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November 21, 2003

Via e-mail

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 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 (PCAOB Release No. 2003-017, October 7, 2003)

Ladies and Gentlemen:

Covington & Burling is pleased to respond to the request of the Public Company Accounting Oversight Board for comments on its Proposed Auditing Standard referred to above (as so proposed, the "Standard"). Our comments relate solely to the application of the Standard to consolidated or majority-owned subsidiaries ("Subsidiary Registrants") that have non-equity securities listed on a national securities exchange or quoted in an automated inter-dealer quotation system of a national securities association ("SROs"). We believe that the Standard does not make adequate provision for the Subsidiary Registrant exemption provided by the SEC in its recently adopted Rule 10A-3(c)(2) under the Securities Exchange Act of 1934. In addition, we wish to call to the attention of the PCAOB certain other issues unique to Subsidiary Registrants that are raised by the Standard.

As you know, Securities Exchange Act Rule 10A-3, which was adopted pursuant to Section 301 of the Sarbanes-Oxley Act of 2002, directs SROs to prohibit the listing of any security of an issuer that is not in compliance with prescribed audit committee standards. In response to comments received from Subsidiary Registrants and their parent companies on Rule 10A-3 as initially proposed, the SEC adopted an exemption to Rule 10A-3 as adopted for Subsidiary Registrants (the "Subsidiary Registrant Exemption") if the parent company (a) has a

class of common equity securities (or similar securities) listed on an SRO and (b) is subject to, and otherwise in compliance with, Rule 10A-3.¹

Evaluating the Effectiveness of the Audit Committee's Oversight of the Issuer's External Financial Reporting and Internal Control Over Financial Reporting

Evaluating Audit Committee Independence

Paragraphs 56-59 of the Standard prescribe standards for an auditor's evaluation of the effectiveness of an audit committee's oversight of an issuer's external financial reporting and internal control over financial reporting. The Standard directs auditors to place particular emphasis in the course of their evaluation on the independence of audit committee members from management and an issuer's compliance with applicable listing standards adopted pursuant to Section 301 of the Sarbanes-Oxley Act. These listing standards include Rule 10A-3.

In the SEC Audit Committee Release, the SEC explains that subjecting Subsidiary Registrants to the audit committee independence and other requirements of Rule 10A-3

would add little additional benefit if the subsidiary is closely controlled or consolidated by a parent issuer that is subject to the requirements. Instead, imposing the requirements on these subsidiaries could create an onerous burden on the parent to recruit and maintain an audit committee meeting the requirements for each specific subsidiary.

Therefore, the SEC determined it was appropriate to exempt Subsidiary Registrants from the requirements of Rule 10A-3.² However, the Standard does not provide a corresponding exemption for Subsidiary Registrants.

We note that Rule 10A-3(d) requires an issuer utilizing certain exemptions from Rule 10A-3 to disclose in its annual report and proxy statement the nature of the exemption and its assessment of whether, and if so how, such reliance would materially adversely affect the ability of the issuer's audit committee to act independently and to satisfy the other requirements of Rule 10A-3. The purpose of Rule 10A-3(d) is to alert an issuer's securityholders that an issuer's audit committee may not be acting independently or have systems in place to insure effective oversight of the company's external financial reporting and internal control over financial reporting. Significantly, Rule 10A-3(d) does not require an issuer availing itself of the Subsidiary Registrant Exemption to make such disclosure or assessment. This, we believe, evidences further recognition by the SEC that reliance on the Subsidiary Registrant Exemption does not jeopardize the effectiveness of the Subsidiary Registrant's external financial reporting and internal control over financial reporting.

For the reasons stated above, we believe that evaluation under the Standard of the effectiveness of an audit committee's oversight of the company's external financial reporting and

¹ The SEC determined that this exemption was consistent with the purposes and policies of Section 301 of the Sarbanes-Oxley Act and the protection of investors. See Section II(F)(2) of SEC Release No. 33-8220, dated April 9, 2003 (the "SEC Audit Committee Release").

² Section II(F)(2)(a) of the SEC Audit Committee Release.

internal control over financial reporting and, in particular, the independence of audit committee members from management, should explicitly recognize that Subsidiary Registrants may be exempt from the application of Rule 10A-3 (including the audit committee independence requirements). The Standard should specifically affirm that the use by a Subsidiary Registrant of such exemption should have no negative effect on the auditor's evaluation of the effectiveness of an audit committee's oversight. By enacting the Subsidiary Registrant Exemption, the SEC has endorsed the view that investor protection is not compromised by exempting Subsidiary Registrants from the audit committee independence requirements (and the other requirements) of Rule 10A-3 where the parent company audit committee is providing that protection, and we strongly urge the PCAOB to endorse that view.

Evaluating the Effectiveness of an Issuer's Audit Committee in Other Contexts

Paragraph 56 of the Standard notes the important role that an issuer's audit committee plays within the company's control environment by setting a positive tone at the top and in monitoring components of internal control over financial reporting by challenging, and creating an environment where others within the Company are able to challenge, the company's financial activities. In order to eliminate any confusion over references to the term "audit committee" as used in paragraph 56 and throughout the Standard, footnote 12 of the Standard provides that if an issuer lacks an audit committee, all references to the audit committee in the Standard shall apply to the entire board of directors of that issuer. As such, footnote 12 reflects the definition of "audit committee" found in Section 3(a)(58) of the Securities Exchange Act of 1934. However, while footnote 12 removes this ambiguity in the audit committee/full board context, it does not address the similar situation that may exist in the Subsidiary Registrant context.

