Consumer Federation of America
Consumer Action
U.S. Public Interest Research Group

February 26, 2007

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

Re: Rulemaking Docket Matter No. 021

Dear Sir:

We are writing on behalf of the Consumer Federation of America,[1] Consumer Action,[2] and U.S. Public Interest Research Group[3] in response to the Board's request for comments on its proposal to replace its existing standard governing audits of internal controls over financial reporting with a new set of standards. CFA, CA, and U.S. PIRG support the stated intent of the proposed standards – to ensure that internal control audits are focused on the areas that pose the greatest risk of material error or fraud, to eliminate unnecessary procedures that drive up the cost of audits without delivering significant benefits, and to ensure that audits are designed with the specific characteristics of the audited company in mind. We also recognize that, in arriving at the proposed approach, the Board rejected a number of alternatives – such as design-only internal control audits for smaller companies, single walkthrough testing of controls, or multi-year rotational testing – that would have effectively eviscerated the control audit both as a deterrent to fraud and as a means of preventing financial statement errors.

That said, we are not convinced that the proposed revisions will accomplish the stated goals. First, although the Board describes the new standards as principled-based, they provide no clear articulation of investor protection principles to guide their implementation. As a result,

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[1] The Consumer Federation of America (CFA) is a non-profit association of approximately 300 consumer groups. It was established in 1968 to advance the consumer interest through research, education, and advocacy.

[2] Founded in 1971, Consumer Action works on a wide range of consumer issues through its national network of 6,500 community based organizations.

[3] The U.S. Public Interest Research Group serves as the federation of state PIRGs, which are non-profit and non-partisan public interest advocacy organizations with one million members across the country.

the proposal has the worst characteristics of a principles-based approach, lack of clarity, without its chief benefit, a plainly articulated desired outcome that auditors can be held accountable for achieving. Second, the Board has proposed a top-down, risk-based approach to the internal controls audit without in any way addressing the short-comings that have made that approach such an abysmal failure in the audits of financial statements. Until the Board analyzes the many failed risk-based financial statement audits and determines what went wrong, it cannot in good conscience propose a risk-based approach to the internal control audit with any confidence that it will provide an appropriate level of investor protection. Finally, the Board sends the strong message throughout this proposal that reducing costs is more important than improving, or even maintaining, the effectiveness of these audits. This not only results in serious weaknesses in the standard itself, it suggests that the Board will not provide the strong regulatory and enforcement backing needed to make a principles-based approach effective. As a result, we are deeply concerned that the current proposal, if adopted, will fatally undermine the effectiveness of Section 404 of the Sarbanes-Oxley Act (SOX 404) just as it is beginning to deliver real benefits to investors.

On the other hand, we are convinced that it is possible to achieve the stated objectives of the proposal without the profound threat to investors that this proposal entails. Specifically, we believe this could be accomplished through a combination of: 1) improved guidance from the Securities and Exchange Commission, particularly for smaller public companies, on their obligations under SOX 404;[4] 2) better individualized and generalized guidance from the PCAOB to auditors on how to ensure that their audits of internal controls are appropriately designed and implemented; and 3) minor tweaking of those aspects of the existing standard, if any, that appear to promote excessive testing.[5]

A Major Rewrite of the Standard is Unwarranted

The PCAOB's decision to rewrite Audit Standard 2 appears to be driven more by political expediency than by any evidence either that the costs of the rule exceed its benefits or that its costs, where excessive, could not be reduced through other, less radical means. Certainly, the Board has produced no cost-benefit analysis justifying its actions. In fact, there is little meaningful record on which to base such an assessment. As the Board's Release points out, only "two annual financial reporting cycles have been completed since auditors began to apply AS NO. 2 to audits of accelerated filers."

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[4] The proposed guidance currently under consideration by the SEC suffers from many of the same short-comings as this proposed standard and therefore does not, in our view, satisfy this condition.

[5] The fact that some commentators complain about a particular aspect of the standard on the grounds that it promotes excessive testing should not be taken as proof of that fact. This sort of complaint is the near universal response of the business community to any increase in regulatory requirements. Instead, the Board should base its assessment on its own evaluations of audits.

