



**RULEMAKING DOCKET MATTER 021**

**RELEASE NO. 2006-007**

**PROPOSED AUDITING STANDARD – AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS AND RELATED OTHER PROPOSALS**

<b>COMMENT #</b>	<b>COMMENTS</b>	<b>DATE RECEIVED</b>
1	Matthew W. Moog	December 20, 2006
2	Frank Gorrell, MSA, CPA	January 2, 2007
3	Stephen R. Rosenkranz	January 2, 2007
4	Alamo Group, Dennis M. Stevens, Director, Internal Audit	January 4, 2007
5	Thorsten Stegmann	January 10, 2007
6	MetLife, Joseph J. Prochaska Jr., Executive Vice President	January 16, 2007
7	Hon. Michael B. Enzi, U.S. Senator	January 20, 2007
8	Danny Goldberg	January 23, 2007
9	Joseph E. Murphy, P.C., Joseph E. Murphy	January 25, 2007
10	Faisal R. Danka	January 25, 2007
11	Matthew Leitch	January 25, 2007
12	Orin & Klein, Richard M. Orin	January 25, 2007
13	James Wall	February 1, 2007
14	Loucks CA, Christopher Loucks	February 2, 2007
15	Monica Radu	February 4, 2007
16	Rockwood Holdings, Inc., P. Andrew Shaw, Director, Internal Audit / SOX	February 9, 2007
17	Patrick Montgomery	February 13, 2007
18	Institute of Management Accountants, Paul A. Sharman, President and CEO; Jeffrey C. Thomson, Vice President of Research & Applications Development	February 13, 2007
19	Donald H. Chapin	February 13, 2007
20	Council of Institutional Investors, Jeff Mahoney, General Counsel	February 13, 2007

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27	Center for Audit Quality	February 16, 2007
28	Thomas I. Selling	February 18, 2007
29	North Carolina State Board of Certified Public Accountant Examiners	February 19, 2007

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**From:** Matthew.Moog@ey.com [mailto:Matthew.Moog@ey.com]

**Sent:** Wednesday, December 20, 2006 5:22 PM

**To:** Comments

**Subject:** Docket 21

1) On page A2-4, #7 reads "The auditor should evaluate the extent to which he or she will use the work of others. Areas in which the auditor might use the work performed by others to reduce the procedures the auditor otherwise would have performed include –

- Procedures the auditor performs when obtaining an understanding of the company's internal control over financial reporting;
- Procedures the auditor performs when assessing risk;
- Procedures the auditor performs when testing the effectiveness of controls; and
- Substantive procedures the auditor performs when testing account balances and disclosures."

Should this be interpreted the auditor may rely on the work of others for walkthroughs and identifying key controls as long as a percentage of the work of others is re-tested? If so, should the auditor's evaluation of the related risk be formally assessed and documented to support the decision?

Regards,

*Matthew W. Moog*

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**From:** Matthew.Moog@ey.com [mailto:Matthew.Moog@ey.com]  
**Sent:** Saturday, January 13, 2007 12:47 PM  
**To:** Comments  
**Subject:** Revision to my comment submission information

January 13, 2007

Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, DC 20006-2803

On December 20th, 2006 I submitted a comment to your comments@pcaob.org mailbox re: Docket #21 with respect to section A2-4, #7. Please note that the submission was made on my personal behalf and as such reflects my personal views and not the views of my employer. Please update my submission record and comment to reflect this.

Sincerely,

Matthew Moog

Copy to: Mr. J. Gordon Seymour, Secretary and Deputy General Counsel

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January 2, 2007

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. 21  
Proposed Auditing Standard – *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements And Related Other Proposals*  
December 19, 2006

Dear Board Members,

I am submitting my comments to you regarding the above referenced Rulemaking Docket Matter. These are my personal comments and do not necessarily reflect those of my employer. You specifically asked respondents to answer thirty-four (34) questions. I begin with some observations on paragraphs 1 through 15 on page A1–4 to the top of page A1–11.

Par. 1. – The Public Company Accounting Oversight Board (“PCAOB” or “the Board”) states the new standard “applies when an auditor is engaged to perform an audit of management’s assessment of the effectiveness of internal control over financial reporting...that is integrated with an audit of the financial statements.” [Footnote and boldface type are eliminated.] This introductory paragraph seems to permit an auditor to bifurcate the audits. If the Board truly intends to *require* integration of an audit of internal control over financial statements with financial statement audit procedures, I recommend making a direct statement here. See my comments on paragraph 7 and question 19 below.

Par. 2. – This paragraph concludes with the statement, “A material weakness in internal control over financial reporting may exist even when financial statements are not materially misstated.” Later in paragraph 72 on page A1–27, the Board states this again. To someone unfamiliar with auditing and the concept of “reasonable assurance,” this must read like an oxymoron. “How,” one may ask, “can there be a very serious problem with internal control over how the numbers are reported, but not a problem with the numbers that have been reported?” The Board mentions adjusting financial statement audit procedures beginning on the bottom of page A1–19 in paragraph 46. Let us consider basic safety standards to aid those who may not understand. One may remove oil soaked rags from a pile of paper not because there was a fire, but the *potential* of a fire exists. It appears that this is what the Board is promoting. Nonetheless, management and auditor will have to communicate. The imagination of the auditor will be assessed by management in these cases.

Par. 5. – Whether in this paragraph or another section to follow, I recommend discussion of how multiple locations may have different *specific* controls under a standard framework promulgated by the parent company (corporate headquarters). For example, a large company may provide this broad company-level control: “The VP Finance or Controller is the only person who may

open a new bank account. Approval for the new account must be secured from Corporate Treasury.” One business unit or division may have only one of those two titles. Therefore, they write their version of the control: “The Controller may open a new bank account when needed after receiving an approved ‘Request for New Bank Account’ form from the Corporate CFO.” The Board may find it helpful to make this paragraph more robust directing the auditor to acquire and test the *local* framework as approved by the corporate powers that be.

Par. 7. – This paragraph is presently written as a *suggestion* by stating that the audit of internal control over financial reporting “should be integrated with” the financial statement audit. Appendix B provides more detailed guidance. I note that paragraph B1 starts with the phrase, “In an integrated audit of internal control over financial reporting and the financial statements...” This again leads to the possibility that these two audits may not be concurrent. See my reply to question 4.

Par. 8. – Integrating the audit guides the auditor in the reverse direction, too. The auditor must assess risk of misstatements on the financial statements. Therefore, the processes that yield the numbers and disclosures surrounding these risk points ought to lead the auditor to assess internal control risk accordingly. This means if Inventory is deemed to be high risk, perhaps more so given the particular client, the internal controls surrounding inventory need to get more attention. The Board hints that stronger internal control may reduce the risk of material misstatement in an area. What is being described here is how internal controls over financial reporting and the financial data produced are integrated by definition; a lattice if you will. Data is entered in the system after passing through a prescribed process. The natural extension of the process requires we retrieve that data to ensure it is accurate. Continuing with the example, a well-controlled process for inventory data input and usage reduces our risk of misstating inventory. The only exposure remaining is the process of inventory valuation. While circular in appearance, the auditor has gone from assessing the risk of a material misstatement of inventory to finding strong controls to reduce that risk. This in turn leads to reduced testing on the financial statement audit. The auditor may opt to spend more time on the internal control audit to ensure this. Overall, the amount spent may go down. If controls are weak, then the auditor needs to broaden procedures on the financial statement side, while spending *less* time on testing internal controls, which may not prevent misstatement of inventory.

Par. 9. – The Board presents this standard as benefiting smaller companies rather than all companies. Why ignore the “accelerated filers,” who are ending the third year of compliance with Section 404 of the Sarbanes-Oxley Act of 2002 (“SOX 404”). I agree with scaling the audit of internal control over financial reporting. I recommend that the Board make it clear that everything presented in this standard applies to integrated audits of all companies.

Par. 10. – The fifth bullet point is an indication of *increased* risk in my opinion. Managers with broad control may direct the auditor to assess the overall control environment and company-level controls in greater depth. The familiarity between senior management and company personnel, as mentioned in paragraph 11, may permit a manager to bypass a control—especially when unwritten—without being second guessed by the employee.

Par. 12. – The Board may find it helpful to include discussion in the first bullet point that the lack of client documentation will require the auditor to supplement with their own documentation of what was observed. This leads to more detailed walkthrough documentation. Segregation of duty issues are mentioned in bullet four. A division or business unit of a larger company may face a similar dilemma. In the fifth bullet point the Board writes of control performer competency. Suppose an auditor finds that a person in the accounting department actually has a degree in English (more likely in a small company). If the auditor feels this person is not competent to properly perform the internal controls under his or her purview, how can the auditor trust the numbers produced by the process? The auditor ought to expand testing in this area of the financial statement audit. If the numbers are deemed to be fairly accurate, would this rescind the auditor’s premise of a lack of competency? I suggest it does. This premise nicely ties to the Board’s later requirements presented in paragraphs 65 through 69. Finally, I suggest the Board add some reference to the use of spreadsheets in the sixth bullet point. Smaller companies may rely heavily on spreadsheets, even with very good software programs available. A small manufacturer may not have an integrated software package that handles job costing and the general ledger simultaneously. Data may have to be extracted from the job costing system, passed through a spreadsheet to yield journal entries, and then be input to the general ledger. The Board may not feel comfortable presenting guidance on how auditors ought to test software and spreadsheet packages. However, coordinating with another organization may be very helpful.

### **Directing the Auditor’s Attention Towards the Most Important Controls**

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

The Board wisely presented detailed information in the order the Board wants the auditor to follow.

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

Paragraph 31 on page A1–16 is a double-edged sword. To answer this question it clearly instructs the auditor to consider how misstatements occur, most likely due to fraud. See my response to question 3 below.

**3. Will the top-down approach better focus the auditor’s attention on the most important controls?**

I wrote above in my response to question 2 that paragraph 31 points the auditor in the direction of fraud detection by asking “what could go wrong?” It has been my experience that auditors asking this question quickly revert to a bottom-up approach. An auditor may want to know how a company prevents a false timesheet from being entered. If the auditor follows the top-down approach, he or she may discover that in order for a timesheet to be entered, the employee has to be entered by Human Resources and the

payroll requirements must be entered by Payroll. To wrap the process up in a neat package, a computer-based timekeeping system may prevent an employee from charging an expense or project to which the employee is not assigned. This company-level set of controls mitigates the possibility of a false timesheet being entered especially when combined with supervisory review. It may be harder to prevent fraud where paper timecards may be in use, unless there are fewer employees in one location. Therefore, I recommend cautionary words here directing the auditor to develop tests for fraud and asking “What if” *after* the auditor makes an initial determination of what controls to test.

**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?**

I recommend merging the first two sentences in paragraph 16, page A1–11, to read, “A top-down approach to select the controls to test begins at the financial statement level...” Throughout the proposed standard the Board employs the word “should” and does so here regarding the use of a top-down approach. “Should” is the past tense singular of “Shall,” and it is also conditional. It is true that more current usage equates “should” with “must.” I believe the Board ought to use the word “must” if that is the true intention, as you do in paragraph 19, page A1–12. Lastly, paragraph 22, page A1–13, may include a bullet on period-end due dates, *i.e.*, are they too aggressive leading to exhausted people trying to complete the numbers.

**Emphasizing the Importance of Risk Assessment**

**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?**

On page A1–22, paragraph 53 is very important, and I agree with its premise. The conventional wisdom in place as of this writing is that just one exception causes the entire sample to be spoiled. For instance, if a control is to be tested with a sample of sixty (60) items, and tests are evenly spread throughout the year, if the sixtieth (60<sup>th</sup>) item is an exception, a new “clean” sample of sixty (60) must be obtained. Perhaps the Board can include a brief discussion of acceptable deviation rates in statistical testing.

Inquiry regarding a control generally confirms what has been learned during the walkthrough. The Board may add to paragraph 55, page A1–22, that inquiry either confirms the control has not changed, or permits the auditor to update walkthrough documentation of a significant process.

Reperformance ought to be used only for high risk controls, especially where the auditor is uncertain as to the skills and competency of the control performer. Management can reduce costs using a similar approach. Would an auditor want to re-perform all bank reconciliations if the performer is deemed to be competent? Management may be able to avoid this as well. This is *not* to say that re-performing a sub-sample is not needed to ensure the reconciliation was correctly performed as presented in control documentation.

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

I advise altering the first sentence in paragraph 36 on page A1-17 to read, “The auditor ~~should~~ must perform a walkthrough for each significant process, and ought to consider performing a walkthrough of other processes to reduce or eliminate testing in those lower risk areas.” I hope this sentence captures the Board’s intention.

**Revising the Definitions of Significant Deficiency and Material Weakness**

**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?**

I am concerned that the use of the word “significant” to describe a process, an account, and a deficiency will be problematic to management, auditors, and courts. We start with a “significant process” to determine what areas provide us with “significant accounts.” These numbers and related disclosures have controls surrounding them that management assesses and auditors may also test. Because the Board uses “significant” to describe these areas, and they are important enough to warrant all of this attention, to suggest that a “significant deficiency” ought to be noteworthy, but *not* a major (material) issue may be confusing. Professional judgment is gray enough. I recommend eliminating this middle class deficiency. A deficiency would then be either a “control deficiency” or a “material weakness.” Materiality is a number derived by the auditor for both financial statement and internal control over financial statement reporting purposes, therefore less gray.

**8. Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or 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?**

I commented on paragraph 2 that auditing procedures on the financial statements and internal control over financial reporting form a lattice. I reiterate that one must ask oneself whether a material weakness exists if there is *no* material misstatement. This is especially true where compensating controls are in place. The auditor must document his or her opinion that a material misstatement can occur and communicate this to management. Referring to the example I used in my paragraph 2 comment, the auditor documents evidence that oil soaked rags create small amounts of heat—studies, insurance records, etc. When oil from the rag is absorbed by paper, the amount of heat needed to ignite the paper decreases. Therefore, while no fire has occurred as of this date, the company needs to remove the oily rag and paper to prevent a fire. In SOX 404 parlance, the company needs to match purchase orders, receiving reports and invoices prior to paying a vendor invoice.

**9. Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statements?**

In theory the Board's decision to rely upon a definition that has been in the accounting and auditing domain ought to reduce the effort. If the Board eliminates the middle category as suggested in the response to question 7, this may further reduce the effort.

**Revising the Strong Indicators of a Material Weakness**

**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?**

It appears the Board will permit an auditor to conclude that no deficiency exists when the fourth bullet point of paragraph 79, page A1-30, exists. It may better serve users of the standard if this item is either placed in a separate paragraph or includes an introductory sentence specifically stating that the auditor may conclude no deficiency necessarily exists if this specific issue is found. In addition, one may argue that the second bullet may not necessarily lead to a deficiency, especially if management identified the misstatement through a new or improved internal control process. It could be that management opted to restate to be consistent with the current year's presentation, which would not necessarily be due to a change from one generally accepted accounting principle to another.

I believe that bullet points one and three are *prima facie* indicators of deficiency. If either of those exists both management and auditor ought to be instructed to report a material weakness.

Bullet point five may be a clear indication of deficiency *especially* for large, complex companies that ought to have an internal audit department. Smaller companies may not have the ability to employ internal audit staff. The Board may be aware that many companies have started to employ personnel strictly for SOX 404 compliance efforts in order to maintain internal audit staff independence. I recommend that the standard include consideration for the size and complexity of the company.

I suggest the Board either eliminate bullet point six or remove the language stating that only complex entities in regulated industries may be deficient due to regulatory compliance efforts. If, for example, a small regional airline company has trouble meeting Federal Aviation Administration ("FAA") requirements, it is more likely the FAA will impose sanctions against them—harming their financial performance. An airline may have a company-level control process regarding maintenance and inspections. One may argue that smaller companies may have a more difficult time meeting requirements, such as workers' compensation insurance, health benefits, sales tax remittance, etc. due to cash flow requirements.

In my response to question 7 above I mention the gray realm of professional judgment. I appreciate the Board's reluctance to impose requirements or draw a bright line for auditors to follow. Having reviewed external audit firms' reports from the Board for 2004 and 2005, it appears the number one issue raised is "insufficient evidence." This is a judgment area. At the time of the audit procedures, the auditor was satisfied with the evidence gathered. Upon further review, and I am assuming that it was PCAOB review because I do not have access to the correspondence, the evidence was deemed lacking. If it is hard enough to determine how much evidence is required to determine that accounts receivable is presented fairly in all material respects, then how can an auditor have confidence that deficiencies are properly categorized? I hope that the Board takes my advice to separate these items in paragraph 79, bottom of page A1-29 to the middle of page A1-32, into one group that may not be a deficiency and another group that are *de facto* deficiencies.

### **Clarifying the Roles of Materiality and Interim Materiality in the Audit**

#### **11. Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?**

I like the Board's decision to directly tie materiality for financial statement audits to those of internal control over financial reporting. Any further attempt to define or clarify may create more questions.

#### **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 of the scope of the audit?**

I have suggested above that "significant deficiency" be removed. Therefore, reference to interim financial statements in the Board's proposed definition in paragraph A12 on page A1-48 would be moot. Regarding paragraph A8 on the previous page, until and unless the Security and Exchange Commission decides that interim (quarterly) financial statements do not expose a registrant and/or registrant's external auditor to legal action, the reference to interim statements ought to be maintained. Even a short-term impact on markets may have a negative affect on investors.

### **Removing the Requirement to Evaluate Management's Process**

#### **13. Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?**

Absolutely! The requirement for the auditor to assess the competence and objectivity of the internal control over financial reporting tester, reviewer and/or SOX 404 project manager ought to cover this evaluation.

However, the Board counters this in the accompanying proposed standard *Considering and Using the Work of Others in an Audit*. Paragraph 10 of that proposed standard on page A2–5 includes three sub-paragraphs. The first two, a. and b., start with the word “Evaluate.” Sub-paragraph c. directs the auditor to “[t]est some of the work performed by others to evaluate the quality and effectiveness of their work.” [Underscore added.] The auditor must re-perform management’s internal control testing under this guidance. It also depends on what the Board’s definition of “some” is. Does the Board mean testing management’s work only on high risk company-level controls? Is it the Board’s intention to limit the auditor’s testing to ten percent (10%) or twenty percent (20%) or twenty-five percent (25%)? The Board may not wish to publish such a bright line. The guidance ought to keep the percentage small (10% to 20%) given that there is a concurrent assessment of competence and objectivity.

**14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management’s process?**

If the auditor determines that management’s personnel are either not competent or not objective to perform testing, the auditor will have to broaden his or her testing for both audits. To re-perform management’s testing regardless of competence and objectivity of management personnel is a colossal waste of time and money.

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

I believe it will more clearly communicate the scope and results of the auditor’s work. The process starts with the auditor determining the controls to test based upon the rubric presented on pages A1–11 to the top of page A1–20 in paragraphs 16 through 46. If the auditor observes that management has selected the same, or as much as ninety percent (90%) of the same controls to test, the auditor has an indication that management’s assessment will be consistent with what the auditor now anticipates finding. With the requirement to assess competence and objectivity in place, the auditor ought to have a solid understanding of management’s assessment process without repeating it. In actuality, this encourages *management* to hire competent personnel to perform SOX 404 work, and to compensate personnel in a way to enhance objectivity.

