

AMERICAN BAR ASSOCIATION
Section of Business Law
750 North Lake Shore Drive
Chicago, IL 60611

December 2, 2003

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

Re: PCAOB Rulemaking Docket Matter No. 008

Dear Board Members:

On behalf of the Committee on Law and Accounting and the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association (jointly, the “Committees”), we are pleased to have the opportunity to comment on the Public Company Accounting Oversight Board’s (the “PCAOB”) proposed auditing standards relating to audits of internal control over financial reporting (the “Proposed Standards”).

The comments expressed in this letter represent the views of the Committees only and have not been approved by the American Bar Association’s House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, they do not represent the official position of the ABA Section of Business Law, nor do they necessarily reflect the views of all members of the Committees.

The Committees recognize the PCAOB’s obligation to implement the legislative mandate of Sections 103(a)(2)(iii) and 404(b) of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) and support the PCAOB’s overall approach in the Proposed Standards. While the Committees believe that the Proposed Standards should achieve the goal of ensuring the confidence of the investing public in the integrity of public companies’ internal control over financial reporting, highlighted below are certain aspects of the PCAOB’s proposals with which the Committees do not agree and our suggestions that are intended to clarify the Proposed Standards.

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I. Audit Committee Proposals.

The Committees acknowledge the central role of the audit committee in the oversight of a company's financial reporting process. However, we believe that the proposed attestation standards relating to the audit committee are not consistent with the requirement that the audit committee appoint and oversee the outside auditors.

Under Section 301 of Sarbanes-Oxley and the rules and regulations promulgated thereunder by the Securities and Exchange Commission (the "SEC"), the New York Stock Exchange and The Nasdaq Stock Market (the "SROs"), a listed company's audit committee is directly responsible for the appointment, compensation and oversight of the work of the company's outside auditors. Because of the direct supervision obligations that have been imposed on such audit committees by Congress, the Proposed Standards appear flawed and circular in their requirement that the very body that is directly responsible for appointing and determining compensation of the outside auditors, as well as directly overseeing their work, would be subject, in turn, to that outside auditors' scrutiny as part of its audit of internal control over financial reporting.

In addition, we believe that a weakness in the oversight by the audit committee of the financial reporting process may suggest a deficiency in the way the outside auditors manage their relationship with the audit committee. Such a deficiency should be addressed by the outside auditors through better communication with the audit committee. If such dialogue does not improve the effectiveness of the audit committee, the outside auditors should consider resigning.

We disagree with the identification in Paragraph 53 of the activities of the audit committee as an example of the activities that the outside auditors should evaluate as a part of the "monitoring of controls." The audit committee's oversight role is not comparable to the monitoring role of the internal audit function, the CEO and CFO certification process or any other process that a company follows to ensure the adequacy of its financial disclosures, including as a result of the certifications required by Sections 302 and 906 of Sarbanes-Oxley. In our opinion, it is more appropriate for any evaluation of the audit committee's oversight role to be considered in connection with a general review of a company's control environment.

In our view, not only are the proposed attestation procedures relating to the audit committee not contemplated by Sarbanes-Oxley, they may be duplicative of the responsibilities imposed and enforced by the SEC, the SROs, state law and stockholders on boards of directors and audit committees. Moreover, some of these proposed procedures would require that the outside auditors make legal judgments and therefore not judgments within their expertise. We specifically recommend deleting, or revising, if not deleting, the following proposed procedures:

- Paragraph 57 of the Proposed Standards would require the outside auditors to evaluate the independence of the audit committee as one of the factors related to the effectiveness of the audit committee's oversight of external financial reporting and internal control over financial reporting. In evaluating the audit committee's independence, Paragraph 58 of the Proposed Standards would require the outside auditors to evaluate how audit committee members are nominated and selected and whether they act independently from management. We do not agree with, and are troubled by, the conclusion in Paragraph 58 that audit committee members are more likely to be independent if they are nominated through an independent process. More importantly, the evaluation of independence is more properly a corporate governance matter, which is governed by the mandates of Section 301 of Sarbanes-Oxley, state law, SEC regulations and listing standards (as acknowledged by the PCAOB in Footnote 13 to the Proposed Standards), than a matter for the outside auditors in the context of their evaluation of internal control. Boards of directors are required by applicable listing standards to make an affirmative determination of independence for each outside director. Furthermore, a recently-adopted SEC rule that addresses, in part, disclosure relating to nominating committee functions, will result in significant public disclosure of the details surrounding a company's nomination process. See SEC Release No. 33-8340 (November 24, 2003). Therefore, the Committees find it an unnecessarily duplicative and costly requirement, and one with respect to which the outside auditors lack expertise, for the outside auditors to evaluate matters of director independence. Moreover, because the audit committee is established by the board of directors, which has the ability and responsibility to replace committee members and alter the audit committee charter as necessary or appropriate, the board of directors is the proper body to evaluate the audit committee's performance.
- Paragraph 57 would require the outside auditors to evaluate the clarity with which the audit committee's responsibilities are articulated and how well the audit committee and management understand those responsibilities. We assume that this factor would require a review of the audit committee charter, which is a publicly-filed document available to stockholders. We believe that the review of the charter by the outside auditors and evaluation of whether the audit committee and management understand those responsibilities are matters more appropriately covered by the board self-assessment process and are not matters within the expertise of the outside auditors.
- Paragraph 57 would require the outside auditors to evaluate the level of involvement and interaction of the audit committee with the outside auditors, including the audit committee's role in their appointment, retention and compensation. This circular requirement could create conflicts of interest for the audit committee. As noted above, audit committees of listed companies will be required by law to perform these duties.
- Paragraph 57 would require the outside auditors to evaluate the level of involvement and interaction of the audit committee with the internal audit department, including

the audit committee's line of authority and role in appointing and compensating employees in the internal audit function. In addition, Paragraph 24 identifies the internal audit activity as a control intended to address the risks of fraud. These Paragraphs assume, incorrectly, that all companies have an internal audit function. While NYSE-listed companies are required by the new corporate governance listing standards to have an internal auditor function, NYSE-listed companies are permitted to outsource the internal auditor function and Nasdaq-listed companies and other companies are not so required. Therefore, this requirement, if retained, should be revised to acknowledge that some companies may not have employees performing internal audit functions or may not have, and may not need to have, an internal audit function at all.

- Paragraph 57 would require the outside auditors to evaluate the audit committee's compliance with applicable listing standards adopted pursuant to Section 301 of Sarbanes-Oxley. As noted above, this is a circular requirement and one that would be inconsistent with Rule 10A-3 promulgated under the Securities Exchange Act of 1934, as amended, under which audit committees must comply with applicable listing standards or face delisting.
- Paragraph 57 would require the outside auditors to evaluate whether the audit committee has an audit committee financial expert. Besides the fact that this information is required to be disclosed in a company's public filings, we question whether the existence of an audit committee financial expert is probative of whether an audit committee is functioning appropriately.
- Paragraph 57 would require the outside auditors to evaluate the amount of time the audit committee devotes to control issues and other committee activities. An evaluation of the time spent would be incomplete absent discussions with the members of the audit committee to determine the time that each member spends preparing for audit committee meetings. Interviewing audit committee members to determine this accurately does not seem like a good use of auditor time. In addition, the time spent by the audit committee is of far less importance to the evaluation of the oversight role played by the audit committee than the way in which that time was used. Intense analytical discussions about accounting or internal control issues during a four-hour period among fully prepared audit committee members will result in far more effective oversight than unfocused discussions between audit committee members who are not prepared to discuss the issues. We believe this proposal should be deleted. If it is retained, we request that the PCAOB consider revising the language to focus on the audit committee's quality of participation in committee activities rather than the amount of time the members devote to those activities.
- Paragraph 72 would require the outside auditors to evaluate the nature and extent of the audit committee's involvement in the period-end financial reporting process. This evaluation would appear to require, with respect to NYSE-listed companies, an

evaluation of compliance with listing standards, a legal judgment. Furthermore, because the audit committee's period-end evaluation process significantly depends upon input from and interaction with the outside auditors, we are not certain what is contemplated by the inclusion of this factor as an auditing standard.