For a variety of reasons, the first year's experience under the new standard can hardly be viewed as representative. First, no reasonable person would expect implementation of a major new requirement such as this to go off without a hitch. Beyond the problems inherent to introducing any major new standard, many public company managers were ill-prepared and slow to perform their own documentation and assessment of internal controls, without which the auditor's assessment could not go forward. This, combined with the arrival of the standard and guidance on implementation after planning and data gathering for financial statement audits had already begun, effectively prevented auditors from conducting an integrated audit of financial statements and internal controls in most cases during that first year.

We frankly question whether the remaining one full year's experience with AS2 provides an adequate basis on which to assess the costs and benefits of the standard. To the degree that such a record exists, however, it strongly supports the conclusion that the benefits substantially outweigh the costs. Given that fact, it is difficult to understand the reasoning behind the Board's decision not only to reopen the standard at this point, but to rewrite it completely.

The Benefits of the Existing Standard Outweigh the Costs

We are aware of two leading surveys that attempt to assess the costs of compliance associated with Section 404 of the Sarbanes-Oxley Act – one by Financial Executives International and one by Charles River Associates. The FEI survey, which did not differentiate among companies based on size, found average second-year 404 compliance costs among its members of $3.8 million.[6] For its assessment, CRA did divide companies by size and found second-year costs of $4.77 million for larger companies (those with more than $700 million in market capitalization) and $0.86 million for smaller companies (those with market capitalizations between $75 and $700 million).[7]

As expected, both surveys showed a marked drop in costs between the first and second year of implementation. Specifically, FEI members reported 404 cost declines of 13 percent between 2004 and 2005. On the CRA survey, costs were found to have declined by 43 percent for larger companies and by 31 percent for smaller companies. There is every reason to believe that the smaller companies that have yet to implement the rule would experience still lower costs, even without any adjustments to the standard or additional learning from further experience implementing the internal control audits.

Moreover, substantial evidence supports the conclusion that SOX 404 brings benefits that greatly exceed its costs. That evidence takes a number of different forms. These include:

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[6] "FEI Survey: Sarbanes-Oxley Compliance Costs are Dropping," Financial Executives International Press Release, April 6, 2006.

[7] "CRA Survey: SOX Costs Falling from 2004 to 2005," *Big Four Blog*, April 2006, found at http://bigfouralumni.blogspot.com/2006_04_01_archieve.html. This information is also reported in the Interim Report of the Committee on Capital Markets Regulation, Table V.3, page 135.

statements by institutional investors that they have seen significant post-SOX improvements in the quality of financial reporting;[8] statements from senior managers of public companies that it has helped them to streamline and improve processes and make better business decisions;[9] evidence that, absent the requirement, many public companies had failed to maintain adequate internal controls or report weaknesses in those controls; and academic research on the effects of SOX 404.

One important goal of SOX 404 is to improve the accuracy of financial disclosures, which should then reduce the incidence of financial restatements.[10] These restatements result in substantial costs to investors, beyond the misallocation of capital that can result when financial disclosures are erroneous or misleading. A recent analysis by the General Accounting Office, looking at financial restatements from July 2002 through September 2005, found an average negative market impact of 1.9 percent in a three-day window around the restatement.[11] Based on its data, and using this very narrow time frame, the GAO calculated an aggregate negative market impact from financial restatements of $40.9 billion in 2004 alone and $63 billion for the entire period of the study, far above even the most inflated estimates of SOX 404 compliance costs.[12]

Given the significant negative effect restatements can have on share price, investors stand to benefit greatly if SOX 404 improves the reliability of financial statements and reduces the incidence of restatements. Early evidence indicates that this is occurring. First, financial restatements are up dramatically since the implementation of SOX, indicating that it has helped bring to light a number of problems that had previously gone undetected. A recent analysis by AuditAnalytics reported 1,876 restatements in 2006 by 1,591 unique filers.[13] That represents a 17 percent increase over 2005, which itself saw a 57 percent increase over 2004.