**Permitting Consideration of Knowledge Obtained During Previous Audits**

**16. Does the proposed standard appropriately incorporate the value of cumulative knowledge?**

This proposed standard does appropriately incorporate the value of cumulative knowledge. Benchmarking automated controls will save time for the auditor and management. It will encourage companies to automate as many controls as possible. The Board’s inclusion of guidance to the auditors to reflect on prior years’ assessment of competency, objectivity, and risk is very helpful. *Can an auditor reduce tests on a high risk control if prior tests are clean without reducing risk to moderate or low?*

**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?**

Walkthrough procedures may provide sufficient evidence in highly automated areas, as well as processes with highly effective controls that have not been changed. I advise the Board to include wording to instruct the auditor to test high risk controls in these processes to ensure there was no change. One sample item from the population ought to suffice. In addition, by using acquired knowledge of the client's internal control over financial reporting, simple observation may be sufficient for certain controls. An example of this is general ledger account reconciliation, which follows.

The internal control states that the company reconciles balance sheet and related income statement accounts each month within five days of reporting to corporate headquarters (or small company equivalent, such as the Chief Financial Officer). In the past, the auditor has tested 60 such reconciliation packages and found no exceptions. To reduce time and cost the auditor asks management in writing if there have been any changes or enhancements to this process. Upon receiving the written reply from management that there are no changes or enhancements, the auditor looks at the reconciliation packages for the latest period-end in scope. Past experience guides the auditor in knowing what attributes ought to be observed without asking the client for population and copies of the sample. This will also reduce paper and storage costs. Management will store their documentation for future reference, and this will allow subsequent observation or testing if it ever becomes necessary if the auditor properly documents the items and attributes observed. (The auditor may wish to make one copy of this "sample" to include in the work papers. This is still a dramatic reduction in the amount of paper produced in the audit.)

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

**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?**

The benefits that can be realized with the proposed standard's risk-based approach combined with the proposal on using past experience are numerous. As an example, suppose the auditor obtains the budgets and goals for a large company's various business locations. The auditor sees that a seemingly small office is asked to produce gross profit of forty percent (40%) or more in a given year. This represents a large portion of the overall company's consolidated gross profit. Under AS No. 2's current "coverage approach," audit procedures on financial data and internal control over financial reporting may not have been done for this office. However, the auditor may feel the gross profit percentage to be fairly aggressive. Testing this location seems warranted. In addition, a business location where the local economy has sagged or where a very narrow segment has a high concentration of risk (key customers and/or vendors), more audit attention is needed.

## **Removing Barriers to Using the Work of Others**

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

This question reflects on my comment regarding paragraph 1 on page A2–3 of the proposed standard. The audits ought to be integrated. The only time that this would not occur is when two external audit firms are engaged as referred to in the note to paragraph 1. Specifically, a scenario where one firm audits internal control over financial reporting while a second audits the financial statement. Even here, however, the Board ought to encourage—even require—synergy between the two firms. For example, an agreement as to the level of materiality would have to be in place.

The fewer frameworks put in place, the better for all parties. By building scalability into the replacement for AS No. 2 the Board has addressed many of the fears smaller publicly traded companies face. I believe that most important facet to this process is integration of the two audits, and the Board ought to clearly require it.

**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?**

I believe the proposed definition does capture the correct scope of activities. However, the Board limits itself by stating, “Only tests that provide audit evidence may be considered relevant activities.” A walkthrough performed by a competent and objective company employee may permit the auditor to rely upon that work for a low or moderate risk process (where the auditor uses three levels of risk). The auditor may also wish to rely upon flow charts of high risk processes to add to his or her walkthrough documentation.

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

I believe it will be helpful, provided those “others” are competent and objective. This can point the auditor towards troubled areas, reducing time spent before fieldwork commences.

**22. Is the principal evidence provision that was in AS No. 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?**

If the Board truly wants auditors to utilize others' work, the principle evidence provision in paragraph 111 of AS No. 2 must be set aside. The auditor must be permitted to rely upon the evidence derived from others in order for this proposed new standard to work.

**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 is good, in general. This sentence on page A2–6 in paragraph 13 confuses me: “...[T]he auditor should make judgments about the degree of competence and objectivity of the individuals rather than form an absolute conclusion about whether the individuals are competent and objective.” Does the Board intend to remind the auditor that the perception of competence and objectivity may change over time? My comment on introduction paragraph 12 on page 3 of my comment letter provides an example of someone with a degree in English working in an accounting department. Given the guidance in paragraph 13 of this proposed standard, the auditor may at first feel the person has a low level of competence. As testing of controls this person performs progresses—and in light of using what is learned from prior years’ work—the auditor may come to believe the person has a higher level of competence. The auditor may also add into the equation the apparent accuracy of the numbers produced by this person. We are still confronted with judgmental terms such as low and high levels.

**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 right factors for assessing competence and objectivity. Other factors I recommend are as follows. I believe the Board ought to include a note that those who perform tests may *not* be trained as auditors, nor even have experience in public accounting and auditing. This is acceptable provided these “testers” are first trained and supervised by an individual who is trained as an auditor—a Certified Public Accountant (“CPA”) or Certified Internal Auditor (“CIA”) with a current license. The external auditor may want to consider if management’s “tester” is asked to test a control the auditor would not him or her self ask a junior member of the external audit team to perform. The theory is that the auditor is loath to ask this team member to perform a function, even though that person has taken courses and is preparing for licensure. How competent is management’s “tester” by comparison?

**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?**

The Board may find it beneficial to include any plan based on company stock as impugning the objectivity whether it is “compensation” or not. This would include a savings plan that may be readily accessed. Conversely, a 401(k) plan that includes company stock may not be accessible until the “tester” reaches a certain age. If it is determined that the “tester” has arranged a loan from the plan, this ought to give pause to the auditor. If management borrows “testers” from within who *do* partake in a stock-based plan of any kind, the auditor may gain comfort if the person specifically hired to manage the SOX 404 project is well compensated in terms of salary *without partaking in*

*a stock-based plan*, and holds a professional designation as described in my answer to question 24 above. If “testers” are specifically hired for SOX 404 work, they must not partake in stock-based plans.

### **Recalibrating the Walkthrough Requirements**

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

The Board is attempting to point external auditors towards the top-down, risk-based approach. To this end it is appropriate to guide the auditor to walkthrough the significant processes. This ought to permit the auditor to calibrate his or her initial assessments. The auditor will be able to determine if management has covered all of the financial statement assertions adequately. If the auditor is concerned that another process may be significant afterwards, he or she may look towards management’s walkthrough of that process (see my answer to question 27 below).

#### **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?**

The auditor may be able to utilize the work of an internal auditor and/or a person who is employed to perform SOX 404 compliance for the company. The auditor will assess both the competence and objectivity of those persons. I recommend that the Board stipulate that in order for the external auditor to be able to rely upon the walkthrough the person or persons performing or overseeing the work have a professional designation, such as a CPA or CIA.

### **Scaling the Audit for Smaller Companies**

#### **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?**

Yes, the proposed standard does describe how auditors ought to scale the audit based upon a company’s size and complexity. Smaller companies may not have either an internal audit department with time to perform SOX 404 testing, or the ability to hire personnel to perform this function. There may be a trade off on the external auditors’ opportunity to use the work of others. One wonders if scalability is really a reallocation of focus. The auditor may find that more testing ought to be performed on period-end controls because of lacking of segregation of duties. Furthermore, the overall control environment may be “paternalistic” if the founder of the registered company is heavily involved in day-to-day operations. If this is the case and all decisions pass through this person (or family members) then the auditor may have to increase certain tests to gain comfort with the financial statements and internal controls over financial statement reporting.

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

One attribute that the Board ought to consider adding to paragraph 10 on page A1–8 of the proposed standard is “corporate governance.” The auditor will have to assess the impact of a Chief Executive Officer who is also Chairman of the Board of Directors. In addition, I recommend that the Board add that the auditor consider if the company’s Board of Directors includes family members and/or persons who have been “promoted” to board member. While reducing work for smaller companies is an admirable goal, it is my belief that greater risk exists in smaller companies.

**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?**

There is an opportunity for the external auditor to adjust the scale of all compliance audits in subsequent years if audit results indicate a healthy internal control environment and test results indicate effectively designed and operating internal controls.

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

I believe that the Board may do well to address scalability to *all* registrant companies, as I mention in my answer to question 30 above. A large company may have many more effective controls in design and operation than a smaller company. The Board ought to “reward” all companies by guiding external auditors to scale down their procedures as the risk of material misstatement is reduced.

**32. Are the market capitalization and revenue thresholds described in the proposed standard meaningful measures of the size of a company for purposes of planning and performing an audit of internal control?**

According to the footnote (6) on the bottom of page A1–7 there appears to be an emphasis on “aggregate worldwide market value.” In order to promote comparability from year to year, I recommend that the Board use a threshold based on the *number* of shares issued and outstanding. The other criterion to consider is how many of those shares are actually publicly traded. Market forces may be too volatile to determine audit scale and scope over time.

**Proposed Rule 3525 – Audit Committee Pre-approval of Services Related to Internal Control**

**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?**

The Board’s note inserted after paragraph (b) provides a clear case of where such work is not be permitted. It may be useful to require the auditor’s submission to the audit

committee include the auditor's written discussion why such non-audit service will *not* impair auditor independence. One may also make the argument that this correspondence be mentioned either in management's discussion and analysis ("MD&A"), even though MD&A is not within the scope of SOX 404, or in another disclosure (cash paid to the audit firm for non-audit services, for instance). Ultimately the investing public needs to be protected. Having knowledge that such services are being performed will aid investors in assessing the nature, timing and extent of future cash flows, which is the purpose of financial statements. How much cash is flowing to the external auditor? Is this "fee" enough of an enticement for the auditor to be persuaded in management's favor on significant issues?

### **Effective Date**

#### **34. How can the Board structure the effective date so as to best minimize 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 the decision?**

While bringing these new standards on line in 2007 would be fantastic, it is impractical because of the impact of tester objectivity. Many companies have stock plans as a benefit. Many persons may have to withdraw from those plans in order for external auditors to place more reliance on management's testing. This will also alter how those of us in SOX compliance are compensated. It would be unwise to offer a "bonus" to SOX compliance personnel to compensate for not being part of the stock-based plan determined by what would have been earned had they been a participating member. Accelerated filers, who are entering year four compliance efforts, will have to make the compensation adjustments. Competent persons will need to be found by smaller companies whose compliance efforts will be commencing in 2007.

This will also impact external audit firms. Firms will have to devise methods for assessing management's work (competence and objectivity), and/or the work of another external firm performing an audit. Each external firm will also have to adjust the audit teams' strategies to fully integrate the audits.

Unless the SEC can approve these standards before June 1, 2007, they ought to become effective for fiscal years ending on or after December 15, 2007.

In closing, an area of concern for both management and external auditors is documentation requirements. We generally copy original documents to include in work papers. With the introduction of software compliance tools, processes, individual controls, test plans, test results, and documents can be stored electronically. The Board may wish to address this technology within these proposed standards.

Respectfully submitted,

*Frank Gorrell, MSA, CPA*

Frank Gorrell, MSA, CPA

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**From:** rosenkranz@ScottStringfellow.com [mailto:rosenkranz@ScottStringfellow.com]  
**Sent:** Tuesday, January 02, 2007 10:17 AM  
**To:** Comments  
**Subject:** PROPOSED AUDITING STANDARD - Feedback

Dear Sir or Ma'am,

I am writing in response to Release No. 2006-007, published December 19, 2006. My concern pertains to your use of "Risk Assessments" in evaluating the effectiveness of internal controls. Speaking from a strictly information technology perspective, risk assessments are an involved and detailed undertaking comprised of both objective and subjective elements. They also vary significantly from the risk assessment I believe you are alluding to, which are subjective and operational in nature.

In my opinion, the differences between the two types or "risk assessments" must be captured and articulated before using them as the foundation for assessing whether or not a company's internal controls are effective. Based on my experience, auditors evaluating the effectiveness of information security controls as part of SOX Section 404 compliance are quick to assess a control as insufficient without identifying either the level of residual risk troubling them or how they derived that residual risk. This lack accountability in making such determinations is both frustrating and troubling. I believe that individuals performing evaluations should adhere to the same standards of due diligence and due care as the organization they are evaluating. Again this is my opinion, and I confess my perspective may be colored by the fact that I am the recipient of external audits and not the one performing them.

Finally, a variety of methodologies exist to perform information security-type risk assessments, and it might be prudent to articulate a general structure or approach which would be considered acceptable for companies to use so they are not deliberating the utility (or lack there of) of their process prior to auditors arriving to perform their evaluation and analysis.

Thank you for your attention in this matter and for working to make audits more efficient, effective and useful.

Regards,

Steve

**Stephen R. Rosenkranz**

CISSP, CBCP

SSI Security/Disaster Recovery Engineer

Information Systems Department

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**From:** rosenkranz@ScottStringfellow.com [mailto:rosenkranz@ScottStringfellow.com]  
**Sent:** Wednesday, January 31, 2007 5:00 PM  
**To:** Public Affairs  
**Cc:** Comments  
**Subject:**

January 31, 2007

Public Company Accounting Oversight Board

1666 K Street, NW

Washington, DC 20006-2803

Dear Sir or Ma'am:

On January 2, 2007, I submitted a comment to your comments@pcaob.org mailbox regarding the proposed auditing standard published in PCAOB Release No. 2006-007. Please note that the submission was made on my personal behalf and as such reflects my personal views and not the views of my employer. Please update my submission record and comment to reflect this.

Sincerely,

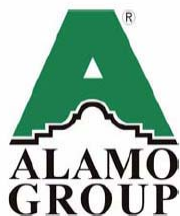
Stephen R. Rosenkranz

CISSP, CBCP

SSI Security/Disaster Recovery Engineer

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Dennis M. Stevens  
Director, Internal Audit  
Alamo Group  
1502 E. Walnut  
Seguin, TX 78155  
January 3, 2007

Rep. Nancy Pelosi  
Speaker Elect  
House of Representatives  
2371 Rayburn HOB  
Washington, DC 20515-0508

Rep. Charles B. Rangel  
Chairman Designate  
Committee on Ways and Means  
1106 Longworth HOB  
Washington, DC 20515

Rep. Barney Frank  
Chairman Designate  
House Financial Services Committee  
B-301C Rayburn HOB  
Washington, DC 20515

Senator Chris Dodd  
Chairman Designate  
Senate Committee on Banking,  
Housing and Urban Affairs  
534 Dirksen SOB  
Washington, DC 20510

CC: Nancy M. Morris  
Secretary, SEC  
100 F Street, NE  
Washington, DC 20549-1090  
Re: SEC File Number S7-24-06

Office of the Secretary  
PCAOB  
1666 K Street NW  
Washington, D.C. 20006-2803  
Re: Rulemaking Docket No. 021

Honorable Members of Congress:

On December 19, 2006 the Public Company Accounting Oversight Board (PCAOB) issued Release 2006-007 proposing changes to rules governing external auditor responsibilities under the Sarbanes-Oxley Act of 2002 Section 404 (SOX 404)<sup>1</sup>. At the same time the Securities and Exchange Commission (SEC) proposed Release 33-8762 to clarify responsibilities for the related management assessment of internal control<sup>2</sup>. These proposals have been exposed to public comment through February 26, 2007 after which they may be adopted by the PCAOB, approved by SEC and supersede present requirements.

**The PCAOB/SEC proposals perpetuate the existing requirement for a full-blown external ‘audit of internal control,’ which in our experience has been the single largest contributor to the extraordinarily high expense associated with SOX 404 compliance.** Over the past three years this requirement has resulted or contributed to huge audit fees, a massive transfer of wealth, a continuing erosion of shareholder value, a substantial shift to private from public financing and possible loss of U.S. global competitiveness.

**We urge you to use the power of your office on or before February 26, 2007 to halt adoption of PCAOB Release 2006-007. Further, we urge the Congress to consider amendments to the Sarbanes-Oxley Act that would either better define or limit requirements presently imposed on public accounting firms under the Act.** Such amendments should reinforce the notion that the maintenance of a system of internal control, its assessment, and reporting on that assessment is primarily a management responsibility that management must satisfy as management considers necessary and appropriate to protect and enhance shareholder value.

January 3, 2007

**The PCAOB's external 'audit of internal control' is *not* required by SOX 404 and represents an approach to protecting the interests of investors that has been specifically considered *and rejected* in the UK, Canada and perhaps other international jurisdictions, yet the PCAOB has never encouraged any serious public debate about the need for or value of an external 'audit of internal control' in the United States.** The PCAOB's proposed Release 2006-007 perpetuates this trend by providing 131 pages of redefinition and redirection on *how auditor's should perform* an external 'audit of internal control' without ever addressing *the need for and value of the service itself*.

The manner in which this matter has been handled causes serious concern about the independence and objectivity of the PCAOB, its focus on protecting the public interest and the controls surrounding the standards-setting process itself. After three years of waiting, it no longer appears the PCAOB alone is capable of the innovative thinking and bold action needed to address the serious problems the American business community has experienced with SOX 404. **We need assistance from Congress and revisions to the Sarbanes-Oxley Act itself.**

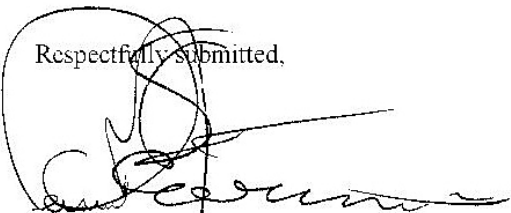
This might be accomplished by relatively minor amendments limited to Section 103(a)(2)(A) and Section 404(b) of the Sarbanes-Oxley Act of 2002. After these amendments are in place, both the PCAOB and the SEC can develop and propose revised requirements. Further detail on amendments and requirements that might be considered is provided in the following pages.

**Should the changes we suggest be made, we believe public accounting firms will be able to report on management's assessment in much the same way, and investors should benefit from the same level of protection or more, than is provided in other international jurisdictions.** Costly and unnecessary redundancy in the internal control assessment process would be removed for all registrant's, accelerated filers would enjoy a substantial reduction in audit fees, and non-accelerated filers would have a much more practical approach to satisfying the requirements of SOX 404. We believe that with assistance from Congress, management teams, Boards of Directors and public accounting firms can and will work together much more efficiently to design, implement, assess and report on internal control systems as needed to protect the interests of shareholders and investors.

**Again, we urge you to use the power of your office on or before February 26, 2007 to halt adoption of PCAOB Release 2006-007. Further, we urge the Congress to consider amendments to the Sarbanes-Oxley Act** that would either better define or limit requirements presently imposed on public accounting firms under the Act while reinforcing the notion that maintaining, assessing and reporting on internal controls is primarily a *management* responsibility that *management* must satisfy as *management* considers necessary and appropriate to protect and enhance shareholder value.

Thank your for your consideration.

