements?

The change in definition is of benefit, because it reduces the real confusion surrounding the "more than remote likelihood" terminology. However, it would be useful to understand what "reasonable probability" means in practice. This guidance should ideally come from the PCAOB.

4. Revising the Strong Indicators of a Material Weakness

Question 10: Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present? Will this change improve practice by allowing the use of greater judgment? Will this change lead to inconsistency in the evaluation of deficiencies?

We support the proposed change. It will allow the greater use of judgment, which we consider to be appropriate. Our expectation is that audit firms will apply rigorous professional standards to ensure deficiencies are evaluated appropriately.

5. Clarifying the Role of Materiality in the Audit

No questions are raised by the PCAOB in relation to this area.

We observe conflict between this section of the proposal and the practical application of the audits required by local law around our Group. Specifically:

- Group s404 scoping of entities and significant accounts is based on Group materiality. Our auditor has planned the nature, timing and extent of s404 procedures on the same basis.
- However, at each operating company, the local materiality is less (sometimes significantly) than Group materiality. In each case the auditor will conduct more work than is required for s404 sign-off in order to issue the overall opinion that the statutory accounts of the operating company are fairly stated. It is very likely that, at a given location, some accounts will be out of scope for s404 but in scope for the local audit.

We believe that the following statement should be modified to reflect this practical difference:

"inherent risk also is the same for both audits and, therefore the proposed standard clarifies that significant accounts identified in the audit of internal control should be the same as the significant accounts identified in the financial statement audit"

6. Clarifying the Role of Interim Materiality in the Audit

Question 11: Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?

We believe the matter is clear.

Question 12: Should the reference to interim financial statements be removed from the definitions of significant deficiency and material weakness? If so, what would be the effect on the scope of the audit?

It may be of benefit to remove reference to it, if it causes confusion.

B. Eliminating Unnecessary Procedures

1. Removing the Requirement to Evaluate Management's Process

Question 13: Will removing the requirement for an evaluation of management's process eliminate unnecessary work?

Having carefully considered the proposal, we believe that it is not necessarily the most effective way to eliminate unnecessary work. In our view, an alternative option would be for the auditor to evaluate management's process, and if it is adequate, rely on it. The extent of reliance needs to be considered carefully but a reasonable approach would be for the external auditor to perform their own work in high risk areas and rely on the work of management in all others.

Question 14: Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?

Yes, however this is not necessarily the most effective way of delivering and assessing s404 compliance (please refer to our response to Question 13).

Question 15: Will an opinion only on the effectiveness of internal control, and not on management's assessment, more clearly communicate the scope and results of the auditor's work?

Not necessarily. The reader may not be clear what procedures the auditor engages in to opine on the effectiveness of internal controls. They may presume that the auditor has reviewed the quality of management's assessment. The only certain way to avoid lack of clarity would be to put in an exclusion clause in the audit report ("we have not reviewed the quality of management's assessment").

2. Permitting Consideration of Knowledge Obtained During Previous Audits

Question 16: Does the proposed standard appropriately incorporate the value of cumulative knowledge?

We welcome the move to omit the statement "each year's audit must stand on its own", because we consider it to be one of the major contributory factors to high audit costs. However we do not consider the standard makes it sufficiently clear exactly how cumulative knowledge should be applied.

Question 17: What are the circumstances in which it would be appropriate for the auditor to rely upon the walkthrough procedures as sufficient evidence of operating effectiveness?

Based on our practical experience, the walkthrough is the key mechanism for identifying operating ineffectiveness. Where walkthroughs have been done, and the required remediation put in place, operational effectiveness generally follows as a matter of course. We believe there is a strong argument for the auditor relying on walkthrough procedures (including, in low risk areas, those performed by management) as sufficient evidence of operating effectiveness.

3. Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage

Question 18: Will the proposed standard's approach for determining the scope of testing in a multi-location engagement result in more efficient multi-location audits?

We agree that the wording of AS2 results in excessive and unnecessary work.

Whilst there is some consideration of risk by our auditor, there is also an overriding expectation that we will achieve a certain percentage coverage across defined key metrics. This coverage is measured in terms of direct testing of transaction level controls, and excludes the assurance gained from Company Level Controls and similar testing, where the coverage is less easily quantifiable. Taken as a whole, we consider that management and auditor are conducting too much testing and incurring avoidable costs.

We believe that risk should become the real priority, and the application of a 'required' level of coverage should be discouraged. The focus should be 'what can really go wrong'.

As such, we support the removal of the provision requiring testing of controls over a large portion of the company. However we are concerned as to how the auditor would react in response to the direction to use a risk based approach to determining the proper strategy for auditing multiple locations. We believe that many auditors will be tempted to fall back on more tangible 'measurable' criteria. The extent to which a true risk-based approach is adopted by companies will be dependent on whether auditors are in practice able to make themselves comfortable with something they can not easily measure and may lead to large variations in the amount of work performed by management and auditors at different companies, potentially impacting the consistency of reporting.