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[8] "Not Everyone Hates SarbOx," by David Henry, *BusinessWeek Online*, Jan. 29, 2007. Found at http://www.businessweek.com/print/magazine/content/07_05/b4019053.htm?chang=gl.

[9] "Examining Section 404, With Two Years of Hindsight," by Richard M. Steinberg, *Compliance Week,* Jan. 24, 2006.

[10] Although the long-term goal is to reduce restatements, a short-term rise in restatements is predicted as a result of the new level of scrutiny being applied to corporate disclosures and public company audits as SOX is implemented.

[11] *Interim Report*, Committee on Capital Market Regulation, Dec. 1, 2006, pg. 120.

[12] Ibid., Table V.2, page. 122. Also, footnote 138. Table V.3 on Page 135 shows estimated aggregate compliance costs of $15 to $20 million in 2004 and $11 to $13 million in 2005.

[13] *Audit Analytics Briefing Paper: 2006 Financial Restatements, A Six Year Comparison*.

Of particular note when considering the effect of SOX 404, however, is the fact that restatements among accelerated filers (those that have implemented AS2) are down significantly – from 16.1 percent of such companies in 2005 to 13.3 percent in 2006.[14] Meanwhile, the number of restatements among non-accelerated filers has continued to increase – from 921 in 2005 to 1,318 in 2006.[15] One clear implication of these findings is that the large companies that have already implemented SOX 404 have begun to improve their procedures and clean up their books. As one commentator noted, this appears to indicate that "the Sarbanes-Oxley law is working and investors are getting higher-quality financial statements than ever before."[16]

Many of these financial restatements were accompanied by reports of a material weakness in internal controls. In fact, since SOX 404 was implemented, several thousand companies have reported material weaknesses in their internal controls (more than 1,500 in 2005, and 1,105 through September 2006).[17] In most cases, the disclosure of material weaknesses came only after an independent audit of the controls. Specifically, only one out of eight of these companies had reported a material weakness as recently as the quarter preceding the filing in which the material weakness was disclosed.[18] In other words, the certifications that many CEOs and CFOs had been making since 2002 attesting to the adequacy of their controls were unreliable.[19]

The significant difficulty that many public companies experienced in implementing Section 404 – a factor that has helped to drive up implementation costs – has been taken by some to imply a problem with the standard itself. AS2 can hardly be blamed, however, for public companies' poor compliance with a requirement that has been on the books for decades, for their lack of adequate competent personnel to oversee controls, or their failure to adopt adequate control systems. The costs associated with deferred maintenance should therefore not be laid at AS2's door. Nor should AS2 be blamed for the SEC's failure to provide clear and timely guidance to public companies on how best to comply with their obligations under SOX 404. Indeed, the widespread failure among public companies to maintain an adequate system of internal controls or report in a timely fashion on weaknesses in those controls is evidence, if anything, of how badly SOX 404 was needed, and of how essential the independent audit component of the rule is to ensuring its effectiveness.

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[14] Ibid.

[15] Ibid.

[16] Ibid.

[17] Glass, Lewis & Co., LLC analysis of company filings.

[18] "Learning from Accounting History: Will We Get It Right This Time?," by Lynn Turner, *Issues in Accounting Education*, Nov. 2006.

[19] Ibid.

Several recent academic studies have also helped to document the substantial benefits of SOX 404. One study found, for example, that companies with poor internal controls have poorer quality financial reporting. When they improve their internal controls (as reflected in an auditor attestation that they have corrected a reported weakness) the quality of their financial reporting improves.[20] A separate study found that, after controlling for other risk factors, firms with internal control deficiencies "have significantly higher idiosyncratic risk, systematic risk, and cost of equity capital."[21] Furthermore, this study found that "remediation of an internal control deficiency is followed by a significant reduction in the cost of equity capital" and that "the magnitude of the cost of equity capital effects of the internal control deficiency are economically important, ranging from 50 to 150 basis points depending on the analysis."[22] In other words, not only is SOX 404 improving the quality of financial statements, but these improvements are recognized and rewarded by the market with a lower cost of capital.