Respectfully submitted,



Dennis M. Stevens  
Director, Internal Audit  
Alamo Group

dstevens@alamo-group.com

## **Background**

In March 2003 the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued a proposal to have an external ‘audit of internal control’ performed to comply with SOX 404<sup>3</sup>. The full-blown external ‘audit of internal control’ proposed by the AICPA appeared to be a far broader scope of service than the more focused report on management’s assessment contemplated in SOX 404(b). Subsequent to the ASB proposal, the PCAOB was organized and assumed responsibility for setting auditing standards. Nevertheless one year later, in March 2004, the PCAOB issued their Auditing Standard 2 (AS2), which adopted the AICPA’s proposal requiring a full-blown external ‘audit of internal control’<sup>4</sup>. The estimated aggregate annual cost of implementation was \$1.24 billion or \$91,000 per registrant.<sup>5</sup>

The Alamo Group, with operations in five countries and roughly \$360 million in annual sales, was defined as an “accelerated filer” to whom the provisions of SOX and AS2 have been applied for the past three years. During those three years Alamo had **18** internal control reviews, assessments and audits performed, consisting of:

- management’s review and update of approximately 1,000 control procedures each quarter (12 reviews as required by SOX Section 302),
- management’s annual assessment, inspection and test of these controls (3 assessments as required by SOX Section 404), and
- the external ‘audit of internal control’ performed each year (3 audits as required by AS2).

Additionally, our external auditors have reviewed and reported on management’s assessment each year, also as required by SOX 404. In total **21** internal control related projects have been managed and performed at Alamo in the past three years. Our costs have been substantial. External audit fees associated with Section 404 work represent about 40% of those costs, with the majority of those fees related to the full-blown external ‘audit of internal control’ required by AS2. We believe only a small portion of those fees relate specifically to the external auditor’s report on management’s assessment as required by SOX 404.

Every accelerated filer in the United States has been subjected to essentially this same level of scrutiny for the past three years, resulting or contributing to huge audit fees, a massive transfer of wealth, a continuing erosion of shareholder value, a substantial shift to private from public financing and possible loss of U.S. global competitiveness<sup>6</sup>. In contrast to the original estimate of \$91,000, the Committee on Capital Markets Regulation recently estimated the average first-year cost for companies to comply at \$4.36 million<sup>7</sup>. Venture capitalists suggest the average compliance cost for smaller portfolio companies is in the area of \$1 million to \$3 million<sup>8</sup>.

There have been benefits. Through an array of comment letters and roundtable discussions sponsored by the SEC and PCAOB, many report a focus on corporate governance that had not existed in the past and improvements in the quality and efficiency of important corporate processes and controls. Corporate board members note an improvement in audit committee oversight, while investors suggest public company financial reporting is of higher quality and transparency.

## **The PCAOB Proposal**

The benefits noted above are among those cited by the PCAOB in the introduction to its proposed Release 2006-007, which SEC Chairman Christopher Cox recently characterized as a “proposal to repeal the unduly expensive and inefficient auditing standard under Section 404 of Sarbanes-

Oxley"<sup>9</sup>. The unduly expensive and inefficient auditing standard to which Chairman Cox refers is the PCAOB's AS2 issued in March, 2004 which adopted the AICPA's earlier proposal to have a full-blown external 'audit of internal control' as a means of satisfying the requirements of SOX 404.

Incredulously, in its Release 2006-007 the PCAOB attributes all benefits noted above solely to the external 'audit of internal control' required by the PCAOB's unduly expensive and inefficient AS2. The PCAOB suggests the work of others is irrelevant - neither the Congress nor management teams nor Boards of Directors throughout the United States contributed to these benefits. This arrogant presentation is symptomatic of a much more significant problem – **the PCAOB has never encouraged any serious public debate about the need for or value of an external 'audit of internal control'.**

Of the **21** internal control related projects that Alamo has been subjected to in the past three years, the PCAOB proposal would eliminate those three that have had the **least** impact on our SOX 404 related expenses. In its Release 2006-007 the PCAOB proposes to maintain and clarify requirements for the external 'audit of internal control' while eliminating an existing requirement for the external auditor's evaluation of management's assessment process. The external auditor would continue to report on management's assessment as required under SOX 404(b), but that report would apparently be based on written representations from management and a comparison of results from the external audit and the management assessment of internal control.

**In our experience, the requirement for an external 'audit of internal control' promulgated by the PCAOB in AS2 has been the single largest contributor to SOX 404 compliance expense.** It is significant to note that an external 'audit of internal control' was **NOT** required by the elected members of Congress through SOX 404; it is solely an invention of the appointed members of the PCAOB. **Further, the external "audits of internal control" we have experienced have been entirely redundant with our own management assessments,** which WERE required by Congress through SOX 404(a). In each of the past three years we have had a management team doing an assessment and external auditors performing an audit of internal control – essentially two teams doing the same thing at the same time. Again, **due to the requirements of the PCAOB's unduly expensive and inefficient AS2, every accelerated filer in the United States has been subjected to essentially this same redundant exercise.**

**Under the terms of the PCAOB and related SEC proposals, every accelerated filer in the United States will continue to be subjected to redundant management assessments and external "audits of internal control" each year. Smaller firms, who have not yet had to comply with SOX 404, are to perform a management assessment in their first year of compliance efforts, and then enjoy redundant management assessments and full-blown external "audits of internal control" in all subsequent years.**

### **Justification**

Title I of the Sarbanes-Oxley Act established the PCAOB in part to protect the interests of investors and further the public interest. Nevertheless there is not now, nor has there ever been, any indication of how or why an external 'audit of internal control', when performed in addition to the verifiable management assessment of internal control contemplated in the SOX 404(a), better protects those investors or their interests.

Further there is not now, nor has there ever been, a cost-benefit justification for this redundancy provided by the PCAOB. "AS2 is a big, vague document that requires a lot of interpretation," said

David Chavern, Vice President of the Capital Markets Program at the U.S. Chamber of Commerce. “Here we are, tens of billions of dollars later, and I have not heard an argument that the benefit even comes close to a small portion of the cost,” Chavern said.<sup>10</sup>

The historical record however does provide some insight as to why the PCAOB continues to require an external ‘audit of internal control’ in addition to the management assessment required by SOX. In a Financial Times article titled “Auditors In Fight with Regulators” dated August 3, 2003, Adrian Michaels in New York reported as follows:

US businesses and the large accountancy firms are fiercely lobbying regulators in a dispute over corporate governance reform that has millions of dollars in fees at stake.

The two sides are arguing about the reach of a crucial part of last year's Sarbanes-Oxley Act, sweeping legislation passed in the wake of corporate scandals.

The Act says that a company's auditor has to sign off on management's assessment of internal controls - the mechanisms by which financial statements are assembled, fraud is detected and other monitoring operations are carried out.

But the audit firms argue they need to go further. If investors see they have signed off on the controls, they will believe that the auditors have tested them.

This expectation gap could harm the profession's already battered reputation if companies have to restate earnings. Partners at KPMG and Deloitte Touche Tohmatsu were last week lobbying regulators on the issue.

As this article suggests, the external ‘audit of internal control’ is focused less on direct concern about the public interest and more on alleviation of the audit firms’ concerns about their potential liability. The external audit community has long held the view that any public assurance they provide on internal control could carry with it enormous potential liability, since virtually any subsequently discovered problem could be attributed to a failure of internal control.

This is a valid concern. In November 2006 the CEOs of the six leading global audit networks provided a paper<sup>11</sup> which in part described in painful detail the problems caused by the U.S. litigation environment and their concomitant risk of liability. The Committee on Capital Markets Regulation recently reported that the nearly “open-ended responsibility of auditors in complying with Section 404 has made an already consolidation-shriveled profession virtually uninsurable for this work”.<sup>12</sup> Public accounting firms have an important function in the global economy and clearly the interests of investors would not be better protected by letting them sink under the weight of extensive litigation.

**The proposed PCAOB Release 2006-007 however will NOT resolve the audit firm’s valid concerns about potential liability.** The PCAOB indicates their proposal is designed, among other things, to clarify requirements for the external ‘audit of internal control’ by “directing the auditor's testing to the most important controls, emphasizing the importance of risk assessment”, revising an array of definitions, “directing the auditor to tailor the audit to reflect the attributes of smaller, less complex companies”, and “reducing detail and specificity”. These may be laudable objectives, but if achieved they **will NOT change the U.S. litigation environment** and they will NOT reduce the audit firm’s valid concerns about their concomitant risk of liability.

## Effects

The PCAOB and SEC proposals will however result in some changes, and not all will be desirable. The proposals give both the external auditor and management considerable latitude in determining what each will do to satisfy their respective responsibilities. When considered together and projected over time along with the audit firm's continuing concerns about potential liability, we might reasonably expect the effects of these proposals to be as follows:

- Management of accelerated filers may determine that they can, in the absence of other considerations, reduce the amount of documentation and testing that supports their assessment. They may also find that the firm performing the external 'audit of internal control' can rely upon management's work if that work is performed and documented to the level of detail required by the external auditor. In an effort to reduce the combined expense of management's assessment and the external 'audit of internal control', management will perform and document their assessment to the level of detail required by the external auditor. **This is essentially the same situation that has existed for the past three years.** The principal difference is a de-emphasis on the need for a management assessment that is independent of the external 'audit of internal control'. In time the work may be combined into one project performed to the level of detail dictated by the external audit firm, thus resulting in a subtle shift of responsibility from management to the external auditor.
- Management of smaller firms, who have not yet had to comply with SOX 404, will turn to their external auditors for advice. They will undoubtedly be advised to implement, document and test control procedures to the level of detail required by the audit firm. In time the external auditor becomes responsible for the review and test of a system of internal accounting control that the external auditor has designed or influenced to a significant degree, thereby compromising the external auditor's independence and objectivity and reducing the value of both the external 'audit of internal control' and the financial audit itself.

The PCAOB recognizes the potential effect of its proposals on auditor independence and on page 33 of Release 2006-007 appears to address these concerns in a novel way:

(The existing AS2) includes discussion of the application of principles of independence to internal control-related services and specifically notes that designing or implementing an issuer's controls would place the auditor in a management role and result in the auditor auditing his or her own work. The Board proposes to not repeat this independence guidance in the auditing standard or in a separate independence rule. . . . (Instead the) Board proposes to add a Note to this portion of the pre-approval rule . . .

## Standards-Setting

Those responsible for developing and setting *new* auditing standards may reasonably be expected to abide by *existing* standards in executing their responsibilities. Among the existing standards is the need to maintain independence in fact and appearance, which in this case would serve to encourage the independent, objective evaluation of alternatives to the unduly expensive and inefficient full-blown external 'audit of internal control.'

The PCAOB's appearance of independence however appears compromised with regard to this matter. The PCAOB's present Chief Auditor and Director of Professional Standards was the Deputy Chief Auditor when the PCAOB's unduly expensive and inefficient AS2 was developed. Prior to joining the PCAOB he was a partner with a major public accounting firm that was reported to be lobbying regulators on the issue. Prior to joining that firm, he was the senior technical advisor to the AICPA's Auditing Standards Board<sup>13</sup>, the group that initially proposed the full-blown external 'audit of internal control' as a means of addressing the requirements of SOX 404. In fact it appears he served on the Internal Control Reporting Task Force of the Auditing Standards Board – the group that in 2003 wrote the original proposal.<sup>14</sup>

Further, the original cost estimate of \$91,000 per registrant has proven to be so grossly in error that it raises questions about whether those who prepared the estimate had the necessary training and proficiency to do so. While the original estimated annual aggregate cost was \$1.24 billion, AMR Research estimates that companies will spend \$6 billion on complying with Sarbanes-Oxley Act (SOX) requirements in 2006, on par with the \$6.1 billion spent in 2005.<sup>15</sup> If the experience of other accelerated filers is similar to our own, some 40% of those dollars can be attributed to the PCAOB's unduly expensive and inefficient AS2 and its insistence on a full-blown external 'audit of internal control'.

After the first year of compliance efforts the PCAOB knew of this error and was repeatedly advised that the costs of SOX 404 compliance appeared to far exceed related benefits. As stated on page 3 of PCAOB Release 2006-007, "Over the last two years, the Board has heard a consistent message that compliance with the internal control provisions of the Act has required greater effort and resulted in higher costs than expected." Nevertheless, during those two years the PCAOB response was more verbiage and further "guidance" – their response did not appear to include reexamination of the fundamental need for and value of their full-blown external 'audit of internal control'. As other international jurisdictions considered *and rejected* the PCAOB approach they did not waiver, and now propose in their Release 2006-007 that still more verbiage will resolve significant concerns about redundant work, high costs, the erosion of shareholder value, a substantial shift to private from public financing and the competitive disadvantage of U.S. companies.

These matters would appear to suggest a need for reconsideration of the composition, internal procedures and supervision of the PCAOB itself.

### **Comments**

The international business community does *not* universally see value in the full-blown external 'audit of internal control' required by the PCAOB. Such services have been considered by regulatory authorities in Canada, the UK and perhaps other international jurisdictions. None mandated them.

### ***Canadian Securities Administrators Notice 52-313, Status Of Proposed Multilateral Instrument 52-111 - Reporting On Internal Control Over Financial Reporting***, dated March 10, 2006

On February 4, 2005, the securities regulatory authorities in every Canadian jurisdiction, other than British Columbia, published for comment Proposed MI 52-111 . . . (which) was substantially similar to the requirements of the SOX 404 Rules.

After extensive review and consultation . . . we have determined not to proceed with proposed Multilateral Instrument 52-111. . .

(Instead) The CEO and CFO of a reporting issuer, or persons performing similar functions, will be required to certify in their annual certificates that they have evaluated the effectiveness of the issuer's internal control over financial reporting as of the end of the financial year. They will also be required to certify that, based on their evaluation, they have caused the issuer to disclose in its annual MD&A their conclusions about the effectiveness of internal control over financial reporting as of the end of the financial year. . . .

The issuer will not be required to obtain from its auditor an internal control audit opinion . . .

This will contribute towards achieving our objectives while balancing the costs and benefits associated with the internal control reporting requirements.

**Chris Hodge, Corporate Governance Unit, Financial Reporting Council**, the independent regulator responsible for promoting confidence in corporate reporting and governance in the United Kingdom, in comments to the SEC/PCAOB dated April 28, 2006:

In the UK external auditors of listed companies are required under the Listing Rules to review the board's compliance statement relating to its review of the internal control system, and to add an additional paragraph to their audit report if they believe that the board's internal control statement is inconsistent with the auditors' knowledge. . . . There is no requirement on the auditor to express a view publicly on the effectiveness of the company's internal control system.

There was virtually no demand from investors or companies for an increased role for external auditors. The existing powers and remit of the external auditors were considered sufficient; in particular, there was no support for the external auditor being required to attest as to the effectiveness of the company's internal controls.

**David L. Shedlarz, Executive Vice President & CFO, Pfizer Inc., writing as Chairman - Principle Financial Officers Subcommittee, Corporate Governance Coordinating Committee of the Business Roundtable**, an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and \$3.7 trillion in annual revenues, in comments to the SEC/PCAOB dated November 26, 2003:

. . . the Proposed Standard appears to expand the scope of the auditor's responsibility beyond that contemplated under Section 404. By proposing at the outset that the auditor's attestation required under Section 404 be characterized as "an integrated audit of the financial statements and internal control over financial reporting," we believe that the Proposed Standard proceeds from an incorrect premise. . . .

by proposing that the auditor conduct an audit of the internal control over financial reporting, the Proposed Standard embraces a level of testing that is more extensive than that contemplated under the statute. . . . Accordingly, we urge the Board to revisit the scope of the Proposed Standard.

**Richard M. Whiting, Executive Director and General Counsel of The Financial Services Roundtable**, representing 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer, in comments to the SEC/PCAOB dated May 1, 2006:

Section 103 (of the Sarbanes-Oxley Act) does not require an audit of a company's internal control structure.

Section 404, likewise, does not require an independent audit of management's assessment of internal controls. The statute only requires the external auditor to "attest to and report on the assessment made by management of the issuer." Nonetheless, the PCAOB has interpreted the statute to call for a "full-blown" audit. The elimination of the separate audit would significantly lessen the compliance burdens imposed by Section 404, without impairing the integrity of the Section 404 process as envisioned by Congress and set out in Section 103 of Sarbanes-Oxley.

**Paul A. Sharman, ACMA, president and CEO of the Institute of Management Accountants (IMA®)**, writing on behalf of their worldwide network of nearly 65,000 professionals in response to the Committee on Capital Markets Regulation interim report released on November 30, 2006, stating in part:

IMA believes the way the PCAOB has interpreted Section 404 Part B (the external auditor attestation) must be significantly changed to align with what Congress asked for – a report on management's risk and control assessment process.

Current PCAOB rules require auditors to arrive at the subjective pass-fail opinion on "how much control is enough". This regulatory interpretation is at the root of an inordinately high burden on management and litigation-wary auditors, leading to excessive testing and record audit fees. . . .

It is time that audit firms cooperated in this endeavor in a serious and thoughtful manner for the benefit of investors, corporations and the U.S. economy.

**David A. Richards, CIA, CPA, President, The Institute of Internal Auditors**, representing more than 124,000 members across the globe, in comments to the SEC/PCAOB dated September 18, 2006:

The IIA continues to recommend a fundamental change be considered to legislation and PCAOB's Auditing Standards Number 2 be modified accordingly. Currently three attestations are being produced to provide assurance on internal controls over financial reporting . . . We believe the intent and the benefit of the Sarbanes-Oxley Act are met with only two attestations . . .

This approach (two attestations) is prevalent in other securities trading markets and would provide for international consistency, harmonization, and fair treatment for corporations in a global economy. Requiring all three attestations creates a competitive disadvantage for U.S. companies, especially for those doing business abroad.

We further believe that the third attestation – the auditors own report on internal control over financial reporting – represents a fundamentally unrealistic and unfair expectation on the part of the auditors, which in turn leads to operating inefficiencies and costs. . . . Making statements about operations status, financials, internal controls accomplishments, tone at the top, and strategy, is the sole responsibility of management and are duties that solely management has capacity to fulfill. For the auditors, the best auditing methodologies and techniques cannot compete nor make up for

- Management position in an organization
- Management responsibility over operations and processes
- Management accountability

### Arguments

There is however a wide range of opinion as to the need for and value of a full-blown external ‘audit of internal control’. One extreme might be represented by the CFO of a \$76 million company: “This has turned into a check-the-box process. The work is being done by individuals – often only 22 to 26 years old – with very little business knowledge. They just don’t know where to begin.”<sup>16</sup> Here the feeling is that the external ‘audit of internal control’ as performed for the past three years provides little value to shareholders and has little to do with the problems inherent in the corporate accounting scandals that gave rise to Sarbanes-Oxley.