4. Removing Barriers to Using the Work of Others

Question 19: Is the proposed standard's single framework for using the work of others appropriate for both the integrated audit and an audit of only financial statements? If different frameworks are necessary, how should the Board minimise the barriers to integration that might result?

We believe it is appropriate to have a single framework – failure to do so would cause greater mismatch between activities under a financial statement audit and activities under the integrated audit. We have some reservations about the achievability of a truly integrated audit (please refer to section A5) and our primary concern is that the application of local materiality at subsidiary entities by default results in more audit work on the financial statements than is required in relation to the audit of internal control over financial reporting.

Question 20: Does the proposed definition of relevant activities adequately capture the correct scope of activities, including activities that are part of the monitoring component of internal control frameworks?

The proposed definition appears clear.

Question 21: Will requiring the auditor to understand whether relevant activities performed by others identified control deficiencies, fraud, or financial statement misstatements improve audit quality?

There is an expectation that the auditor would conduct such a review as part of their routine audit work.

However, specifically referring to the requirement should ensure this occurs and enable the auditor to target audit activity and potentially achieve a higher quality of audit.

Question 22: Is the principal evidence provision that was in AS2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?

No. We believe that provided the circumstances under which the auditor may rely on the work of others are clear, the auditor should use its discretion.

Question 23: Does the proposed standard provide an appropriate framework for evaluating the competence and objectivity of the persons performing the testing? Will this framework be sufficient to protect against inappropriate use of the work of others? Will it be too restrictive?

The framework provides adequate guidelines which we do not believe are restrictive.

Question 24: Has the Board identified the right factors for assessing competence and objectivity? Are there other factors the auditor should consider?

The Board has identified the common factors.

Question 25: What will be the practical effect of including, as a factor of objectivity, a company's policies addressing compensation arrangements for individuals performing the testing?

This may cause an issue for smaller companies where such clearer segregation is harder to achieve. However provided compensation arrangements are only one element of the assessment, a balanced picture of objectivity should be achievable.

5. Recalibrating the Walkthrough Requirements

Question 26: Will requiring a walkthrough only for all significant processes reduce the number and detail of the walkthroughs performed without impairing audit quality?

A single walkthrough per process rather than a walkthrough of every class of transaction in a process would undoubtedly reduce the number and detail of walkthroughs. Given that management has performed walkthroughs to the higher level of detail, we do not consider that the reduction in auditor activity would compromise audit quality. The auditor could reasonably limit their walkthroughs to the high risk areas.

Question 27: Is it appropriate for the auditor to use others as direct assistance in performing walkthroughs? Should the proposed standard allow the auditor to more broadly use the work of others in performing walkthroughs?

It is our view that the auditor should rely on the walkthroughs done by management in all areas except those agreed to be higher risk. Please refer to Question 4.

We also support the proposal referred to in Question 27 specifically, that the auditor should more broadly use the work of others in performing walkthroughs.

C. <u>Scaling the Audit for Smaller Companies</u>

Question 28: Does the proposed standard on auditing internal control appropriately describe how auditors should scale the audit for the size and complexity of the company?

No comment.

Question 29: Are there other attributes of smaller, less complex companies that the auditor should consider when planning or performing the audit?

No comment.

Question 30: Are there other differences related to internal control at smaller, less-complex companies that the Board should include in the discussion of scaling the audit?

No comment.

Question 31: Does the discussion of complexity within the section on scalability inappropriately limit the application of the scalability provisions in the proposed standard?

No comment.

Question 32: Are the market capitalisation and revenue thresholds described in the proposed standard meaningful measures of the size of a company for purposes of planning and performing and audit of internal control?

No comment.

D. Simplifying the Requirements

Question 33: Is there other information the auditor should provide the audit committee that would be useful in its pre-approval process for internal control-related services?

We are not aware of any.

Question 34: How can the Board structure the effective date so as to best minimise disruption to on-going audits, but make the greater flexibility in the proposed standards available as early as possible? What factors should the Board consider in making this decision?

Any changes arising from the final AS5 will be too late to benefit Vodafone in its first year of compliance, as of 31 March 2007. However, it is important that the final standard is issued as quickly as possible such that all companies can optimise the available efficiencies. Ongoing audits should be subject to transitional arrangements, such that the auditor reduces audit activity in line with AS5 even though management has conducted more extensive documentation and testing under AS2.

Yours faithfully

Linda Lewis
Vodafone Group s404 compliance programme manager

Cc: Andy Halford — Chief Financial Officer Vodafone Group
Paul Stephenson — Director of Financial Reporting, Vodafone Group Plc