Finally, we believe that the Proposed Standards inappropriately broaden or characterize the scope of audit committee duties. In some cases, the Proposed Standards go beyond what the law requires. For example, Paragraph 24 of the Proposed Standards suggests that the audit committee is responsible for monitoring the code of conduct. Although the audit committee often has this responsibility, it is not required under applicable listing standards and regulations or any state or federal law. In addition, the reference in Paragraphs 34 and 35 of the Proposed Standards to the audit committee's responsibilities with respect to the outside auditors' independence could be understood to suggest a shift to the audit committee of some of the outside auditors' independent burden to determine its own independence.

II. Issues Related to the Scope of the Audit.

The Committees agree that the process of auditing internal control over financial reporting should be done in connection with audit of the financial statements and will require more than just merely acknowledging that auditor agrees with management's assessment. Audit fees appear to have increased significantly since 2002, and costs associated with an audit of internal controls will surely result in substantial additional increases in audit fees. We urge the PCAOB to consider ways to reduce the scope of the procedures required by the Proposed Standards, and thereby reduce the attendant costs to reporting companies, to more closely tailor the procedures to those required by Sarbanes-Oxley without adversely affecting the quality of the internal control audit.

Mindful of mounting compliance costs, the Committees submit that certain of the approaches contemplated by the Proposed Standards appear to be duplicative of other procedures and, therefore, unnecessary. In addition, the Proposed Standards require a great deal of origination of supporting evidence by the outside auditors. For those procedures that are necessary in the audit process, we generally support, where appropriate, greater permissibility of the outside auditors' use of professional judgment in determining the extent to which reliance on the work performed by the internal auditors is appropriate.

The PCAOB states on page eight of the Summary of the Proposed Standards that: "the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be." We agree with the appropriateness of this approach but, as drafted, the outside auditors do not appear to be permitted to rely very much on management's work at all. Therefore, we question the conclusion that the Proposed Standards will permit the outside auditor's work to be less extensive if management's assessment is relatively more complete. Given that management's

assessment is at a level of “reasonable assurance,” which “includes the understanding that there is a relatively low risk that material misstatements will not be prevented or detected on a timely basis” (as contemplated by Paragraph 16 of the Proposed Standards), we also recommend that the Proposed Standards permit a reasonableness evaluation by the outside auditors in determining what procedures are required in the audit.

As noted above, the Proposed Standards require that a great deal of the supporting evidence for the outside auditors’ opinion originate with the outside auditor. However, Paragraph 109 of the Proposed Standards is unclear as to whether all “principal evidence” must originate with the outside auditors.

We also question whether the procedures called for by the Proposed Standards ought to be required to be performed on an annual basis and whether the same level of testing each year is really necessary to justify the additional expense of such testing. It may be more appropriate to permit the outside auditors to use the previous year’s audit evidence in some cases. However, with increased reliance on internal auditors, as discussed below, annual testing may be more acceptable.

Where appropriate, the PCAOB should consider permitting more reliance on the internal auditors’ work once the outside auditors confirm their understanding of internal control over financial reporting and test the internal auditors’ tests. We note that Statements on Auditing Standards Number 65, *The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements*, provides well-established guidance to outside auditors in determining the nature, timing and extent of auditing procedures to be performed in an audit of an entity’s financial statements. We would suggest that the PCAOB consider allowing outside auditors to use the same or similar criteria in assessing the appropriateness of reliance on the work of the internal auditors in connection with an internal control audit, even with respect to matters covered in Paragraphs 104 and 105 of the Proposed Standards. To do otherwise could result in unnecessary re-testing of controls. If an internal auditor follows applicable professional standards, reports to the audit committee, is deemed independent of management and is considered by the outside auditors to do reliable work, reliance ought to be permitted consistent with current practice.