The Global Competitiveness Argument against SOX 404 Has Been Discredited

In making its case against SOX 404, the business community has repeatedly argued that a relaxation of the standard is needed to preserve the competitiveness of U.S. securities markets. Recent reports have thoroughly discredited this argument. For example, a study by Thomson Financial analyzing 20 years of initial public offerings (IPOs) reportedly found no noticeable ill effects from SOX.[23] Instead, they found that foreign IPOs accounted for 16 percent of IPOs in the United States last year, the highest proportion in the 20 years covered by the study. Furthermore, the $10.6 billion foreign companies raised through U.S. IPOs last year represented a 23 percent share of U.S. IPO volume, the highest level since 1994, according to the study.

To the degree that the United States has seen a decline in its share of global IPOs, a number of analyses, including recent reports by Goldman Sachs[24] and Ernst & Young[25], have

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[20] *The effect of Internal Control Deficiencies and Their Remediation on Accrual Quality*, Ashbaugh-Skaife, H. (University of Wisconsin-Madison), Collins, D. (University of Iowa), Kinney, Jr., W., (University of Texas at Austin), and LaFond, R. (Massachusetts Institute of Technology-Sloan School of Management) May 30, 2006.

[21] *The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital*, Ashbaugh-Skaife, H.; Collins, D.; Kinney, Jr., W.; LaFond, R., April 2006.

[22] Ibid.

[23] "Do Tough Rules Deter Foreign IPO Listings in U.S.?," by Yvonne Ball, *The Wall Street Journal*, Feb. 20, 2007.

[24] "Is Wall Street Doomed?," by Jim O'Neill and Sandra Lawson, *Global Economics Weekly*, Goldman Sachs Economic Research, Issue No. 07/06, Feb. 14, 2007.

[25] *Global Capital Market Trends*, by Maria Pinelli and Joseph A. Muscat, Ernst &

clearly documented that other factors are primarily responsible. The Goldman Sachs analysis notes that U.S. share of global equity market capitalization dropped dramatically from 1970 to 2000, long before the passage of SOX, attributes recent IPO trends to "economic and geographic factors" as well as the spread of the "U.S. capital market 'culture,'" and notes that U.S.-based but globally minded firms stand to benefit from the growth of world markets. The Ernst & Young analysis demonstrates that companies have always tended to list close to their home markets, that as a result only a very small percentage of international listings can truly be viewed as competitive, and that U.S. markets have done extremely well in recent years in attracting listings from among those that are competitive.

Indeed, even those who have argued most strenuously for a relaxation of internal control audits have been forced to acknowledge that SOX 404 is, at most, a minor influence on recent IPO trends. Despite their obvious biases, both the Interim Report of the Committee on Capital Markets Regulation and the McKinsey Report commissioned by Sen. Schumer and Mayor Bloomberg clearly document that global economic and market trends, rather than the U.S. regulatory or legal environment, are the key factors behind a drop in the U.S. share of foreign IPOs. Although they continue to argue for a relaxation of U.S. regulatory standards, they offer no evidence that these measures would have any beneficial effect on the global competitiveness of U.S. markets.

The PCAOB has made clear that its proposed revisions were developed in response to complaints from the business community about the costs of AS2. We are deeply concerned that the Board appears to have made so little effort either to verify the validity of these complaints, which are typical of complaints from industry any time they are faced with a major new regulation, or to explore alternatives means of driving down the cost of SOX 404 compliance. It is ironic, to say the least, that members of the business community arguing for weakened investor protections have not been required to meet the same cost-benefit test they would impose before protections could be strengthened – a test they would clearly fail. We are similarly concerned that the Board has failed to seriously explore whether its proposed top-down, risk-based approach is likely to be effective. For a number of reasons, as described below, we believe it is not.