On the other hand, groups that represent consumers and large institutional investors see any attempt to water down the SOX provisions as shortsighted. These groups might argue that a full-blown external ‘audit of internal control’ is critical to restoring and maintaining investor confidence. Without it, management is free to use what the proxy research firm Glass, Lewis & Co., characterized as “a rubber stamp to certify the effectiveness of internal controls”.<sup>17</sup>

**It is significant to note that the SEC’s currently proposed Release 33-8762 is the first guidance provided directly to management since the Sarbanes-Oxley Act itself became effective.** For the past three years there has been no guidance whatsoever as to the depth and scope of procedures to be included in management’s annual assessment as required under SOX 404. In the interim much has been learned, and an entire industry appears to have developed around SOX 404 and the provision of assistance when needed. Any management team that finds it necessary to get assistance in performing their management assessment will surely find that assistance readily available.

**While there may be wide-ranging arguments about *how* to satisfy the requirements of SOX 404, there is no argument about the importance of restoring and maintaining investor confidence.** To date, efforts to restore and maintain investor confidence have proven to be unduly expensive and inefficient. The PCAOB proposes to maintain the fundamental approach inherent in those efforts. **Bold action is needed to develop a better way of providing management with the ability to assess and report on internal controls while also providing investors with reasonable assurance that results have substance and are not in fact a “rubber stamp”.**

### Amendments

The concerns of public accounting firms appear to center on existing requirements for them to provide public reports that suggest they have tested or “signed off ” on controls. In their experience, doing so evidently gives rise to an “expectation gap” and substantial potential liability.

Thus they attempt to protect themselves by performing a full-blown external 'audit of internal control' at great expense to all registrants.

The external auditor's report on management's assessment of internal control is required by Section 404(b) of the Sarbanes-Oxley Act. Section 103(a)(2)(A)(iii) of the Act provides specific requirements for that report. Those requirements in part include a description of "the scope of the auditor's testing of the internal control structure and procedures of the issuer" as well as other references to external auditor testing.

It would seem that the concerns of the public accounting firms can be effectively addressed by focusing on just these two sections of the Sarbanes-Oxley Act. The external auditor's participation in the annual internal control assessment process could for example be eliminated entirely by deleting the two sections of the Act referenced above. While expedient, this would be an extreme measure that would not inure to the benefit of investors.

Investors benefit by receiving independent assurance that management's annual assessment has substance. This we believe was the original intent of Congress. **We would hope that the public accounting firms can find a way to provide such assurance at a more reasonable cost by making a determination as to whether management's assessment meets standards established by the SEC.** This should be a much more focused service compared to the broad, all inclusive, full-blown external 'audit of internal control' that is currently required.

To facilitate a determination as to whether SEC standards were met, it would be incumbent upon the SEC to establish certain benchmarks that management must meet. These benchmarks must be verifiable to permit public accounting firms to objectively determine if they have been met. Should this approach be pursued, the existing Section 103(a)(2)(A)(iii) of the Act might be deleted in its entirety and replaced with new wording as follows:

(iii) provide in each audit report their conclusion as to whether management's assessment of internal control for financial reporting performed as required under Section 404(a) met standards established by the Securities and Exchange Commission.

Section 404(b) of the Act could be reworded to read as follows:

With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall report on the assessment made by the management of the issuer. Any such report shall not be the subject of a separate engagement.

As stated on page 38 of the SEC's proposed Release 33-8762, "Management's assessment must be supported by evidential matter that provides reasonable support for its assessment." The SEC should expand its proposal to establish benchmarks that reasonably define that evidential matter and represent the minimum level of verifiable support that management of all registrants must provide. These benchmarks might include for example:

- 1) A written plan that is submitted to and approved by the registrant's Board of Directors or its Audit Committee at least annually, describing in reasonable detail:
  - a) the risks to reliable financial reporting that management has identified,

- b) the degree to which those risks are affected by multiple locations of the registrant, if any,
  - c) management's evaluation as to whether the design of the controls that address each of those risks is such that there is a reasonable possibility that a material misstatement in the financial statements would be prevented or detected in a timely manner,
  - d) the methods and procedures management plans to utilize to gather and evaluate evidence as to the effectiveness of those controls as well as any entity-wide or other pervasive elements of internal control that management considers applicable in the circumstances.
- 2) Reports provided by management to the registrant's Board of Directors or its Audit Committee, on a schedule that is acceptable to the Board of Directors or its Audit Committee, describing in reasonable detail progress against managements plans to gather and evaluate evidence as described above,
- 3) A written description and evaluation, provided to the registrant's Board of Directors or its Audit Committee in a timely manner, of any control failings or weaknesses that management considers significant, including the impact those failings had or may have had on any information reported or to be reported by the registrant in compliance with any known requirement or request of the Securities and Exchange Commission,
- 4) A written description and evaluation, provided to the registrant's Board of Directors or its Audit Committee in a timely manner, of any control failings or weaknesses that management considers to be material, including their root cause, the impact those failings had or may have had on any information reported or to be reported by the registrant in compliance with any known requirement or request of the Securities and Exchange Commission, as well as management's plans to rectify and report upon each such control failing or weakness.

**Should these relatively simple amendments be made and benchmarks provided, public accounting firms should be able to report on management's assessment in much the same way, and investors should benefit from the same level of protection or more, than is provided in other international jurisdictions.** Redundancy in the internal control assessment process would be removed for all registrant's, accelerated filers would enjoy a substantial reduction in audit fees, and non-accelerated filers would have a much more practical approach to satisfying the requirements of SOX 404. We believe that with assistance from Congress, management teams, Boards of Directors and public accounting firms can and will work together much more efficiently to design, implement, assess and report on internal control systems as needed to protect the interests of shareholders and investors.

Again, the proposed PCAOB Release 2006-007 and SEC Release 33-8762 have been exposed to public comment through February 26, 2007, after which they may be adopted by the PCAOB, approved by SEC and supersede present requirements. **We urge you to use the power of your office on or before February 26, 2007 to halt adoption of PCAOB Release 2006-007. Further, we urge the Congress to consider amendments to the Sarbanes-Oxley Act** that would either better define or limit requirements presently imposed on public accounting firms under the Act while reinforcing the notion that maintaining, assessing and reporting on internal controls is primarily a *management* responsibility that *management* must satisfy as *management* considers necessary and appropriate to protect and enhance shareholder value.

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<sup>1</sup> For full text of Release 2006-007 see [http://www.pcaobus.org/Rules/Docket\\_021/2006-12-19\\_Release\\_No.\\_2006-007.pdf](http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf)

<sup>2</sup> For full text of Release 33-8762 see <http://www.sec.gov/rules/proposed/2006/33-8762.pdf>

<sup>3</sup> AICPA Auditing Standards Board, Proposed Statements on Auditing Standards, *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, March 18, 2003

<sup>4</sup> For full text of AS2, see [http://www.pcaobus.org/Rules/Rules\\_of\\_the\\_Board/Auditing\\_Standard\\_2.pdf](http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_2.pdf)

<sup>5</sup> American Electronics Association, *Sarbanes-Oxley Section 404: The Section of Unintended Consequences and its Impact on Small Business*, February 2005, page 6

<sup>6</sup> The *Summary of the Interim Report of the Committee on Capital Markets Regulation*, November 30, 2006, reports on page 2 as follows:

- 5% of the value of global initial public offerings was raised in the U.S. last year, compared to 50% in 2000.
- The U.S. share of total equity capital raised in the world's 10 top countries has declined to 27.9% so far this year from 41% in 1995.
- The decrease in U.S. listing premiums erodes the traditional edge maintained by the U.S. on cheaper cost of capital.
- Private equity firms, almost non-existent in 1980, sponsored more than \$200 billion of capital commitments last year alone.
- Since 2003, private equity fundraising in the U.S. has even exceeded net cash flows into mutual funds and going private transactions have accounted for more than a quarter of publicly announced takeovers. The increased use of private markets disadvantages the average investor, who typically cannot participate in such markets.
- The dramatic increase in the use of private U.S. markets is important evidence that regulation and litigation are keeping them out of the public market.

<sup>7</sup> *Interim Report of the Committee on Capital Markets Regulation, November 30, 2006, page 5*

<sup>8</sup> Sean Wolfe, "SEC Shifts SOX Strategy—Can SOX really be scalable?," *Red Herring The Business of Technology*, December 14, 2006

<sup>9</sup> U.S. Securities and Exchange Commission, Press Release 2006-213, *Statements of SEC Chairman Christopher Cox and Chief Accountant Conrad Hewitt Regarding PCAOB's Proposed Section 404 Auditing Standard*, December 19, 2006

<sup>10</sup> David Rath, "Backlash Against Sarbanes-Oxley - Is the cost of compliance too high?," *The CRO*, 2006

<sup>11</sup> *Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks*, November 2006

<sup>12</sup> *Summary of the Interim Report of the Committee on Capital Markets Regulation*, November 30, 2006, page 3

<sup>13</sup> PCAOB News, *Board Names Thomas Ray as PCAOB Chief Auditor, Succeeding Douglas R. Carmichael*, December 16, 2005

<sup>14</sup> AICPA Auditing Standards Board, Explanatory Memorandum to Proposed Statements on Auditing Standards, *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, March 18, 2003, page 4 of 10, lists the following members of the Internal Control Reporting Task Force: Garrett L. Stauffer, Chair, Robert Dohrer, John A. Fogarty, Lynford Graham, William F. Messier, Jr., Keith O. Newton, Thomas J. Ray, George H. Tucker, Michael T. Umscheid

<sup>15</sup> Kevin Reilly, "AMR Research Estimates Sarbanes-Oxley Spending Will Exceed \$6 Billion in 2006," *AMR Research Press*, November 29, 2005

<sup>16</sup> American Electronics Association, *Sarbanes-Oxley Section 404: The Section of Unintended Consequences and its Impact on Small Business*, February 2005, page 5

<sup>17</sup> Melissa Klein Aguilar, "SOX 404 Deficiencies Preceded By "Effective" 302 Reports", *Compliance Week*, July 26, 2005

From: Thorsten-Trygve Stegmann [mailto:TrygveSt@gmx.de]  
Sent: Tuesday, January 02, 2007 6:06 AM  
To: Phillips, Laura  
Subject: proposed new AS No.2 "significant deficiency"

Dear Mrs. Phillips,

during my study of the proposal of the new auditing standard no.2 I had slight difficulties with the change in the definition of "significant deficiencies" as the header itself indicates a certain importance but by using the word "significant" again in the definition and defying it as less than material ... (see page 10 & 11, question 7) mitigates the overall definition itself. I believe this will broaden the gap between material weakness and significant deficiency too much. It can not be the objective to put too much emphasize on the material weakness as you run into the danger of loosing the stated "benefits" (page 2) as companies could loose their focus on the process controls. It is not impossible to cover all process controls by the top down approach, therefore a underestimated process control not covered by a management control and defined as a significant deficiency could have an unwanted impact on the financial reporting.

Kind regards

Thorsten Stegmann

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**From:** kcarey@metlife.com [mailto:kcarey@metlife.com]  
**Sent:** Tuesday, January 16, 2007 9:26 AM  
**To:** Comments  
**Subject:** Comment Letter

Public Company Accounting Oversight Board  
1666 "K" Street NW  
Washington, D.C. 20006

Re: Comment Letter

To Whom It May Concern:

Please include the attached letter, dated December 11, 2006 in the comment file as a comment on the Board's internal control rulemaking process. It is our understanding that the comment period formally began shortly after December 11 and we would like MetLife's submission to be included in that process.

If there are any questions or need for further information, please don't hesitate to contact me.

Thank you.

Kate Carey

Kate Carey  
Vice President  
MetLife  
1620 "L" St., NW, Suite 800  
Washington, D.C. 20036  
(202)296-2361

*(See attached file: Prochaska to Olson 121106.pdf)*

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1 MetLife Plaza,  
27-01 Queens Plaza North  
Long Island City, NY 11101

**Joseph J. Prochaska, Jr**  
Executive Vice President  
Finance Operations and  
Chief Accounting Officer

Mark W. Olson  
Chairman  
Public Company Accounting Oversight Board  
1666 K Street N.W.  
Washington, D.C. 20006

Dear Mark,

It was a pleasure to meet you at the FEI Luncheon in New York City on November 17, 2006 and I appreciate the opportunity to communicate MetLife's views on the Sarbanes-Oxley Act of 2002 ("SOX"). These views are derived from our experience in connection with the requirements of Section 404 and 302 of SOX and subsequent guidance released by the Securities and Exchange Commission ("SEC") and the Public Company Accounting Oversight Board ("PCAOB"). Without question, SOX re-emphasized the importance of financial controls for public companies and established new demands for corporate accountability. Overall, we support SOX's positive impact on MetLife's culture as it has elevated the awareness of accounting and control issues and enhanced accountability throughout the organization.

Since the passage of SOX, MetLife has monitored the development and proactively participated in the application and adoption, and as such, we recognize that there are several areas where additional guidance may enhance the effectiveness and efficiency of the underlying process without compromising the benefits of the legislation.

MetLife has always valued strong internal control over financial reporting, and have been obtaining internal control letters under the old audit standard prior to the issuance of AS2 since the mid-eighties. Starting in 2003, we aligned our control evaluations with the quarterly certifications that the Chief Executive and Chief Financial Officers were required to complete for Section 302. In fact, we were the only client our external auditor to receive an opinion letter on our internal controls over financial reporting in 2003.

Further, MetLife was one of the first companies to execute a significant acquisition subsequent to the adoption of SOX. The completion of the Travelers acquisition on July 1, 2005 required significant effort to achieve SOX compliance. In keeping with our leadership position, we decided to incorporate Travelers in our annual assessment of internal controls over financial reporting for the year ended December 31, 2005, rather than to use the scope exception available at the time.

While we are pleased with the benefits derived from the SOX process, we appreciate this opportunity to provide some observations resulting from our experiences for your consideration.

## **1. Emphasize a Top-Down, Risk-Based Approach**

***The Board should consider incorporating all aspects of the May 16, 2006 guidance into the revised AS2 standard.*** A top-down risk-based approach is the most effective and efficient approach to assess internal controls over financial reporting. Further the new standard should emphasize the importance of a company's internal control environment, and how it can impact the risk of the risk financial reporting fraud or other material failure, in order to focus auditors on what really matters, which is identifying material weaknesses in a company's system of internal control before such weaknesses result in material misstatements in the company's published financial statements.

## **2. Service Organizations**

***The Board should allow management to place reliance on SAS 70's performed on its own processes by external auditors engaged by management.*** In providing services, many of our business partners rely on our internal control structure. Accordingly, we provide them with SAS 70 reports covering the processes and controls upon which they rely. SAS 70 reports are issued by independent auditors using a prescribed format established by the AICPA to conclude as to the design and effectiveness of specific processes and controls within an organization. In accordance with the revised SEC October 6, 2004 FAQ, when management engages auditors to prepare SAS 70 reports, management is not allowed to rely on these reports yet business partners and external auditors are able to for SOX 404 testing purposes. As such, management must duplicate previously completed efforts and incur unnecessary costs, to arrive at an already known and certified conclusion. To maximize efficiencies, there needs to be close coordination between the SEC and the PCAOB to ensure both parties are in harmony to maximize the potential benefits associated with this revision.

## **3. Auditor's Role in Assessing Management**

***The Board should consider eliminating the auditor's opinion on management's assessment.*** We believe that the issuance of an independent audit report on the effectiveness of internal control over financial reporting provides substantial value to both the investing public as well as audit committees. However, the current requirement for separate opinions on both the financial statements, and on management's assessment of the internal controls over financial reporting (the "dual opinion system") is unnecessarily complex. We recommend that the auditor express an opinion only on the effectiveness of the internal controls as it relates to the audit of the financial statements. We believe this change retains the benefit of management's focus on internal controls but does not require the cost of a full blown audit of the management assessment process.

## **4. Work of Others**

***The Board should consider allowing the work of others to be relied on at a higher level by its external auditors in "low" and "medium" risk areas after the initial audit of internal controls has been completed.*** Auditing Statement No. 2, *An Audit of Internal Controls Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements* ("AS 2") states that the independent auditor must obtain the "principle evidence" for their opinion. After the initial audit, auditors should be allowed to rely on management walkthroughs when completed by competent and objective personnel in "medium" and "low" risk areas. Changes of this nature would align the amount of auditing effort with the perceived risk of a potential financial misstatement and would enable significant cost savings for both management and its auditors.

## **5. Improved Term Definitions**

***The Board should consider rewording the assessment of the likelihood of a material weakness to be at least "reasonably possible" as opposed to "more than remote."*** While we believe these terms are synonymous, there appears to be a perceived difference in the marketplace. For example, current implementation guidance does not require that a material weakness in internal control over financial

reporting be found in every case of a restatement; however, current practice would lead to a different conclusion. If an error is detected, it should be evaluated like any other deficiency based on all facts and circumstances available. This has been an area of concern for many registrants and additional guidance on this topic would help eliminate any inconsistencies among audit firms.

## 6. Auditor Independence

*The Board should consider creating a “diminimus” rule on monitoring auditor independence.* We support the pre-approval concept and believe that it enhances transparency and communication between the Audit Committee and the auditors. However, the current guidelines are too restrictive and require both management and its auditors to focus their attention on trivial details that can be construed as violations of independence instead of focusing their judgments on meaningful company issues.

As stated earlier, to ensure that companies optimize any revised guidance from the SEC and PCAOB, both regulatory bodies should issue such guidance simultaneously. Compliance with SOX at MetLife is an extensive, ongoing effort, which involves significant personnel and financial resources. We are proud of our efforts to-date and feel that we are on the forefront of the thought leadership in this endeavor. We thank you for allowing us to communicate some of our experiences and recommended enhancements that we feel would be of benefit to MetLife, and to many organizations facing the same issues.

Should you have any questions or would like to discuss this topic further, please don't hesitate to contact me.

Best regards,

A handwritten signature in black ink, appearing to be 'J. J. [unclear]', written in a cursive style.

December 11, 2006

MICHAEL B. ENZI  
WYOMING



**United States Senate**  
WASHINGTON, DC 20510

January 17, 2007

The Honorable Mark W. Olson  
Chairman  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, D.C. 20006-2803

Dear Chairman Olson:

After the passage of the Sarbanes-Oxley Act (the "Act"), the American public has seen the enormous benefits achieved by renewed confidence in our markets. However, these benefits have carried a high price, and many companies have struggled to implement the provisions of the Act, especially Section 404. I have been vocal in the need for company and auditor guidance to help smooth the implementation of Section 404 and reduce costs. I am pleased that the Securities and Exchange Commission (the "SEC") and the Public Company Accounting Oversight Board (the "Board") listened when, late last year, they issued cooperative guidance to help lower the costs of the Act for public companies, especially small public companies.

The SEC and the Board face the tough challenge of balancing efficiency and reliability in company audits. In an effort to find this balance, I am pleased that the Board has decided to take another look at their auditor guidance to find new ways to reduce costs for large and small businesses. I have included more detailed comments on the Board's proposal below.

One of the most important revisions made by the Board, and one of the biggest potential cost-savers, is in the auditor's use of the work of others. This

Mark Olson  
January 17, 2007  
Page 2

includes company management's own internal control evaluation, as well as past audits. Duplicating control evaluations despite low relative risk multiplies audit costs unnecessarily. Allowing auditors to evaluate and utilize past work would allow them to focus resources on high-risk areas and reduce costs.