The Standard contains numerous references to the obligation of an auditor to make assessments of an issuer's audit committee's performance on matters other than independence.³ In the Subsidiary Registrant context, each of these enumerated audit committee activities could be undertaken by any of: (i) the audit committee of a Subsidiary Registrant; (ii) the full board of a Subsidiary Registrant; or (iii) the audit committee of a Subsidiary Registrant's parent. We believe that a Subsidiary Registrant should be able to retain flexibility to allocate these responsibilities as it (or its parent) sees fit (so long as the parent company discharges its obligations to supervise the Subsidiary Registrant's audit committee under Rule 10A-3). For example, there may be circumstances where a Subsidiary Registrant's audit committee monitors its code of ethics while the audit committee of the Subsidiary Registrant's parent oversees the Subsidiary Registrant's external financial reporting process and internal control over financial reporting. We believe that the Standard should be clarified in order to avoid confusion as to what committee or equivalent body is performing the role of "audit committee" for purposes of the Standard and, at the same time, to maintain maximum flexibility for parent companies to manage their Subsidiary Registrants. The Standard should explicitly instruct Subsidiary Registrants and/or their parent companies to include in their management report a specific identification of the committee or equivalent body responsible for each required audit committee

³ See, e.g., paragraphs 24-25, 39 (bullet seven), 53 (bullet five), 72 (bullet six) and 126 (bullets three and seven) of the Standard.

activity and instruct auditors to assess the committee or equivalent body so identified as being responsible for the particular audit committee activity.

Mandated Communications with an Issuer's Audit Committee

The Standard contains numerous provisions that either require an auditor to make certain communications to the issuer's audit committee or make reference to such communications. These required communications include the following situations in which shortcomings have been identified by an auditor: (a) an auditor's determination that management has failed to meet certain obligations under the Standard (paragraphs 20 and 128(f)); (b) an auditor's identification during the course of an audit of significant deficiencies or material weaknesses in controls (paragraph 100) or in internal controls over financial reporting (paragraphs 190-91); (c) the failure of management to disclose or identify a material weakness in its management report (paragraph 163, second bullet); (d) the presence of a material misstatement of fact in a management report (paragraph 176); (e) the failure of management to respond to an auditor's communication that changes to the issuer's disclosure about changes in internal control over financial reporting are necessary (paragraphs 188-89); and (f) an auditor's identification during the course of an audit of fraud or possible illegal acts (paragraph 192).

In order to avoid any ambiguity in the Standard as to which committee or equivalent body of a Subsidiary Registrant should receive mandated communications from its auditors, we believe that the Standard should clearly state that such required communications should be made to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the Subsidiary Registrant pursuant to Rule 2-01(c)(7) of Regulation S-X.

Section II.H of the SEC Audit Committee Release clarifies that a parent company's audit committee is permitted under Rule 2-01(c)(7) to perform the pre-approval function for any consolidated subsidiaries both with respect to the parent company's consolidated financial statements and with respect to the financial statements of any consolidated subsidiary that also is an issuer.⁴ The SEC Audit Committee Release further notes that there may be instances where a controlled consolidated subsidiary issuer has its own audit committee. In this case, only the subsidiary audit committee need pre-approve the auditor's audit services under Rule 2-01(c)(7). Finally, the SEC Audit Committee Release reminded issuers that in circumstances where the SEC's rules require auditors to communicate directly to the issuer's audit committee, the same body responsible for the pre-approval of audit and non-audit services pursuant to Rule 2-01(c)(7) should be the body to whom these required communications are made by the issuer's auditor.

We believe that there should be an explicit statement in the Standard that an auditor must deliver required communications pursuant to the Standard to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the Subsidiary Registrant.

⁴ Note that "controlled consolidated subsidiary issuers" is a subset of our defined term "Subsidiary Registrant," in that the latter term captures both consolidated subsidiaries and majority-owned subsidiaries. The Rule 10A-3(c)(2) exemption discussed in the first section of this letter applies to "a direct or indirect consolidated subsidiary or an at least 50% beneficially owned subsidiary of the issuer." The SEC discussion of the application of Rule 2-01(c)(7) in Section II.H of the SEC Audit Committee Release applies only to controlled consolidated subsidiary issuers and not to unconsolidated majority-owned subsidiary issuers. We do not believe that this distinction affects the analysis that follows.

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This would have the benefit of removing any ambiguity in the Standard over what committee or equivalent body should receive communications required to be delivered to the “audit committee” pursuant to the Standard and harmonizing the Standard with the SEC’s application of Rule 2-01(c)(7). We believe this can be most efficiently accomplished by adding a general statement to this effect to the Standard, rather than explicitly modifying each such reference.

* * *

We appreciate the opportunity to comment on the Standard. If you have any questions with respect to this letter or require any further information, please do not hesitate to contact the undersigned (212.841.1060: bbennett@cov.com) or David B.H. Martin (202.662.5128; dmartin@cov.com).



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cc: Jeffrey J. Minton
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