Risk-based Audits Have Not Proven Effective

Everyone can agree in theory that audits should take a top-down, risk-based approach that focuses on those areas that present the greatest risk of a material misstatement. In analyzing the merits of this approach, however, we need not rely solely on theory. Audit firms have been conducting top-down, risk-based audits of the financial statements for several decades – with often disastrous results. In fact, many of the failed audits implicated in recent massive accounting scandals were risk-based audits.[26] Time and again – in audits of companies like Enron, WorldCom, Tyco, HealthSouth, Global Crossing, Bristol Myers, and an endless litany of

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Young, Jan. 2007.

[26] "Behind Wave of Corporate Fraud: A Change in How Auditors Work," by Jonathan Weil, *The Wall Street Journal*, March 25, 2004.

others – audit firms have shown that they are unable to correctly identify high-risk issues, to appropriately design the audit to address those issues, or to stand up to high-risk clients.

There are doubtless a variety of reasons for this. Likely causes include poor training of auditors in subjects related to risk-analysis and excessive reliance on junior team members to perform the bulk of the work in the audit, including in areas that require analysis of complex issues and the exercise of professional judgment. Other causes may include the pressure on auditors to reduce the cost of the audit, even at the expense of its effectiveness, and reluctance among auditors to risk losing an important audit client.

Although the PCAOB has extensive authority to review audits, we are unaware that the Board has undertaken any serious effort to determine what are the root causes behind the numerous recent massive failures of risk-based financial statement audits, let alone feed those results back into their audit standards. Yet, this would seem to be a minimum first step before proposing a major expansion of the risk-based approach. Not only does the current proposal reflect no effort to address weaknesses in the risk-based audit approach, it actually takes steps that are likely to exacerbate those problems. Of greatest concern in this regard is the expanded reliance on the work of others it allows without imposing appropriate limitations.

The Proposal Lacks a Clear Articulation of Investor Protection Principles

The PCAOB's proposal has been promoted as a principles-based approach. In fact, however, although the standard does allow extensive flexibility in its implementation, it does not include an up-front statement of principles that describe in straightforward terms the investor protection outcome the rule is intended to achieve. We believe the addition of such a statement is essential to ensure that auditors can be held accountable for achieving the appropriate level of assurance about the adequacy of internal controls. With this in mind, we believe the following principles are among those that must be clearly spelled out at the beginning of the standard:

- An independent audit of internal controls over financial reporting provides an essential supplement to reporting requirements of managers, who may have incentives not to report weaknesses in their controls.

- The purpose of the audit is to determine whether internal controls at the company are functioning at a level that provides reasonable assurance they will detect and prevent a material misstatement of the financial statements and, if not, to identify and report on material weaknesses.

- In assessing internal controls, auditors are responsible for obtaining sufficient evidence to support their conclusion about the adequacy of internal controls.

- The auditor must ensure that decisions regarding the audit that require the analysis of complex issues or the exercise of professional judgment are handled by members of the audit team with adequate experience and training to perform those functions.

To the degree that the auditor relies on the work of others in performing the audit, the auditor is responsible for ensuring that the individual performing the work is independent and has sufficient expertise to perform those functions and for reporting to investors on the extent to which it has relied on the work of others and for what purposes.

The auditor must maintain sufficient documentation to allow a third party to review the work performed and determine whether the conclusion reached by the auditor is reasonable.

The addition of this sort of statement identifying the desired investor protection outcome and the standards necessary to achieve it is a fundamental part of a principles-based approach to rulemaking. It is particularly badly needed in this case to counteract a pervasive message throughout the proposing release that reducing costs of the audit takes precedence over ensuring its effectiveness.

The Board Should Rewrite the Standard to Correct its Anti-Investor Tone

There are numerous examples throughout the standard where the language used sends the subtle and not-so-subtle message that a key concern of the auditor should be to reduce the costs of the audit, even at the expense of its effectiveness. An early example of this bias can be found in the note accompanying paragraph three of the proposed standard, which reads:

> "The auditor should select for testing ***only*** those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to a given relevant assertion that could result in a material misstatement to the company's financial statements." (Emphasis added.)