One of the biggest ways the Board is promoting this new auditor culture is by removing the "Principle Evidence Provision" from the standard. This will encourage a more cumulative understanding of a company's financial health, as well as help integrate the financial statement audit and the internal control audit.

From an auditor's standpoint, a clear understanding of risk and the severity of a control deficiency is crucial to implementing a top-down audit approach. The Board is encouraging efficiency by clarifying and refining the definition of "material weakness" and "significant deficiency", as they do in Appendix 1, paragraphs 70-79 of the new standard. I have heard several examples of audit costs skyrocketing when auditors are unsure about material weaknesses and abandon a risk-based assessment to chase down problems that are neither significant nor material. These cases can be avoided when auditors are confident in their ability to target the most significant control deficiencies in a company.

The Board correctly recognizes that their changes to Auditing Standard No. 2 hold the most potential benefit for small companies. Since the drafting stages of the Sarbanes-Oxley Act, I have been concerned with the disproportionate impact the law would have on smaller public companies, and those attempting to access the public markets for the first time. In a Government Accountability Office (GAO) report requested by myself and Chairwoman Snowe, these concerns were proved to be well-founded. According to that report, small companies who had implemented section 404 in 2004 paid a

median amount of \$1.14 in audit fees for every \$100 in revenues, compared to only \$0.13 per \$100 for larger companies. While some of this money was dedicated to the financial statement audit, the internal control audit undoubtedly consumed a large portion of this cost. There is a connection between the size of a company and the functioning of their internal controls and, as shown by this GAO report, small business auditors have not been quick to recognize these differences and modify the scope of their audits accordingly.

Despite these statistics, I am confident that small company audits will become more efficient than in the past due to the Board's emphasis on scalability for small companies. For example, the segregation of duties at a company with 10 employees is necessarily different than those of a 1,000 employee company. Management may be intimately involved in the day-to-day operations of a small company, yet past audits did not reflect that difference. It is crucial that auditors now recognize the unique operations of small business and adapt audits accordingly. It is the Board's responsibility to actively promote this change, even after the new guidance is adopted, to ensure that audit costs do not become prohibitively high for small business.

On a related note, I am pleased that the Board has decided to continue holding their Forums on Auditing in the Small Business Environment. The Board has an exemplary record of reaching out to the accounting community. These forums have helped accountants prepare for internal control audits as well as provided crucial input to the Board on their guidance. As most small business have yet to experience a Section 404 audit, the need for capable small business auditors will only increase as implementation continues.

I am hopeful that the Board's revisions to Auditing Standard No. 2 will significantly reduce costs for public companies, especially smaller public

Mark Olson  
January 17, 2007  
Page 4

companies with limited resources and those preparing to go public. This is an evolving process, and full implementation has not yet been achieved. But the Sarbanes-Oxley Act has been crucial in protecting the confidence of our public markets, and I am dedicated to ensuring that the American markets remain the gold standard for the world.

Sincerely,

A handwritten signature in blue ink that reads "Michael B. Enzi". The signature is written in a cursive style with a large, prominent initial "M".

Michael B. Enzi  
U.S. Senator

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**From:** Goldberg, Daniel [mailto:Daniel.Goldberg@tylertech.com]  
**Sent:** Tuesday, January 23, 2007 2:29 PM  
**To:** Comments  
**Subject:** PCAOB Rulemaking Docket Matter No. 021

I would like to submit the following comments/questions regarding Docket Matter No. 21.

In the Proposed Auditing Standard - Considering and Using the Work of Others in an Audit, paragraph 10 states, in regards to utilizing the work of others, the auditor should:

- Evaluate the nature of the subject matter tested by others;
- Evaluate the competence and objectivity of the individuals who performed the work; and
- Test some of the work performed by others to evaluate the quality and effectiveness of their work

I agree with need for the auditor's evaluation of the work performed; however I think the statement above is too general and can lead to some ambiguity in the interpretation. I believe the last bullet might lead external auditors to retest more than what might be deemed necessary for the auditor to gain comfort as to the quality and effectiveness of the work performed. I would suggest the Board eliminate this ambiguity by addressing the following concerns:

- Is there a way to specify how much of the work the auditor should retest to evaluate the quality and effectiveness of the work? Is it possible to state a percentage of items tested?
- Is there a way to state that this is not necessary throughout the entire year and that once the auditor is comfortable with the quality and effectiveness of the work performed, that continually performing this step is unnecessary?
- Can we capture knowledge that was learned during previous audits, as outlined in the proposed updates to AS No. 02? If the auditor is reasonable comfortable with the quality of the work performed one year, staffing has not changed and the process has not undergone significant changes, should we not be able to gain comfort in the quality and the effectiveness of the work completed without reperformance?

These comments are made on my personal behalf and do not and reflect my personal views only and not of my employer. Thanks

**Danny Goldberg** | Director of Internal Audit | tel 972-713-3700 ext. 2227 | fax 972-713-3741 | [daniel.goldberg@tylertech.com](mailto:daniel.goldberg@tylertech.com)  
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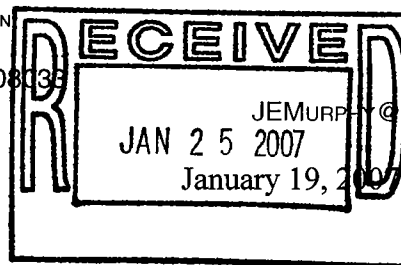
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Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, DC 20006-2803



RE: PCAOB Rulemaking Docket Matter No. 21, Release 2006-007

Dear Sir/Madam:

This letter is in response to the above-captioned release and the opportunity to submit comments on the Proposed Auditing Standard: "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements." Specifically I would like to suggest a change to paragraph, 79, under the heading "Strong Indicators of Material Weaknesses."

The last bullet of this paragraph states

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

A better formulation would be:

"An ineffective compliance and ethics function, especially in complex entities in highly regulated industries. This relates to those aspects of the ineffective compliance and ethics function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting."

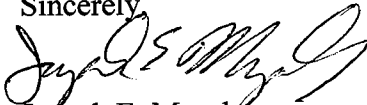
These changes cover several important points. First, the reference to a "regulatory compliance program" uses an outdated term. The Federal Sentencing Guidelines, chapter 8, now define the term as an "ethics and compliance program," and provide a definition that is generally accepted throughout industry. There is nothing to be gained by using an undefined, outdated term in this context.

Second, while it makes sense for the PCAOB to keep to its mission of addressing accounting issues, there is really no basis in logic or experience for limiting the focus to "complex entities in highly regulated industries." While it is certainly true that financial fraud has hit entities meeting this description, such fraud has also shown up in industries without such regulation (e.g., numerous high technology companies, small home appliances – Sunbeam comes immediately to mind), and there can be no doubt that even simple entities can engage in financial fraud. Compliance and ethics programs are key elements in any entity's efforts to prevent fraud.

Third, the use of the word “solely” is overkill. If a compliance and ethics program is ineffective this may show up in many ways. The auditor may not know which of these defects will relate to financial fraud until after the harm has occurred. Better just to ask the auditor to point out where weaknesses occur, without being tied to an unrealistically circumscribed standard.

Thank you for this opportunity to comment and I hope this comment is useful.

Sincerely,

A handwritten signature in black ink, appearing to read "Joseph E. Murphy". The signature is fluid and cursive, with the first name "Joseph" being the most prominent.

Joseph E. Murphy

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**From:** Danka, R. Faisal [mailto:FaisalRDanka@FastMail.CO.UK]  
**Sent:** Thursday, January 25, 2007 7:59 AM  
**To:** Comments  
**Subject:** Docket 21

My Comments are below for:

PCAOB Release No. 2006-007: Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements

[http://www.pcaob.org/Rules/Docket\\_021/2006-12-19\\_Release\\_No.\\_2006-007.pdf](http://www.pcaob.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf)

### **Comment #1**

On page A2-4. number 7 reads “The auditor should evaluate the extent to which he or she will use the work of others. Areas in which the auditor might use the work performed by others to reduce the procedures the auditor otherwise would have performed include –

- Procedures the auditor performs when obtaining an understanding of the company's internal control over financial reporting;
- Procedures the auditor performs when assessing risk;
- Procedures the auditor performs when testing the effectiveness of controls; and
- Substantive procedures the auditor performs when testing account balances and disclosures.”

My comment/query is that, shouldn't the auditor initially focus, whether he/she can rely on the risk assessment performed by others instead of performing walkthroughs to understand the internal control?

Secondly, in a situation where auditor cannot rely on risk assessment performed by others, is it still applicable to go further with re-testing of walkthroughs and operating effectiveness assessment performed by others. Keeping in view that for an auditor, the unsatisfying risk assessment work done by others will follow through in their similarly unsatisfying scoping, walkthroughs and operating effectiveness assessment as well.

### **Comment #2**

In relation to above, as it then related to page A2-8 number 18 which reads “*Testing the Work of Others*. If the auditor uses the work of others to reduce the

procedures the auditor otherwise would have performed, the auditor should test some of the work of others to evaluate the quality and effectiveness of the work. The nature and extent of the tests that the auditor should perform depend on the effect of the work of others on the auditor's procedures but should be sufficient to enable the auditor to make an evaluation of the overall quality and effectiveness of the work the auditor is considering. The auditor also should assess whether this evaluation has an effect on his or her conclusions about the competence and objectivity of the individuals performing the work.”

My comment/query is that, the wording “some of the work of others” is very subjective, a minimum baseline should be recommended. Also the wording states “auditor should test some of the work of others”, does it mean re-performing the test of the same controls with different samples? or same samples? or desktop review of evidence and testing documentation performed by others would suffice.

Regards,

FD

Note: This submission is made on my personal behalf and as such reflects my personal views only and not the views of my employer or clients.

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Faisal R. Danka  
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**From:** Matthew Leitch [mailto:m.leitch1@ntlworld.com]  
**Sent:** Thursday, January 25, 2007 10:54 AM  
**To:** Comments  
**Subject:** Docket 21

Here are some observations and suggestions applying to both the draft guidance from the SEC and the draft AS2 from the PCAOB.

1) Quantitative vagueness

Despite the new guidance the amount of work needed by companies and their external auditors, and the assessment of controls reached, will continue to depend on negotiation rather than definition.

The guidance writes as if COSO's internal controls framework defines effective control, but it does not. It lists things to consider, but it does not quantify what should be in place in such a way as to provide a definition.

It is analogous to defining a "Long" piece of string without ever saying exactly how long a piece of string has to be to be considered "Long". Trying alternative phrases and referring to existing pseudo-definitions does not solve the problem.

This is consistent with the conventional approach of external auditors, but there are examples of regulatory regimes that have defined such things as billing accuracy using precise numbers, showing that it can be done using well known statistical techniques.

Progress should be made towards quantifying the requirements.

2) Technically narrow guidance

The guidance explicitly calls for assessing two things: (a) the design of the control system, and (b) the operating effectiveness of controls within it. Operating effectiveness is considered one control at a time and focuses on whether the control is being carried out as originally designed.

While these assessments are relevant and likely to form a part of any competent evaluation there are other approaches that can be used as well and are used by sophisticated companies and their auditors. The drafts as they stand leave sophisticated companies and their auditors with the impression that some of their most useful techniques are ignored or even contrary to the official requirements.

Other approaches that can be useful, and highly efficient in the right circumstances, include:

\* Putting test transactions through a system and measuring the error rate.

- \* Collecting and analysing figures on discovered errors and backlogs.
- \* Testing the reliability of those figures using analytical tests.
- \* Gathering evidence to confirm initial views about inherent risk levels. (E.g. if inherent risk from software changes is thought to be low this can be confirmed by looking at records of software changes or comparing files.)

In addition, the guidance describes an approach that is intended to be top down and risk focused, but only achieves that to a limited degree. Again, people who have already learned to employ more whole-heartedly risk focused, responsive methods could feel their skills are ignored or contrary to the requirements. For example, before 2002 PricewaterhouseCoopers adopted an audit approach globally called “Towards Performance Audit” that involved continuous planning throughout the audit as teams shared the results of every meeting and set of tests, as input to planning the next steps.

The methods of more sophisticated companies and auditors should at least be recognised and given approval in some way, even if detailed guidance is not feasible. This would allow and even encourage people to move towards more effective and efficient evaluations.

### 3) Attestation on management’s assessment

Before 2002 external audit firms assessed internal controls to the extent that they thought it a contribution towards more efficient auditing of financial statements. The major value of sections 404 and 302 was to focus on what *management* should be doing.

Removing the requirement for auditors to comment on management’s evaluation lessens the focus on management’s activities and cements the idea of an external audit of ICFR.

Now is the time to reconsider the case for an external audit of ICFR. Over the last two years it has become increasingly clear that management have access to information that external auditors do not have, and can therefore put in place an efficient, integrated evaluation as part of normal monitoring activities.

Just asking the external auditor to audit ICFR directly is asking the auditor to do something that has never seemed worthwhile in the past. However, asking the auditor to review management’s evaluation is quite different because of the special qualities of management’s evaluation and the importance of getting management to do things themselves.

Far from taking the focus off management’s evaluation we should be increasing the focus on it and removing the requirement for an external audit of ICFR.

Matthew Leitch

Independent consultant and researcher  
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***TRANSMISSION COVER SHEET***

January 24, 2007

To: Office of the Secretary, PCAOB  
1666 K Street NW, Washington, DC 20006-2803

From: Richard M. Orin

Subject: **PCAOB Rulemaking Docket Matter No. 021**  
Public comment on the publication of the Proposed Auditing Standard  
in the PCAOB Release No. 2006-007 of December 19, 2006

From: Richard M. Orin, Esq., CPA  
To: Public Company Accounting Oversight Board  
Subject: Public comment on the Proposed Auditing Standard,  
“An Audit of Internal Control Over Financial Reporting  
That Is Integrated With An Audit of Financial Statements”  
and related other proposals

PCAOB Rulemaking Docket Matter No. 021

My name is Richard M. Orin. I have several decades of experience as an attorney and certified public accountant. I am a founding member and past president of the American Association of Attorney-Certified Public Accountants. I have lectured on tax, accounting, and accounting ethics at the University of Missouri-Columbia, Southern Methodist University School of Law, New York University, Baruch College and the City University of New York. I am the President of The Foundation for Accounting Practitioners and am currently the sponsor of the annual symposium on accounting ethics at the University of Missouri-Columbia (which has featured speakers such as Barbara Hannigan of the PCAOB and Lynn Turner of the Commission). I am deeply interested in the success of the mission underlying the Sarbanes-Oxley Act, as well as in making the appropriate adjustments for smaller public companies, and would like to submit the following comments for your consideration.

## **Office of the Secretary, PCAOB**

### a. Comment - Risk Assessment

The standards should closely resemble SAS's 104-111 in order to produce the most effective audit. The auditor must consider the substantive audit procedures performed on the financial statement in the evaluation of the internal control audit. The risk-based audit approach focuses the audit on tests of significant or high-risk balance sheet accounts. However, the integrated audit approach of combined detailed testing of internal controls should not be overlooked but be selectively included by the auditors so that audits are not predictable and management is required to maintain their internal control systems documentation on an updated basis for SOX compliance.

### b. Comment - Materiality

The planning and performance of the internal control audit must use the same materiality standard as that used in the audit of financial statements. The auditor must consider both quantitative and qualitative factors in assessing an item's materiality. Internal control can provide only reasonable assurance in any event considering the limitations inherent in all internal control systems. They involve continuous reassessment in the planning, mapping and assessments of internal controls.

c. Comment - Auditor Evaluation of Management Process

The auditor must perform an audit of internal control without evaluating the management process. However, the adequacy of management's evaluation will affect the extent of the work to be done by the auditor. The company's monitoring activities and its competence and objectivity will directly impact upon the time and efforts required of the auditors.

d. Comment - Audit for Smaller Companies

The procedures that an auditor must perform recognize a company's size and complexity. The reliance on principles requires auditors to consider the unique facts and circumstances of each company. Accordingly, the audit must be scaled to be appropriate to the attributes of the smaller company. However, it is typical that senior management may be extensively involved in day-to-day activities which would require the auditor to tailor the type and extent of controls and procedures to this most significant factor. The extensions for non-accelerated filers through December 31, 2007 and the increase in the qualified companies doing SOX compliance consulting work should result in less deadline pressure and reduced overall cost.

e. Comment - Reliance on Prior Audits

The reference to reviewing prior workpapers from past audits by the same firm of auditors negates the objectives of a “fresh look” by the auditors. The Board should reconsider its position of rotation of auditors (the same firm) vis-à-vis rotation of auditors (a different firm). Only through the engagement of a different auditing firm can true “independence” of auditors be maintained by a complement of experienced personnel with industry knowledge. Auditing is not rocket science and competent professionals can be trained and educated to perform as expert auditors from different firms.

f. General Comment

1. Lest the Board forget that the preponderance of fraud, deficiency and internal weakness is committed by the senior management of the public companies:

- (a) CEO's involved in 72% of fraudulent financial statements
- (b) CFO's involved in 43% of fraudulent financial statements
- (c) Either involved in 83% of fraudulent financial statements.

Ineffective internal control substantially opens the gates of fraud, deficiency and material weakness to middle management and others.

2. Although the complaint that compliance with the internal control provisions of the Act has required greater effort and resulted in higher costs, the facts do not bear this out. An analysis shows that although audit fees paid to the big four (five) accounting firms from 2001 to 2004 have increased from \$1,991 billion to \$4,029 billion, the total fees paid the big four (five) for the same period increased from \$4,844 billion to \$4,901 billion. A mere overall increase in cost of outside accounting fees for the four years of 1.2%.

**James Wall**  
1170 Sacramento Street 5C  
San Francisco, California 94108  
415-440-8918

February 1, 2007

Office of the Secretary  
PCAOB  
1666 K Street, N.W.  
Washington, DC 2006-2803  
[comments@pcaobus.org](mailto:comments@pcaobus.org)

Reference: Rulemaking Docket Matter No. 021

It is very encouraging that the PCAOB has recognized that the benefits of Section 404 have come at a disproportionately high cost. Its efforts to bring cost into line and be exceeded by the benefits of Section 404 are to be commended. Should the proposed auditing standard be implemented as proposed, it will improve the cost/benefit relationship, but several hurdles will remain. Some hurdles will be within the PCAOB's ability to control, and others outside:

1. Will the PCAOB field offices follow the proposed audit standard in conducting audits of external auditors? Attention by the PCAOB National Office in training its field staff in protecting against not just poor audit quality, but from excessive audit cost, is appropriate.
2. Will the external auditors accept the new audit standard in spirit? For most external audit firms, the new audit standard will likely reduce public company client billings and a natural reluctance to reduce their income substantially should be anticipated.
3. Will the audit standards be accepted by the courts and juries in dealing with the class action plaintiff's bar, or will external auditors be expected to adhere to higher audit levels than the PCAOB sets forth? The external auditors can be expected to resist reducing their procedures and fees for this reason, and with considerable merit as in practice they are serving as an investor insurance carrier. Comments from KPMG during their 404 Institute webcast of December 18, 2007 stated that while management efforts could decrease under the proposal, external auditor efforts (which are far more costly than internal efforts) could increase significantly to make up for the decreased management efforts.