One of the procedures called for by the Proposed Standards with respect to which the outside auditors would be precluded from relying on others is the proposed requirement that the outside auditors perform “walkthroughs” in the audit process. To the extent that it is reasonable for the outside auditors to rely upon the work of the internal auditors, the outside auditors should be permitted to rely, to a significant extent, on walkthroughs that have already been completed. That said, if a walkthrough is required as part of the final standards, the PCAOB should consider whether it is necessary and cost-effective to extend that procedure to all of the company’s significant processes and include all types of company transactions and events, both routine and unusual, as is currently required by Paragraph 79 of the Proposed Standards.

In our opinion, additional reliance could also be placed on management's work or the work of third parties where the outside auditors appropriately test the work to evaluate the extent to which the outside auditors could reasonably rely upon it. We encourage the PCAOB to consider whether that approach could be permitted in the following specific areas:

- The identification of significant accounts as contemplated by Paragraph 60.
- The identification of relevant financial statement assertions as contemplated by Paragraph 66.
- The identification of significant processes as contemplated by Paragraph 69.
- The identification of controls to test as contemplated by Paragraph 74.
- The evaluation of the use of work performed by management and others as contemplated by Paragraph 103.

We also question the proposal to broaden the responsibilities of the outside auditors to include disclosures outside the financial statements. Paragraph 184 would require the outside auditors to "evaluate" with management appropriate disclosure about a change in internal control over financial reporting resulting from the need to correct a material weakness. It may be more appropriate to require a "review" rather than an "evaluation," as the latter would appear to come very close to requiring the outside auditors to act in a managerial capacity.

We recommend that the Proposed Standards address the attestation and reporting requirements when a company's internal control over financial reporting has not been fully reviewed and appropriately modified after a merger, acquisition or corporate restructuring that took place too close to the end of the fiscal year for such a review to have been completed. For example, the requirement in Paragraph 128 for management representations should acknowledge and provide guidance as to how to respond when management may be unable to make the necessary representations as to the internal controls. In addition, in such circumstances, a qualified opinion or "except for" opinion should be acceptable rather than an adverse opinion, which is what the Proposed Standards would require.

A qualified opinion can be useful to convey information to stockholders that would otherwise not be conveyed by a blanket adverse opinion. In addition to a qualified opinion providing more meaningful information about the impact of a recent acquisition or restructuring on a company than an adverse opinion, a qualified opinion may be preferable to an adverse opinion in other contexts. For example, it could highlight that a deficiency is confined to one business segment.

Finally, we question the requirement in Paragraph 145 of the Proposed Standards that the outside auditors' documentation of their attestation work include an evaluation of

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all deficiencies. We encourage the PCAOB to consider whether the documentation needs to include an evaluation of deficiencies other than "significant deficiencies."

III. Clarification of Definitions.

We are concerned about the clarity and potential consequences of the proposed definitions of "significant deficiency" and "material weakness." Not only has the PCAOB not used the definitions in existing generally accepted auditing standards ("GAAS") (AU Sections 325 and 501) of "reportable condition" and "material weakness," but the PCAOB has also not explained how the proposed definitions would differ from the existing terms under GAAS. Moreover, the PCAOB's use of the term "more than a remote likelihood" in the proposed definitions would appear to be a lower standard than existing GAAS and would require many more deficiencies in internal control to be identified as "significant" or as "material weaknesses" than under current GAAS.

In view of the severe consequences to a company if its internal control over financial reporting is considered to have significant deficiencies or material weaknesses, we recommend that the definitions be clarified to be consistent with existing GAAS. In addition, we recommend that the PCAOB provide further examples of significant deficiencies and material weaknesses to enhance the likelihood of more consistent conclusions by outside auditors as to the types of deficiencies in internal control that should be considered to be significant deficiencies or material weaknesses. Such guidance would be particularly important with respect to the independence and effectiveness of the audit committee if the PCAOB retains the attestation procedures related to the independence and effectiveness of the audit committee.

Thank you for your consideration of our comments on this important matter. Please do not hesitate to contact the undersigned with any questions you may have.

Cordially,

/s/ Thomas L. Riesenber

Thomas L. Riesenber

Chair of the Committee on Law and Accounting of the American Bar Association,
Section of Business Law

/s/ Dixie L. Johnson

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