A pro-investor rewrite would state that the auditor should select for testing ***all*** those controls that are important to the auditor's conclusion. These differences in language matter. As written, the proposed standard sends the strong message that auditors may be asked to justify any decision to test controls that someone later deems were unimportant. As a result, it risks encouraging auditors to under-test – the very weakness that has been identified as central to the failure of risk-based audits of the financial statements.[27] The pro-investor alternative sends the opposite message, that auditors may be asked to justify a failure to test controls that are later deemed to have been important. Some would argue that this statement risks encouraging auditors to over-test, though experience based on the pressure audit clients are able to bring to bear on auditors suggests this concern is exaggerated. A neutral statement would simply state that the auditor should select for testing those controls that are important to the auditor's conclusion.

There are equally serious problems with the note accompanying paragraph 9. Having identified as a key principle behind the design of the rule that audits should be tailored to fit the specific characteristics of the particular company being audited, the proposal immediately

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[27] Ibid.

repudiates that approach by substituting a definition of "smaller companies" based on a combination of market capitalization and revenue.[28] Not only is this completely inconsistent with the principles-based approach the Board claims to have adopted, it sends the clear message that, regardless of the complexity and risks, companies in this size category should be treated as a small company. The underlying message is that auditors who seek to impose potentially costly testing requirements in such an audit – because of their perception they are necessary in light of the risks associated with the company or the complexity of its finances – will be accused, perhaps even by the regulators, of having engaged in excessive testing.

A further example can be found in paragraph 10 of the proposed standard, which lists factors that may call for a different audit approach in a smaller company. The items listed are exclusively those that would likely lead to reduced audit procedures at smaller companies. Among the items missing from the list are those that send the opposite message, such as lack of competent personnel overseeing financial reporting, lack of sufficient personnel to provide checks and balances through segregation of duties, and enhanced potential for management override. Also missing are items such as the complexity of marketing and distribution channels, geographic distribution of the company, and characteristics of the company's information technology systems.

When the proposed standard does deal with some of these issues in paragraph 12 – regarding segregation of duties, for example, and potential for management override – it doesn't emphasize the enhanced risks associated with these factors in a small company. It simply suggests that a different approach to internal control in these areas may be appropriate in a smaller company. In fact, if a small company of the type described here has insufficient controls to prevent management override, the rest of the control environment will be largely irrelevant. Furthermore, given the role of management override as the dominant factor in financial frauds at companies of all sizes, but particularly in smaller companies, evaluating controls designed to prevent management override would seem to be a topic that deserves far more extensive treatment than it receives in this proposed standard.

The note accompanying paragraph 53 provides another example, when it states: "Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, any individual control does not necessarily have to operate without any deviation to be considered effective." Although this statement is true as far as it goes, it omits an important point. Where auditors find a deviation in the operation of a control, they should have an obligation to determine why that deviation exists and whether it is indicative of a bigger problem. Without that addition, the proposed standard sends the strong message that auditors can simply ignore any deviations in controls that they

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[28] The definition is taken from the report of the Advisory Committee on Smaller Public Companies, a group whose make-up was heavily tilted toward those in the business community who favored elimination of SOX 404. The only legitimate investor advocate on the committee, a representative of the CFA Institute, dissented from its findings. It is incomprehensible that the Board would rely on the completely discredited findings of this committee as the basis for its proposal.

happen to uncover. Given the overall tone of the proposing release, it may even be read as discouraging them from conducting additional testing when they uncover such deviations.

These are a few of the most egregious examples that jumped out at us in our review of the proposed standard. Far more can be found in the text of the proposing release. We urge the Board to conduct a careful review designed to identify other similar examples and eliminate them from the standard. Ideally, the Board would replace them with language that sends the opposite message – that auditors are to take seriously their obligation to obtain sufficient evidence on which to base a reasonable judgment about the adequacy of internal controls. At the very least, however, the Board should remove the bias in the standard toward cost-reduction at the expense of everything else.