4. Congressional or judicial action to limit the actions of the plaintiff's bar, who are seemingly sailing under Letters of Marque and Reprisal (Article I, Section 8 of U.S. Constitution), and moving securities violations prosecution from the private sector to governmental authority would be helpful in reducing system cost. This would assist in more rational audit behavior by the external audit firms who are reacting like a lamb in the midst of a pack of hyenas: the occasional bleat followed by a merciless slaughter<sup>(1)</sup>.
5. Following the Canadian example of not having the auditors opine on ICFR would also be helpful, though it would require Congressional action to eliminate the independent certification requirement of Section 404. The Company (the Board) would still formally attest to ICFR. Boards rarely undertake economic exposure without significant due diligence, and in Canada practice is evolving that Boards ask the external auditor to conduct an assessment of management's assertions on ICFR. The objective is to remove the litigation exposure of the external auditor and thereby significantly reduce auditor costs while improving internal control.

The Proposed Auditing Standard has 34 questions that the Board seeks comments on; the following are responses to some of those questions.

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

Yes. The top down approach should produce far more focused and effective reviews of ICFR. The current approach is backward in identifying materiality and decreases audit efficiency by having first to identify all transactional activity, then ferreting out the material.

*#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?*

Yes. The proposed standard does appropriately incorporate risk assessment as it uses a top down approach.

*#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?*

Response combined with question #9 below.

<sup>(1)</sup> The current defendants of the predatory bar could identify well with the victims of the Aragonese Archbishop of Narbonne, Arnold Amaury, who in the early 1200's said in response to a question about distinguishing Cathar (Albigensian Christians) from Catholic, "Kill them all, God will know his own". The contemporary version, in a turn of "capital" punishment, might be "Sue them all, let the courts sort it out".

*#9: Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statements?*

Materiality (reasonable possibility, significant) now appears coordinated with SEC SABs 99 and 108 and that consistency is positive. However, many regard the SEC materiality guidance as flawed as they result in restatements that investors consider immaterial. For simplicity, the new PCAOB guidance should track to whatever the SEC determines is the appropriate level of materiality, whether it is the current method or some new metric. This would leave struggling with materiality to the SEC.

*#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?*

One would expect that a restatement (one of the strong indicators) would normally be evidence of a material weakness in ICFR. Nonetheless, an event theoretically could occur where a restatement did not lead to a material weakness. If management, the audit committee, board and external auditor all concur that there was no material weakness, then it may be appropriate to conclude a material weakness was not present. It seems reasonable that the Standard should permit such a finding, though the occurrence of such findings would be rare, particularly if the SEC re-addresses materiality to reduce the amount of immaterial restatements.

*#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?*

Yes. As the attestation to ICFR is on an annual basis, the relevance of interim materiality would seem moot unless there was a significant interim failure in ICFR. If there were a significant interim period failure in ICFR (for instance, a restatement) materiality should remain the same dollar value as annual periods.

The PCAOB should avoid the difficulties that the SEC finds itself in when attempting to apply percentage materiality to interim periods and either missing a material item, or more often, finding more material items than exist. Both the SEC and PCAOB need to recognize that a material percentage of a financial statement number may or may not result in a material valuation change in shareholder value. Shareholders are concerned with the DCF of future cash flows and if the error materially affects those flows investors are quite concerned. If they are merely backward looking classification errors that will not affect future cash flows, then one should expect investors to exhibit far less concern unless the error is indicative of incompetent or unethical behavior.

The purpose of ICFR is not just annual periods, however the determination of materiality for an interim period is an area that the SEC needs to address further as SABs 99 and 108 can result in immaterial items causing restatements. The PCAOB should not compound the problem by developing a materiality standard different from the SEC definition, but track to that definition, even if flawed, and use that definition on an annual basis only.

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

Yes. Removing the requirement for an evaluation of management's process will eliminate unnecessary audit work. However, as the appropriate number of auditor hours are opaque to most companies, how much will be removed is uncertain. A pessimist would observe that the applicable audit hours were considerable before the external auditor found those hours were being removed, and after removal that the hours were immaterial; thus hours and fees will remain unjustifiably high.

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

Yes. The question for purposes of the attestation is the quality of the controls, not the means by which those controls were attained. The auditor can contribute value without a formal report on management's process.

Shareholders should be able to expect that an auditor would comment to management (§ 87) and the audit committee about the quality of ICFR to point out areas where the company is just passing, or incurring excessive costs or procedural hours in achieving a control objective. The external auditor should be encouraged, preferably required, to comment on the quality of ICFR to management and the audit committee; not just that the company passed or failed.

*#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?*

Yes. Simplicity imparts clarity.

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

(a) Yes, (b) no comment submitted at this time.

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

Yes. The question is whether external auditors can perform the task economically in relation to the risks – including the risks to the company as well as to the audit firm from litigation.

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

(a) Yes, (b) Yes, though it will obviously depend on the application of the spirit of the framework by the external auditor, (c) No.

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

Yes. Both education and experience are appropriate elements to be considered, though formal education (or its lack) alone should not preclude consideration of experience. The complexity of the audit or control area should dictate the appropriate combination of education and experience.

*#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?*

Positive. Conceptually, Internal Auditors and others involved in the assessment of ICFR should be independent of the outcome of the ICFR audit, including financial independence. The compensation of Internal Audit staff should be independent of the results of the audit, though audit efficiency and efficacy could fairly be considered in bonus plans.

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

“Market capitalization” should be clarified to be “equity market capitalization” utilizing a definition of equity consistent with that contained in Securities Exchange Act Rule 12b-2. The use of revenue as a defining measure does not appear to necessarily relevant to shareholder risk – shareholders invest in equity instruments, not in sales. There are numerous industries (particularly more mature industries, but not exclusively) that have high revenues and low gross and net margins, and accordingly lower equity values; at the same time there are companies with small revenues but the market attributes great expectations to future cash flow growth and assigns very large equity valuations. Shareholder risk is correlated with equity value, not sales volume.

The Securities Exchange Act Rule 12b-2 definitions for non-accelerated (<\$75m), accelerated (>\$75m, <\$700m) and large accelerated (>\$700m), which use the amount of

outstanding equity instruments not held by an affiliate, are reasonable size determinates are suitable for use by the PCAOB. Using the SEC definitions would also avoid yet another size definition for preparers and users to deal with.

The SEC itself may wish to move in the direction of the Advisory Committee report describing “Smaller Public Companies” as those with under \$787.1 million in [equity] market capitalization (bottom 6% of public companies) and “Microcap Companies” as those Smaller Public Companies with [equity] market capitalization under \$128.2 million (bottom 4% of public companies) as a very good starting point. Whether it is the SEC or the PCAOB that sets the thresholds, they should round the amounts up to provide an easier reference, perhaps using the thresholds of greater than \$800 million or \$1 billion for “Smaller Public Companies” and under \$200 million or \$150 million for “Microcap Companies”. Further, the Agency setting the level (SEC or PCAOB) should schedule reconsideration of the definition thresholds not less often than every five years to reflect inflation and market developments, and changes should be in large amounts (e.g., minimum \$100 million for Smaller and \$25 million increments for Microcap companies).

It would seem appropriate for the SEC to set the threshold levels and for the PCAOB to track the SEC levels.

*#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?*

I have not seen difficulties in this area from the company perspective; auditors may see greater issues in the loss of revenue from conflicted services. The projected cost of the proposed service and relationship to the projected audit fee would be valuable for the Audit Committee to know. However, anecdotal comments indicate external auditors are currently reluctant to provide many audit committees with estimates of audit fees.

*#34: How can the Board structure the effective date so as to best minimize 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 date selected will be disruptive – either the date will be too late to alter ICFR audit practices to eliminate inefficient ICFR audit practices, or too soon for some audits that might require a significant change in process. A reasonable approach set the effective date for fiscal years ending on or after December 15, 2007, and to permit early adoption. This approach would allow companies to make the determination of whether early implementation would provide the most practical and economic means of making the change.

Thank you for the consideration of the above comments in your process of improving the auditing requirements related to Sarbanes-Oxley Section 404.

Sincerely,

*/s/ James Wall*

James Wall



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Fax: (519) 886-8786

February 2, 2007

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

Ref: PCAOB  
Rulemaking Docket Matter No. 021

Dear Sir:

I have reviewed your latest auditing standard proposals. I currently work with two SEC registrants, mainly in an advisory capacity to assist them to set up internal management processes that will allow them to carry out an effective evaluation of their control processes. I also work with several Canadian public companies that are establishing management control evaluation processes to meet the latest Canadian regulations.

I use your standards as guidance in advising my clients on their internal processes. Many of your proposals will be effective in changing some of the difficulties that both external auditors and management teams are encountering with the existing standards. I do not act as an external auditor. Yet my comments refer to the part of your proposals that change the scope of the external auditors' report. I believe the latest proposals have missed the point of having an external auditor examine and report on these matters.

With respect to the auditors' role in evaluating and reporting on internal controls in a separate report, other than the financial audit report, I believe it was the intention of the Sarbanes Oxley Act to ensure that management's evaluation of controls was based on a process which could be substantiated and which provided appropriate evidence for management to make their conclusions.

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

I cannot agree with this, as I feel it is entirely the point to involve external auditors to evaluate management's process, and to report on whether the process was sufficiently valid to support management's conclusion. I do not think the auditors need to repeat management's work to be able to conclude on whether it is a sufficient and appropriate basis for management's conclusions or not. A certain amount of testing is required in order to evaluate effectiveness, but it should be a subset with the intention of evaluating the process, not for re-auditing controls as a second exercise. Yet the standard still requires the auditor to test controls and give an opinion, which is what the Act requires management to do already.

Furthermore, the audit report that is suggested in the standard still states "...We also have audited management's assessment, included in the accompanying [title of management's report], that W Company maintained effective internal control over financial reporting as of December 31, 20X8, based on...". This statement definitely gives the impression that the audit was of management's assessment of an effective control environment, not a separate audit of controls.

The report then goes on to state, "Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our

audits.” This is contradictory to the first statement. Is the audit to express an opinion on management’s assessment of an effective control environment, or is it an opinion on the company’s internal control over financial reporting?

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management’s process?

The direct answer to your question is yes, it is possible. Again, I do not believe the point was for the auditors to do an internal control audit. The point was to evaluate management’s basis for evaluation of its own controls. In the same way that a financial auditor tests management’s financial statements, based on testing and sampling, rather than reperforming all transactions. In order to add value to the reader of management’s evaluation report, the auditor should attest on management’s process of evaluation, and whether it supports the evaluation itself. The important point is – does management have sufficient basis and evidence to draw the conclusions it has reported, or is it likely that their process is flawed and would not have uncovered a material weakness?

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?

I have already stated under question #13, that I believe the proposed auditor’s report is contradictory and unclear as to what opinion is being expressed. The scope and results are not clear, but I would like to take this further.

Presumably management is taking steps, above and beyond its daily management activities, in order to perform an evaluation of its control effectiveness and to meet its obligation under the Act. While there are no standards that management is obliged to follow, presumably most are attempting to perform a valid, professional exercise which will obtain sufficient evidence to support their conclusions. While it is not independent, management is generally trying to achieve an auditors’ level of evidence. The SEC has given guidance to management, and many managers are also using the audit standards of the PCAOB and other professional standards to design their assessment programs.

In effect, under your proposal, what will happen is that both management and the external auditor will perform an audit of controls.

Both audits could in fact arrive at the conclusion that there are no material weaknesses in controls. In fact, we would expect that this will happen in the majority of cases. What is the benefit of having two such reports?

Consider the following possibility. The external auditor’s conclusion, after testing controls according to professional auditing standards, is that there were no material weaknesses found and controls are effective. At the same time management has made the same conclusion, but without actually gathering any, or gathering much less, persuasive evidence to support its conclusions.

Since the auditor’s conclusions are based on testing it is probable that their tests were appropriate and supportable, and their conclusions were correct according to professional standards. Yet at the same time management’s conclusions were not based on a rigorous process or evidence. Under the new standards what would the auditor have to say about this? It appears to me that nothing would be reported publicly, although the auditors may inform the audit committee.

Also consider the situation where the auditor has discovered a material weakness based on testing, but management had not identified this weakness. Consider also that management’s failure was due to a poor evaluation process, rather than say a different test sample. The poor evaluation process may extend to other control areas where no weaknesses were found by the external auditor. The auditor will report publicly on the material weakness found, but not report on management’s weak assessment process?

Wouldn't the reader of the certifications want to know whether management had any or sufficient evidence to support its conclusions? I propose that this is in fact the only useful information that the reader wants from the auditors. They do not want the auditors to repeat what they are expecting management to do correctly the first time.

Similarly, what role does the auditor play in evaluating and reporting on management's risk assessment? In order to perform its audit of controls, your standard requires the auditor to evaluate risk and test controls related to its risk assessment. It does not state what would happen if the auditor feels there is a major risk factor that management has not considered to be a major risk factor, or for which management has not tested related controls. The standard requires the auditor to determine whether controls exist to address this risk, and if so, to test those controls. If the auditor does audit these controls, and finds that the controls are effective for that period, does it not have any obligation to identify this difference it has with management's risk assessment?

Lastly, what would happen if management gives a clean assessment of its controls, and the auditor performs its own tests of controls, and also gives a clean opinion, yet a major weakness is uncovered later, possibly leading to a re-statement. If management has essentially performed a poor or minimalist evaluation process, and this was "vindicated" by a proper audit, then management's process has essentially been given a clean bill of health when it should not have been. What basis will the SEC or the courts have to find against management? The auditor will be able to protect itself by showing that its audit of controls was done according to professional audit standards. Management will claim that its processes resulted in the same conclusion as the auditors', and that while a different method was followed, they had no reason to believe their method was faulty or inappropriate at the time.

I view the auditor's role in this process as similar to a professional standards audit that the PCAOB might perform on an auditing firm. The PCAOB would check whether professional standards were followed and that there was sufficient evidence of the process followed by an audit firm in arriving at their audit report. You would not reperform the audit itself to any great extent. To my mind, it is the auditor's role to challenge, test and report on management's methods of performing its evaluation that is the important value-add for the readers.

In the case where management has performed a credible, evidence based evaluation of its controls, having a second report stating the same thing is a waste of time and money, and tells the reader nothing. But giving the reader an opinion that management's certification is based on a credible process is worthwhile, whether management issues a clean opinion or otherwise.

#### An Alternative Approach

There is an alternative to all of this but it would require changes to the Act as well as to the auditing standard. That alternative would be to remove the responsibility of management to audit and evaluate their own control systems. Then require auditors to perform tests of controls over high risk accounts as part of the financial statement audit. Remove the professional judgement possibility of auditors to rely on substantive testing alone, and require that control testing be performed in all financial statement audits. Auditors would then be required to define risk, in conjunction with management, and to conduct appropriate professional testing of controls related to those risks. Management would still certify that they are responsible for assessing risk and for designing and implementing appropriate controls. In this way audits and opinions are done by professional auditors, but the entire responsibility for all aspects of financial statements, including controls, clearly rests with management.

I believe that this approach would substantially reduce overall cost as well. The scope of a financial audit would be increased but not exceptionally. Costs of an audit would be higher than they would have been prior to Sarbanes Oxley, but less than the current approach. The evaluation efforts of management would be reduced, although control systems would still have monitoring systems in place that could be audited. A separate evaluation exercise by company staff would likely be avoided, and the emphasis would be on proper design and daily execution of controls, where it should be.

In this case your new standard could almost stand as is, except for removing the words "We also have audited management's assessment, included in the accompanying [title of management's report], that W Company maintained effective internal control over financial reporting". This would be replaced by "We have also audited W Company's effective internal control over financial reporting..."

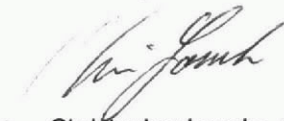
I believe that many readers of financial statements are still unclear as to the possibility that an auditor could, in the past, give an audit opinion on financial statements without in fact testing internal controls. Your proposal of a new combined audit report makes it fairly clear that auditors can no longer do this, at least for large public companies. But we could make it more clear, if the Act itself didn't create confusion by having both management and auditors responsible for proving and certifying that controls are effective.

This suggestion might be complicated by any structure that has separate reporting standards for companies of various sizes. However I also believe that the extent of audits of controls can be different for companies of different sizes, and you have efforts underway to support this. So long as all public companies are required to have an external audit of their financial statements I don't see why audits of controls could not be included, given appropriate guidance for relative size and complexity.

Management of smaller companies have already been certifying their statements, short of a separate evaluation process. We could just stop the progression entirely, at the stage they are now at, and put the responsibility for auditing onto the auditors. Then do the same for larger companies.

I hope that these comments are helpful.

Sincerely,

A handwritten signature in black ink, appearing to read "Chris Loucks", written in a cursive style.

Christopher Loucks, CA

To: Office of the Secretary  
Public Company Accounting Oversight Board

Re: PCAOB Rulemaking Docket 21  
From: Monica Radu  
Date: February 4, 2007

Dear Board Members,

Thank you for the opportunity to comment on the Board's Proposed Standard, it is greatly appreciated.