Specific Anti-Investor Provisions Should Also Be Eliminated

Problems with the standard are not limited to its tone. Several provisions of the standard threaten to directly undermine the effectiveness of the internal controls audit. These include provisions: allowing the auditor to use the work of others without adequate restrictions and in areas where it is inappropriate, recalibrating the walkthrough requirement, weakening the materiality standard, requiring the auditor to use the same framework in evaluating the controls that was relied on by the manager, and restricting the auditor to evaluating controls related to relevant accounts.

Work of Others: The proposal is designed to make it easier for the auditor to rely on work performed by others. In fact, it not only permits the use of work by others, it encourages it, by requiring the auditor to assess the extent to which they will use the work of others and by suggesting that management's own evaluation of internal controls is one aspect of the work of others the auditor should consider using. While we do not oppose all loosening of requirements in this area, we do believe the standard should recognize that this introduces new risks and potential for bias into the audit and, used in excess, could seriously undermine audit effectiveness. The proposal does not, in our view, take adequate steps to mitigate these risks.

Here again, the proposed standard governing use of the work of others fails to lay out clear investor protection principles to guide its implementation. Such a statement of principle should indicate, for example, that auditors are permitted to rely on the work of others to the extent that it improves the efficiency of the audit without undermining its effectiveness. Second, it should make clear that the auditor is responsible for ensuring that the individuals performing the work are both independent and competent. Third, it should state that auditors are responsible for providing adequate oversight and testing of work performed by others to form a reasonable basis for a conclusion that the work is reliable. By introducing these principles, the Board would help to ensure that auditors only rely on the work of others when it benefits shareholders, by improving the quality of the audit or by reducing its cost without compromising its quality.

In contrast, as described in paragraph 13, the proposed standard actually permits the auditor to rely on work performed by individuals who are both lacking in objectivity and of marginal competence. While it includes vague limits on the degree to which the auditor could

use the work of such individuals, it discourages the auditor from reaching an absolute judgment that certain individuals lack the competence or objectivity necessary to perform work related to the audit. The standard should send precisely the opposite message, that auditors are responsible for reaching such judgments.

Second, the integrated audit standard permits use of the work of others in certain circumstances in which auditors should categorically be prohibited from doing so. Of particular concern is the fact that the proposal would permit the auditor to use the work of others when performing walkthroughs for significant processes. These walkthroughs form the basis for key decisions about the design and implementation of control testing. Moreover, the walkthrough provides a key test of whether control design is matched by how it functions in reality. It is inconceivable that the auditor could form an adequate understanding of the control environment or business operations without performing this function him- or herself.

Recalibrating the Walkthrough Requirement: Not only does the standard allow the auditor to delegate much of the work involved in the walkthrough to an outsider, it suggests that "probing inquiries" can substitute for actually following the transaction "through each minor variance in the process." The whole point of a walkthrough, however, is to determine how the process works in reality and whether that is consistent with how the process is described by management. No matter how "probing," using inquiries as a substitute for actually observing the process simply cannot supply the answer to that question. The standard should be rewritten to restore the integrity of the walkthrough process.

Weakening the Materiality Standard: In the name of "clarifying" the role of interim materiality in the audit, the Board essentially clarifies it out of existence. As the proposing release makes clear, concerns about misstatements of interim financial disclosures would not play a role in determining the scope of the audit, and that point is further driven home by the standard's discussion of the role of scoping and evaluation. Then, with its questions in the proposing release, the Board invites the business community to argue that further restrictions are need. Far from further weakening the materiality standard, the Board should restore the language on interim materiality from AS2 as essential to retaining the integrity of the internal control audit.

The Control Framework: Although the auditor will no longer be opining on the adequacy of managements control assessment, the audit standard requires the auditor to use the same control framework relied on by management in assessing the adequacy of internal controls. While this will often be the logical and appropriate course, we can foresee circumstances in which that would not be the case. In particular, we believe the auditor must be free to express a view on the control framework used by management where the auditor does not believe that framework adequately addresses the risks or complexity of the company in question. So, while it may be appropriate to encourage auditors to use the same control framework relied on by management, it should not be required. Furthermore, auditors should be encouraged to communicate concerns about the adequacy of the control framework used by management,

where such concerns exist.[29]

Audit Scope: The proposal effectively restricts auditors to testing those controls that are directly related to significant accounts and disclosures, relevant assertions, and significant processes. This approach seems to prohibit auditors from stepping back and taking the kind of broader look that would allow a more informed view of the general environment at the company and the quality of the financial reporting. In several recent accounting scandals, errors surfaced a variety of areas, some in areas that would have been unlikely to have been assessed as high-risk. At Qwest, for example, a matter as relatively simple as payroll wasn't recorded correctly. It is highly unlikely that payroll would be identified as a high-risk area deserving audit attention under the top-down, risk-based approach described in the proposal. But evidence that a company is getting even the simple things wrong would be an enormous red flag of potential problems elsewhere. As such, it ought to inform decisions about the design of the audit and the scope of testing needed. We believe the standard should not only permit, but encourage, auditors to do a basic level of testing designed to give them a better sense of the lay of the land at the company they are auditing before they reach conclusions about the areas where problems are most likely to emerge.

Pro-Investor Provisions Should Be Added

Adequate Documentation: In addition to including this as a fundamental principle, the standard should include provisions regarding documentation of the audit. Those requirements should ensure that auditors provide sufficient documentation to allow a third-party to review the work conducted, understand the basis for the auditor's conclusions, and assess the reasonableness of those conclusions.

Responsibilities of the Audit Partner and Audit Team Manager: The proposed standard relies heavily throughout on exercise of professional judgment. While this may be appropriate in an ideal world, it makes it all the more important that key aspects of the audit are handled by members of the audit team with adequate experience and expertise. It is our understanding that this is often not the case. On the contrary, we understand that the vast majority of the work on most audits is performed by audit team members with zero to six years experience. We urge the Board to make clear that key aspects of the audit should be handled by the audit partner and audit team manager. These should include the risk assessment, but also other aspects of the audit that involve analysis of complex issues or extensive use of professional judgment.

Use of Information Obtained in Previous Years: The proposal encourages auditors to make use of information they have obtained through previous years' audits. This is a sensible approach that, properly implemented, should allow audits to gain in both efficiency and effectiveness from year to year. The Board should make clear in the standard, however, that auditors have an obligation to go back and assess periodically whether what they learned in previous years is still relevant or whether factors have changed in a way that require the auditor

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[29] It may be appropriate, for example, to require the auditor to communicate any such concerns both the management and to the audit committee.

to reconsider that information.

Misstatements and the Presumption of a Material Weakness: The proposal states that a material weakness may exist even where there is no evidence of a material misstatement. This is appropriate. However, we encourage the Board to expand on this by indicating that the existence of a material misstatement creates the presumption of a material weakness and that, where the auditor determines that this is not the case, the auditor has an enhanced responsibility to provide evidence to support that conclusion. As with all areas of the audit, we believe documentation should be sufficient to allow a third party to review the evidence and assess the reasonableness of the auditor's conclusion.

Report to Investors: The standard details what information should be provided to investors and in what form. This seems to us to be largely boilerplate that does little to actually provide investors with useful information. Among other things, we believe the report should detail the nature and extent of testing performed by the auditor. It should also be required to describe the extent to which the auditor relied on the work of others. This would provide investors with valuable information they could use to assess for themselves the thoroughness and reliability of the audit. We believe it is absolutely essential in light of the flexibility, even encouragement, the standard provides to short-change the audit.

Conclusion

We recognize that the Board has been under enormous political pressure to scale back the requirements of AS2. We nonetheless urge the Board to resist that pressure, assert its independence, and withdraw its ill-founded, ill-advised rewrite of the standard. Not only would that benefit investors directly, by ensuring that internal control requirements continue to work to improve the quality of financial disclosures, it would also benefit investors indirectly, by sending the message that the Board cannot be bullied by a business community intent on achieving cost savings at the expense of investor protections.

Respectfully submitted,

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