Scope of Comment

I would like to comment on appendix B, paragraphs B1-B11, "Integration of Audits", which is describing the interrelationship of two Audits of Internal Control namely:

**Audit 1:** an Audit of Internal Control over Financial Reporting (for SOX Audit) and

**Audit 2:** an Audit of Internal Control for Internal Control Risk Assessment (for Financial Statement Audit).

Thesis

**I would like to propose that the distinction between the two Audits is only in the purpose for which they are used, not in the work performed. Therefore, they are in fact one and the same Audit of Internal Control, which satisfies two purposes; and by performing the work described in the Proposed Standard, both purposes would have been accomplished.**

Background

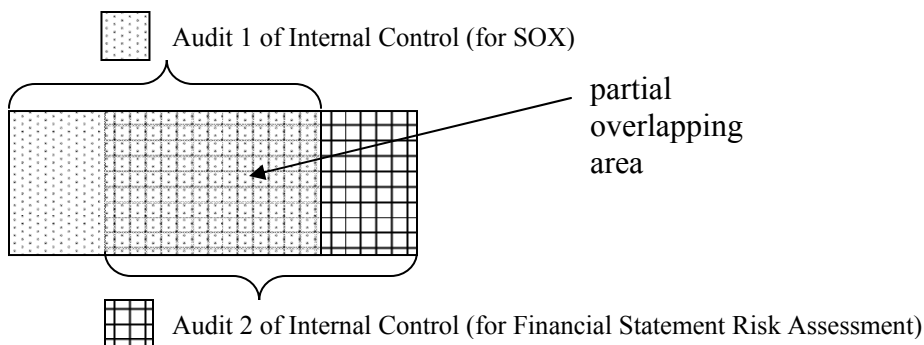
The Proposed Standard is making a between two Audits of Internal Control:

**Audit 1:** an Audit of Internal Control over Financial Reporting (for SOX Audit) and

**Audit 2:** an Audit of Internal Control for Internal Control Risk Assessment (for Financial Statement Audit).

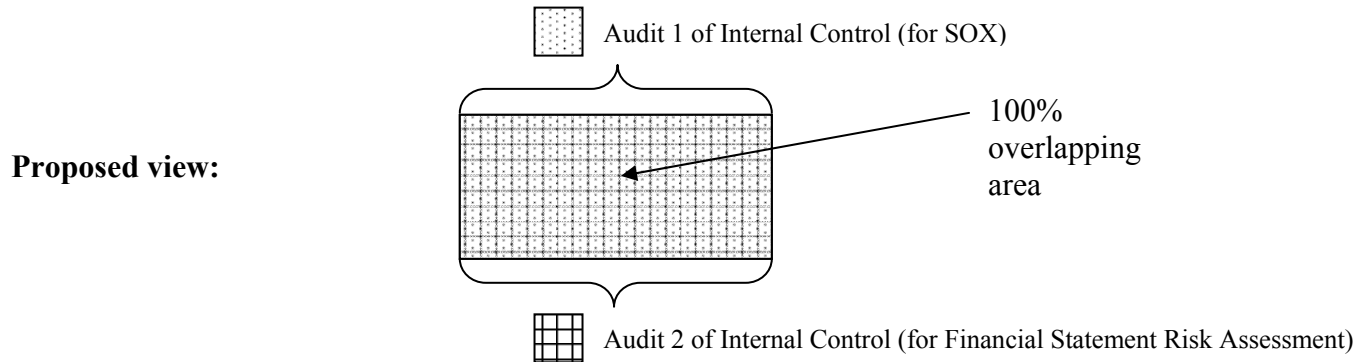
This distinction can be seen in paragraphs such as B4: "This requires that the auditor test the design and operating effectiveness of controls he or she would not test if expressing an opinion only on the financial statements" or B5: "the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements". Based on these paragraphs, the Proposed Standard's current view of the two Audits of Internal Control can be graphically represented as follows (with some overlap but also some differences):

**Current view:**



Argument

I would like to propose that the two Audits of Internal Control are one and the same Audit of Internal Control. The reasons are stated in paragraphs I, II and III below. A graphical representation of the proposed view is as follows:



**Reason I. The same work is performed for both Audits.** This is evidenced by:

- A) the same methodology** (the Proposed Standard and SAS 55, SAS 78, and AU 319)  
The methodology described in the Proposed Standard for Audit 1 of Internal Control (for SOX), is the same as the methodology established in SAS 55 and 78, and AU section 319 for Audit 2 of Internal Control (for Financial Statement Risk Assessment).
- B) the same underlying base** (Financial Statements and Disclosures)  
Both Audit 1 and Audit 2 are of Internal Control over Financial Reporting (preparation of Financial Statements and related Disclosures)
- C) the same materiality threshold level** (reasonable possibility of material misstatement)  
Both Audit 1 and Audit 2 use the same materiality considerations, per the Proposed Standard paragraph 14: “in planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company’s annual financial statements”.
- D) the same scope** (based on B) and C) above, combined)  
As both the underlying base and the materiality threshold level are the same for both Audits, it means that their scope is the same (the same assertions, processes, accounts, disclosures, classes of transactions, risks, controls, etc are relevant for both Audits)
- E) by definition**  
By definition, “Assessing control risk is the process of evaluating the effectiveness of an entity’s internal control in preventing or detecting material misstatements in the financial statements” (AU 319.64) By this definition, Control Risk Assessment (Audit 2 of Internal Control) is also exactly what the evaluation of Internal Control over Financial Reporting (Audit 1 of Internal Control, for SOX) is.

**Reason II. By deductive reasoning, each of the two Audits of Internal Control implies the other one.**

**Part II. A) Audit 1 implies Audit 2.**

Based on AU 319.04, “The auditor may assess control risk at the maximum level because he or she believes controls are unlikely to pertain to an assertion or are unlikely to be effective, or because evaluating the effectiveness of controls would be inefficient.”

Based on AU 319.04, above, there are three instances when the auditor may assess risk at maximum:

- 1) “controls are unlikely to pertain to an assertion” This instance does not apply, because as shown in I. D), both Audits have the same scope, therefore the same assertions pertain to both.
- 2) “controls are unlikely to be effective”
- 3) “evaluating the effectiveness of controls would be inefficient.” This instance no longer applies, since evaluating the effectiveness of controls is now required by law (the Sarbanes-Oxley Act of 2002).

Only instance 2) applies, which shows that when controls are unlikely to be effective, then control risk is at maximum (in other words, ineffective Audit 1 implies ineffective Audit 2), and when controls are effective, none of the instances applies to set control risk at maximum, so it must be set at below maximum (so effective Audit 1 implies effective Audit 2).

**Part II. B) Audit 2 implies Audit 1.**

According to AU 319.70, “Assessing control risk below the maximum level involves:

- identifying specific controls relevant to specific assertions (in the Proposed Standard, this is in paragraphs 16-46)
- performing tests of controls (in Proposed Standard paragraphs 47-69)
- concluding on the assessed level of control risk (in Proposed Standard paragraphs 70-79)

By performing this work for Audit 2, the auditor would have also performed at the same time the work described in the corresponding paragraphs in the Proposed Standard related to Audit 1, in other words, Audit 2 implies Audit 1.

Based on both **Part II. A) and II. B)** above,

**Audit 1 implies Audit 2 and**

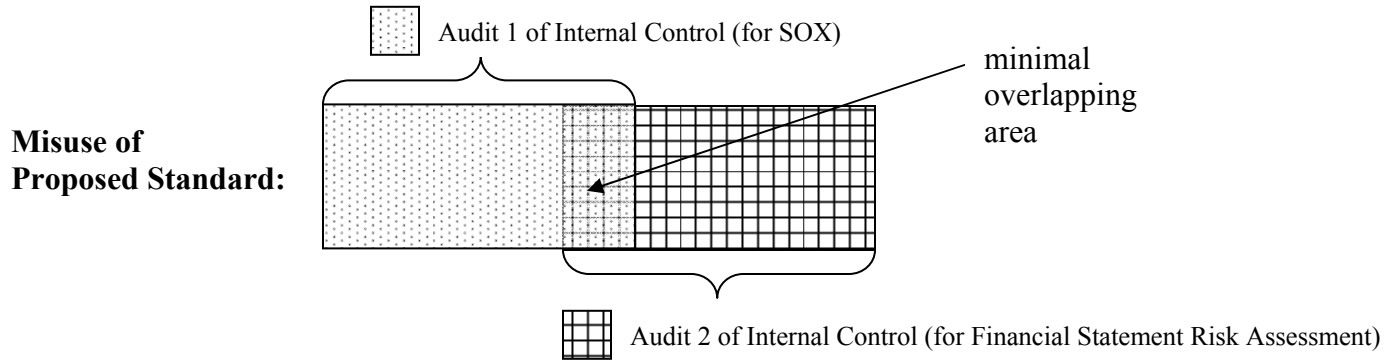
**Audit 2 implies Audit 1**

**Based on both, it results that Audit 1 = Audit 2**

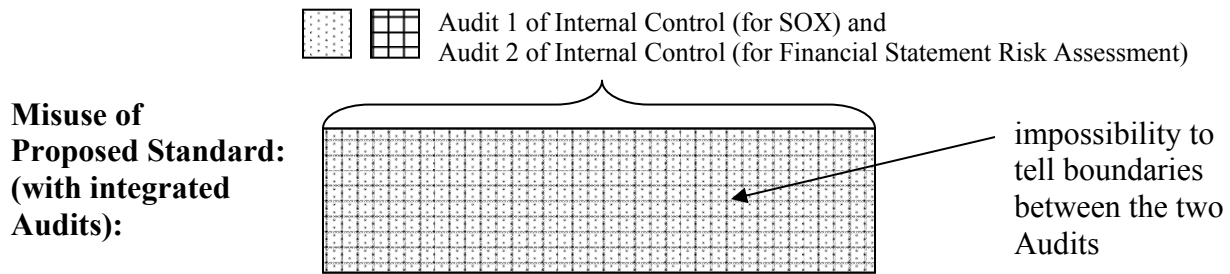
**Reason III. Differentiation between two Audits of Internal Control is a loophole that can be used, and is already used, to nullify the benefits of the Proposed Standard.**

I hope the Board considers the fact that it will be a hard battle for companies’ management to decrease the amount of their work based on the Proposed Standard, because of the various interest groups such as internal or external auditors, who may want to perform more work than needed in order to maintain their overstuffed departments, their influence in the company, or their high fees.

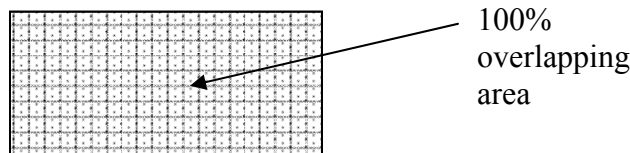
Differentiation between two Audits will allow these groups to keep total work levels the same, but just re-partition them. The amount of work performed that cannot be attributed to Audit 1 of Internal Control, will still be performed, but attributed to Audit 2 of Internal Control. A graphical representation of this is as follows:



In practice, as auditors are instructed to integrate the two Audits, the two are blended together in such a way that it is hard to separate which controls they are auditing for which Audit, resulting in an integrated Audit that is much larger than what the Proposed Standard intends. This is already happening in industry in planning 2007 audits. A graphical representation of this is as follows:



Compared to the Audit size of the Proposed view:



**Conclusion**

**The two Audits of Internal Control are, in fact and in practice, one and the same Audit of Internal Control, based on sameness of methodology, underlying base, materiality threshold, scope, by definition and by deductive reasoning. Considering this, and to prevent misuse of the Proposed Standard, I hope that the Board will indicate in the final Standard that the two Audits of Internal Control are one and the same Audit of Internal Control, which can and should be used for two purposes: to form an opinion on Internal Control over Financial Reporting and to support the auditor’s Assessment of Control Risk as well. In the case of an effective Internal Control over Financial Reporting, no additional work is necessary to be performed to Assess Control Risk at lower than the maximum.**

Sincerely yours,

Monica Radu  
 MonicaRadu1@gmail.com

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**From:** Shaw, Andy [mailto:AShaw@rocksp.com]  
**Sent:** Friday, February 09, 2007 4:22 PM  
**To:** Comments  
**Subject:** Docket 21

I respectfully submit this question / observation regarding materiality, the concept of material misstatements and quantification of material weaknesses.

The PCAOB proposed standard says that the ICFR audit and financial statement audit should be planned and performed using the same measure of materiality. The SEC proposed guidance to management says that both quantitative and qualitative factors are to be considered but is not explicit. Our external auditors have an existing metric used for materiality – a percentage of net income. If management does not use the same metric there is a possibility that the auditor's threshold may be lower and hence they might identify potential material weaknesses that management would not have identified during its assessment. There does not appear to be any prescribed mechanism to reconcile this potential gap in either the SEC or PCAOB proposals. What is the view of the SEC and PCAOB on this potential gap and how management and the external auditor must resolve it?

Thank you.

P. Andrew Shaw  
Director Internal Audit / SOX  
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Subject: Comment on Rulemaking Docket No. 021, PCAOB Release 2006-007  
From: icfr@financeintegrity.com  
Date: Tue, Feb 06, 2007 8:32 am  
To: comments@pcaobus.org  
Cc: phillipsl@pcaobus.org, virags@pcaobus.org

This comment letter concerns Rulemaking Docket Matter No. 021, PCAOB Release 2006-007.

The views expressed in this letter are my personal beliefs and opinions. These views have not been considered or endorsed by any company or organization.

Throughout my career, I have been an advocate of strong internal control, particularly with regard to the processing, accounting, and reconciliation of financial transactions.

As chairman of the audit committee of an eleven thousand member professional association, I convinced the Board of Directors that the annual financial statement audit did not provide assurance on internal control and therefore a separate audit of internal control would be beneficial. Within six months, the association received an attestation report that validated management's assertion that the association had effective internal control. All of this occurred at least five (5) years before Section 404 was even conceived.

I believe the Sarbanes-Oxley Act of 2002 is great legislation that has and will continue to discourage unethical behavior. In my view, the mandated CEO/CFO certifications, severe penalties, and the government's more aggressive pursuit of white collar criminals are particularly effective at discouraging fraudulent financial reporting.

The wording of Section 404 is reasonable and appropriately focuses attention on financial reporting. In turn, the Commission's initial definition of ICFR was correct for what was included and excluded from the definition. Extremely noteworthy, the Commission recognized that ICFR "*does not encompass the elements of the COSO Report definition that relate to effectiveness and efficiency of a company's operations and a company's compliance with laws and regulations ...*" I believe the fatal flaw in AS2 is the Board did not clearly synchronize its guidance with the Commission's definition of ICFR and did not clearly emphasize what was excluded from ICFR.

**Concerning the proposed release, I strongly urge the Board to delete paragraph number five (5). If this paragraph survives, self-serving auditors will be given the power to control which framework is used by management. From a practical standpoint, it is likely most registrants and their accounting firms will use the same control framework; however, the Board should not mandate this be the case. It is important to note the Commission expressed an important view on control frameworks in Footnote # 50 of its proposed guidance to management:**

- *"... we are not requiring that companies use the guidance in the auditing literature to conduct their evaluation approach. The Commission encourages the development of methodologies and tools that meet the objectives of the ICFR evaluation."*

**If paragraph five is not deleted or altered in a significant way, the PCAOB will seriously undermine the Commission's stated preference that new control methodologies and tools be developed. Again, please consider deleting paragraph number five (5).**

I am cautiously optimistic new control methodologies and tools will be developed in the near future. With any luck, perhaps these will be clearly and unequivocally focused on financial reporting.

Patrick Montgomery, CPA, CFE, CTP

[icfr@financeintegrity.com](mailto:icfr@financeintegrity.com)

[icfr@executiveintegrity.com](mailto:icfr@executiveintegrity.com)

Cc: Laura Phillips, Deputy Chief Auditor  
Sharon Virag, Associate Chief Auditor

February 13, 2007

**Re: SEC File No. S7-24-06 and PCAOB Rulemaking Docket No. 021**

The **Institute of Management Accountants** applauds the efforts made to date by the SEC and PCAOB to make SOX implementation more cost-effective and practical while still protecting investors. We are pleased to continue sharing our extensive global research and recommendations with the SEC, PCAOB, professional accounting associations, the trade media, the U.S. Chamber of Commerce, Members of Congress and other security regulators around the world interested in this issue.

IMA's conclusion, after careful consideration of the SEC and PCAOB December 2006 proposals, is that significant additional actions are required to optimize the cost/benefit equation. This letter contains a **main body (7 pages)** and **3 attachments** (Attachment 1 – IMA Risk-Based Framework; Attachment 2 – Technical Analysis of SEC Guidance; Attachment 3 – Technical Analysis of PCAOB draft audit standard).

We have summarized below the five interrelated issues that we believe remain to be addressed, together with our technical analysis and recommendations for change. These five issues have been identified through extensive research and careful consideration of the reasons cited by Canada, the EU and Japan for not fully adopting the current U.S. SOX regulations.

- ❖ **Issue 1:** Two rule books (SEC, PCAOB) for the same assessment task – a recipe for unintended confusion and complexity. In short, without major changes to the draft rules ASX/5 will likely replace AS2 as management's de facto standard.
- ❖ **Issue 2:** The proposals are not risk-based by global risk management standards, reducing the benefits that could accrue from an assessment approach that focuses on identifying specific significant risks and understanding residual risk status.
- ❖ **Issue 3:** The current "quality bar" of zero material defects in draft financial statements is expensive without significantly increasing investor protection. This situation is compounded by the current requirement that identification of even one material control weakness requires management publicly report ineffective ICFR.
- ❖ **Issue 4:** The draft proposals call for elimination of the audit opinion on management's ICFR assessment process and retention of the auditor's subjective opinion on ICFR effectiveness. While some agree with this interpretation of the Act, it is contrary to IMA's and IIA's publicly reported views, some early comment letter responses, and the current stance of the U.S. federal government, Japan, Canada, and the EU capital market regulatory bodies.
- ❖ **Issue 5:** The draft proposals are still not practical for smaller public companies – all four issues listed above disproportionately impact smaller public companies.

<i>Issue #1/Impact</i>	<i>What Needs to Change</i>
<p><b>Two rule books for the same task – a recipe for unintended confusion and complexity.</b></p> <p>The SEC proposed rule is high level and broad to the point of being vague on minimum expectations in a number of key areas, including but not limited to the need to specifically identify, document and assess major risks and residual risk status. The PCAOB standard is more granular, prescriptive and control focused. The PCAOB rules constitute the “exam grading rule book” auditors must use or risk severe PCAOB sanctions and increased litigation exposure.</p> <p>Because under the current proposals auditors will still determine ICFR pass/fail rating, PCAOB rules will likely continue to be the de facto rule book for management that want a passing grade. This is a sub-optimal situation and contrary to what we believe is the true intent of the Act.</p> <p>A few examples of the more significant differences and/or inconsistencies that exist between the SEC and PCAOB proposals include:</p> <ol style="list-style-type: none"> <li>1. <b>Control Environment Evaluation</b> – ASX/5 indicates that the auditor should assess the company’s control environment and lists 5 specific areas for attention. The SEC guide makes passing reference to the concept but does not provide specific evaluation criteria or any information on what would constitute a failing grade on control environment.</li> <li>2. <b>Identifying Significant Accounts</b> – ASX/5 lists 9 specific factors that should be used to identify significant accounts. SEC guidance has no parallel guidance for management.</li> <li>3. <b>Strong Indicators of Material Weakness</b> – ASX/5 lists almost 3 pages of specific factors that are relevant to determining if a material weakness is present. The SEC guidance starting on page 41 provides similar but different criteria to be used by management.</li> </ol>	<p><b>The SEC guidance should be the only ICFR “how to” assessment guidance.</b></p> <p>Management teams that follow SEC interpretative guidance should be fully entitled to say they have done what is expected of them without fear of being overruled and/or contradicted by the more prescriptive, granular and control-centric PCAOB rules. Although the SEC proposed rule states that this result is indeed a goal, we believe that management will have to use and conform to the PCAOB rules in order to satisfy their external auditors.</p> <p>When revisions to the draft PCAOB standard are done following the comment period, we recommend all sections that describe how to complete an assessment of ICFR should be deleted from the Standard and <b>auditors directed to use the same SEC interpretative guidance used by management.</b></p> <p>The focus in ASX/5 should be solely on audit considerations. However, the SEC primary ICFR assessment guidance should be revised to reflect IMA recommendations made in Issues 2-5 below.</p>

<i>Issue #2/Impact</i>	<i>What Needs to Change</i>
<p><b>The SEC proposed rule and PCAOB revised standard are still not top-down/risk-based by global risk management standards.</b></p> <p>If these documents were truly top-down/risk-based users would be encouraged and allowed by the SEC to use globally accepted risk assessment frameworks such as AS/NZ 4360, COSO ERM, or the IMA top-down/risk-based ICFR assessment framework proposed in September. Application of any of these approaches would require that assessments start by formally documenting and assessing significant risks at both the entity and account/note level - risks that are already known to have resulted in materially unreliable financial statements. We would argue that this level of guidance is the appropriate balance between ambiguity at one extreme and prescription at the other.</p> <p>Although there is some reference to this step in the SEC guidance this step is not emphasized sufficiently or clearly enough. No examples or guidance on how to complete this step are currently in either set of draft rules.</p> <p>It is also important to note that nowhere in the SEC or PCAOB draft guidance do the authors use the words "residual risk" or "residual risk status". Identification and assessment of residual risk is a key element of any true risk-based assessment methodology and a cornerstone of all internationally recognized risk management standards.</p> <p>For example, the PCAOB proposed standard on page 5 directs auditors to start by examining and testing company level controls without first carefully identifying and assessing entity-level risks. In contrast, the SEC guidance alludes to starting with risks but does not take advantage of globally accepted methods to provide some level of practical "how to" guidance.</p>	<p><b>Both the SEC and PCAOB proposals should be rewritten to reflect and require a true top-down/risk-based ICFR assessment approach. We are seeking "balance, not bias" between risk and controls-based methods.</b></p> <p>A true top-down/risk-based approach starts with management identifying major risks at the entity level that are already known to be primary causes of material financial statement errors. Controls in place to mitigate these statistically predictable risks are then documented and specifically linked to the risks identified. Management must decide whether to mitigate the significant risks identified using controls, share or transfer risks using vehicles like outsourcing and/or insurance, accept the risk, or avoid the risk entirely. Residual risk status, including current detected error rates, is identified, documented and assessed by both management and auditors.</p> <p>Auditors are entitled and expected to adjust their audit approach to fully compensate for any retained ICFR residual risks the company has decided to accept. In severe cases where the ICFR systems in place exhibit levels of residual risk totally unacceptable to the company's auditor, they have the right and ability to refuse to provide an opinion on the company's financial statements and/or resign from the engagement.</p> <p>Well-run and tightly controlled companies will be rewarded with a lower cost of capital and significantly lower audit fees relative to companies that prepare poor quality ICFR assessments and/or accept higher levels of ICFR residual risk.</p> <p><b>IMA's top-down/risk-based ICFR framework is included as Attachment 1 to this letter with greater detail available at:</b></p> <p><a href="http://www.sec.gov/comments/s7-11-06/s71106.shtml">www.sec.gov/comments/s7-11-06/s71106.shtml</a></p>

<i>Issue #3/Impact</i>	<i>What Needs to Change</i>
<p><b>The draft financial statement and ICFR “quality bars” are set too high, resulting in high cost without a commensurate increase in investor protection.</b></p> <p>Current SEC and PCAOB regulations require management produce draft financial statements with zero material defects for their external auditors or risk being publicly labeled in SEC filings as having “ineffective” ICFR. This is a complex issue that is directly linked to Issue 4 below. We believe that retaining the audit opinion on control “effectiveness” combined with the high quality bar on draft financial statements and ICFR is a dangerous mix.</p> <p>It is important to note that zero material defects is a level of draft financial statement quality and ICFR that is not currently expected, or required, by capital market regulators anywhere else in the world, including Canada, the UK, Europe or Japan. While zero material defects in ICFR and financial statement drafts prepared by management is a laudable “goal”, we believe that it is a level of perfection that will result in the U.S. being at a competitive global disadvantage relative to countries viewed as having similarly reliable corporate governance systems without this requirement.</p> <p>In January, 2007 the McKinsey Report “Sustaining New York’s and the US’ Global Financial Services Leadership” study referenced the UK regulatory approach of discussing (draft) issues constructively and not penalizing companies for proactively coming forward with a potential issue; by contrast, in the U.S. “executives by and large are hesitant to raise even minor problems with regulators for fear that simply broaching the subject will lead to immediate enforcement action or, worse yet, a highly charged public prosecution”.</p>	<p><b>Allow companies to have ICFR systems that are less expensive than zero material defect systems. Require, via specific PCAOB auditing standards, that auditors adjust their work to fully compensate for control deficiencies identified by management and, in cases where management’s ICFR assessment work was not rated as fully reliable, their own supplemental ICFR analysis. Auditors should publicly report on the reliability of management’s ICFR assessment process (see Issue 4).</b></p> <p>We believe that the primary goal of management’s assessment of ICFR should be to clearly identify and candidly report areas of significant residual risk (using robust quality management systems) to the company’s audit committee and external auditors. Using this type of approach external auditors audit and report on the reliability of the risk and control assessment <u>process</u> maintained by management.</p> <p>Auditors are required to modify the scope and extent of their substantive audit work to compensate for any areas of residual risk currently being accepted by the company’s management and audit committee. Any errors identified in the draft financial statements by the company’s auditors must be corrected by management prior to filing the accounts with the SEC. The frequency and magnitude of auditor detected errors in drafts prepared by management should be an important input to auditor opinions on the reliability of management’s ICFR assessment process.</p> <p>A Glass &amp; Lewis research study published in June 2005 provided clear evidence that literally hundreds of U.S. public companies claimed to have fully effective disclosure and ICFR systems right up to the point in time auditors had to provide an opinion on the reliability of their assessment work. At that point in time management, under the zero material defect rule, had to acknowledge material ICFR deficiencies existed. Good regulation should result in providing <u>positive</u> incentives to management to be candid and proactive in identifying issues in the financial statement drafting process.</p>

<i>Issue #4/Impact</i>	<i>What Needs to Change</i>
<p><b>Misapplication of what we believe was Congress’ intent in Section 404 (b), resulting in external auditors duplicating management’s accountability for controls testing and assessment.</b></p> <p>Section 404 (b) of the Act states: “With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer ...”.</p> <p>We do not believe that it was the intent of Congress to require that a company’s auditor provide their own subjective view on whether control is or is not “effective”. IMA research and other studies demonstrate that current ICFR standards and frameworks are not mature enough to produce repeatable conclusions on controls effectiveness. In other words, we do not believe that any framework is “fit for purpose” in terms of the SEC’s four suitability criteria which include repeatability, sufficiently complete, free from bias and relevance.</p> <p>Revenue generation opportunities combined with a litigious environment provide tangible incentives for auditors to “raise the control bar”.</p> <p>While this is a contentious issue, we fully support what we believe is the true intent of 404 (b) – an independent report on whether management is taking the responsibility assigned in section 404 (a) seriously and conscientiously.</p> <p>There is growing support for IMA’s stance on this issue: 1. Global regulatory regimes that have carefully studied the U.S. SOX regime and chosen not to include the audit opinion on effectiveness (e.g., Japan, Canada and the U.K.), 2. The public position taken on the issue by the Institute of Internal Auditors, and 3. The comment letter from The Alamo Group, a \$400M accelerated filer.</p>	<p><b>Eliminate the costly and subjective audit opinion on controls effectiveness but retain/strengthen the audit opinion on management’s assessment process in the context of a true risk-based approach.</b></p> <p>Our basis for this recommendation is that current frameworks are not fit for purpose in making the pass/fail effectiveness conclusion, the process is costly and inefficient, it de-emphasizes management’s accountability, and further increases the enormous litigation exposure of auditors (passed on to management in the form of higher fees). Additionally, an audit of management’s (true) risk-based assessment process is more likely to uncover fraud (<u>leading</u> indicator of material weakness vs. <u>lagging</u> indicator of controls effectiveness).</p> <p>We recommend instead that the company’s auditors audit and report on whether the company’s management “has conformed, in all material ways, with SEC requirements to complete a top-down/risk-based ICFR assessment and reported the results to the company’s audit committee and to us, the company’s external auditors”. This process would include careful analysis of residual risk status (the risk remaining after considering risk treatments) by both management and external auditors.</p> <p>It is important to note that the need for a redefined Section 404 (b) is building globally. Preliminary evidence suggests that, unfortunately, in countries where there is a requirement that management publicly report on ICFR – but, without a requirement for the auditor to report on the quality of that work – some companies do very little formal assessment work to support their public representations. The situation is even worse in countries that have no mandatory requirements for management to assess and report on ICFR. Canadian securities regulators have explicitly acknowledged this very real risk and are currently monitoring the situation to determine if corrective steps are necessary.</p> <p>We believe that audit opinions issued should reference the revised SEC guidance for management as the benchmark.</p>

<i>Issue #5/Impact</i>	<i>What Needs to Change</i>
<p><b>The draft regulations are still not practical or scaleable for smaller public companies.</b> (“SPCs”)</p> <p>As one example, control structures capable of achieving zero material defects in draft statements are very expensive - money that is often better directed in SPCs to growing the company and producing increased shareholder value. All four issues described above disproportionately impact smaller public companies.</p> <p>It is important to note that the AICPA in the U.S. and audit standard setters in countries like Canada, the UK and Europe continue to believe and assert, correctly or otherwise, that auditors can produce a level of audit opinion quality and reliability on financial statements on par with SOX audit opinions without the use of a SOX-like assessment of ICFR. Investors are not currently being explicitly told that there is any differential in audit opinion quality on audited financial statements (e.g., non-accelerated vs. accelerated, public companies vs. private, etc). There is currently no empirical research we are aware of that validates the premise of differential audit quality.</p> <p>The recent study commissioned by the City of New York prepared by McKinsey &amp; Company has recommended that U.S. listed SPCs be allowed to “opt out” of current PCAOB audit requirements but be required to make conspicuous disclosure of the risks that come with less emphasis on ICFR and potentially lower audit opinion reliability. We respectfully do not agree with the study suggestion that SPCs be allowed to opt out of SOX because of the implications of a “grade B” audit opinion, but we do understand the motivation.</p> <p>It is important to note that the U.S. government has, itself, not adopted a requirement that auditors provide opinions on the effectiveness of ICFR in federal departments and agencies at this point.</p>	<p><b>We believe that if all four primary issues above are addressed “disproportionate <i>benefits</i>” will accrue to smaller public companies:</b> one set of assessment rules with management in the lead; a practical and scalable risk assessment process; and, setting the quality bar for material defects in financial statement drafts at a reasonable level combined with auditors opining on the assessment process (and not the pass/fail subjective audit opinion on effectiveness).</p> <p>In addition to generally increasing the practicality of the SOX rules through the reforms we are proposing, the skills and tools necessary to complete true risk-based/top-down assessments can be used in companies of all sizes and types not just for ICFR. They can be applied to other key areas like product quality, customer service, safety, cost control, revenue generation and other areas key to longer term business success. This helps improve the overall ROI of a true risk-based approach for all types of organizations.</p> <p>With due respect to the preeminent committees that have examined this issue, we do not believe that any public company should be exempted from section 404(b) of the Act but do believe the interpretation of the section should be redefined. Investors should be provided with information on the quality of the assessments prepared by management – a very good indicator of ICFR assessment skill and “tone at the top”. This should include assessments made on the quality of operations driven by a robust QMS (Quality Management System). The mantra “building quality in” better enables sustainable financial reliability.</p> <p>Additional research on audit opinion reliability with, and without, ICFR assessment and audit assurance on management’s ICFR assessment process should be initiated by the SEC, PCAOB, and/or the AICPA as soon as possible. If audit opinions produced under the SOX reporting regime prove to be no more reliable than Canadian or UK audit opinions that do not require similarly costly audit assurance on ICFR, Congress should reevaluate the cost/benefit of section 404(b).</p>

IMA solutions-oriented resources available to practitioners include:

1. **IMA Research Study:** "Internal Control: COSO 1992 Control Framework and Management Reporting on Internal Control: Survey and Analysis of Implementation Practices", Professor Parveen Gupta, LLB, Ph.D.
2. **IMA Discussion Paper:** "A Global Perspective On Assessing Internal Control Over Financial Reporting" submitted to the SEC 9/15/06.
3. **IMA Statement on Management Accounting:** "Enterprise Risk Management: Frameworks, Elements and Integration" released January 17, 2007. Professor William Shenkir, Ph.D., CPA, Professor Paul L. Walker, Ph.D., CPA. A second SMA focused on ERM Tools and Techniques ("how to") will be available in the early Spring of 2007.


The IMA is a global organization representing a diverse constituency and as such the observations and recommendations in this letter are meant to have broad application in the private and public sectors in countries around the world. This comment letter went through a formal exposure process with the IMA membership.

We would be pleased to assemble our senior team (including practitioners) and provide further details on the issues we have identified and corrective actions we have recommended. As always, the IMA stands ready to share transformational solutions to SOX 404 implementation that protect and grow shareholder investments, allow company management to get on with the business of doing business, and restore U.S. global competitiveness for sustained long term growth.

Sincerely,



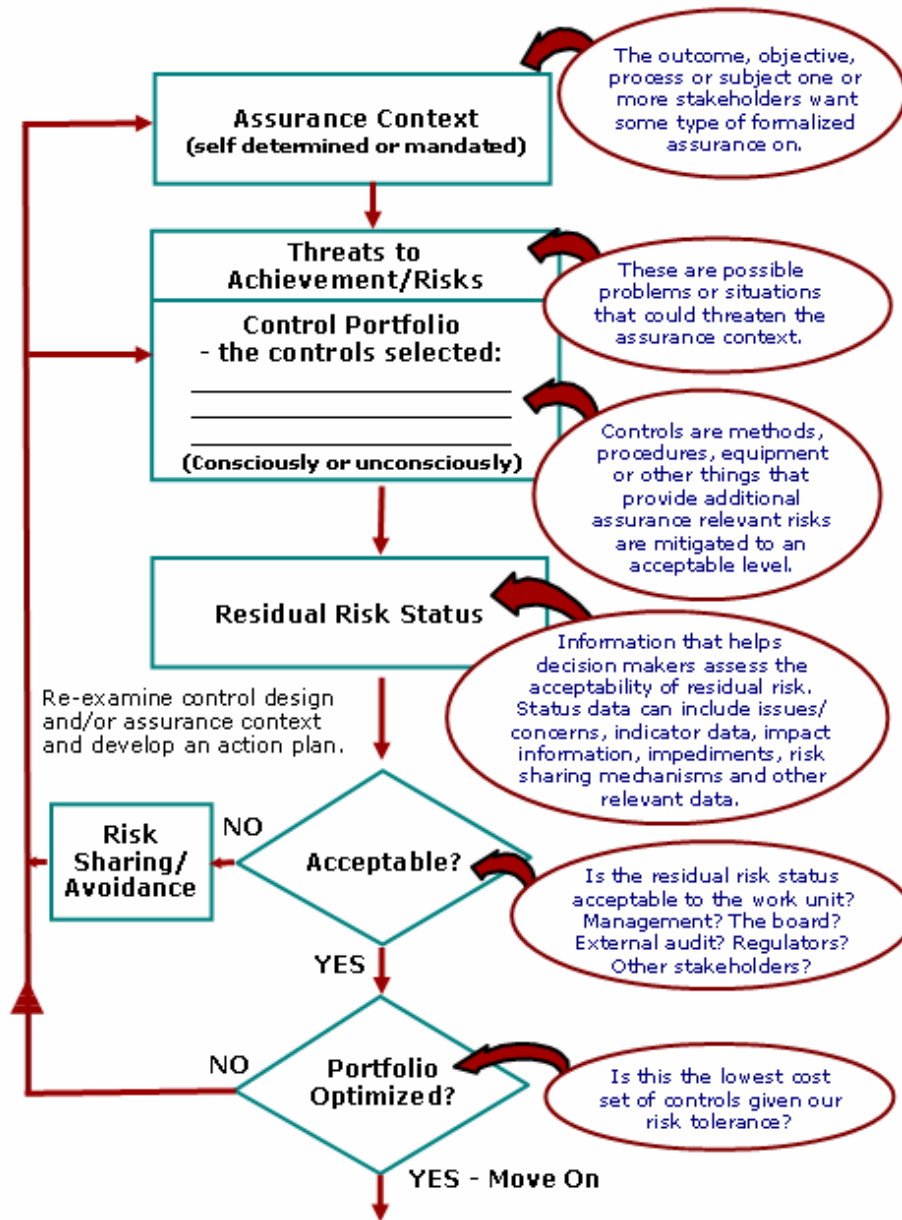
Paul A. Sharman, ACMA  
President and CEO



Jeffrey C. Thomson  
Vice President of Research & Applications Development

Attachment 1 – IMA Global Risk-Based Framework

**Core Components of a Risk-Based Approach**



Attachment 2

**IMA Technical Analysis & Commentary**  
**SEC December 2006 Exposure Draft for Comment**  
***Management's Report on Internal Control over Financial Reporting***

Organized in ascending page order – IMA selected topic headings

**PRIMARY AIM OF THE INTERPRETATION**

**SEC Draft Guidance:**

Page 1 SUMMARY section states “The interpretive guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of internal control over financial reporting”.

**IMA Analysis/Comment:**

With respect, this draft does not accomplish that aim, at least in terms of methods and terminology generally used and understood in risk management.

The words “top-down/risk-based” have been used frequently in guidance issued by the SEC and PCAOB over the past 3 years. A major problem appears to be definitional – what do the SEC authors actually mean by the term “top-down/risk-based”? What is clear from a detailed analysis of the document is that when the term “top-down/risk-based” is used, it is not consistent with globally accepted risk management assessment methods or standards, or in the sense described in the 2004 COSO ERM framework.

Although there are no references anywhere in the guidance that discloses the source of the SEC/PCAOB interpretation of the term “top-down/risk-based”, the evidence suggests that the term has been interpreted primarily drawing from traditional U.S. audit literature and guidance issued over the past 30 years. If a guess was to be ventured as to the primary interpretation source, it appears to most closely align with notions espoused in how to evaluate “audit risk”, the risk of giving an incorrect audit opinion, and the type of steps that should be done during the audit planning phase. Auditing methodologies in use today have not in any significant way adopted internationally accepted approaches to risk management, approaches that focus heavily on determining risk likelihood and consequence, and careful, formal monitoring of the status and acceptability of residual risk. Litigation risk related to adopting a true risk management approach to audits may be at the root of the non-adoption of true risk management methods.

The IMA discussion paper filed in September 2006 in response to the SEC Concept Release proposes a specific market-tested, risk-based ICFR assessment approach that is scalable for organizations of all sizes. An extract from that document that describes the core elements of a risk-based approach that is aligned with global risk management standards appears as Attachment 1 of the primary IMA comment letter this detailed analysis supports.

## **SEC ON FLEXIBILITY ALLOWED**

### **SEC Draft Guidance:**

On page 4 it states "Instead of providing specific guidance regarding the evaluation, we expressed our belief that the methods of conducting the evaluation of ICFR will, and should, vary from company to company and will depend on the circumstances of the company and significance of the controls. We continue to believe that it is impractical to prescribe a single methodology that meets the needs of every company....Management must bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and provides reasonable assurance for its assessment. This proposed guidance is intended to allow management flexibility to design such an evaluation process."

### **IMA Analysis/Comment:**

While the intent of this declaration to allow extensive flexibility and judgment is good, the reality is that, under the current SEC/PCAOB rules, it is the external auditor who decides whether a company's ICFR gets a "passing grade". As a result, the level of flexibility offered by either the current or proposed SEC rules is significantly undermined by the fact that management teams that want a pass on ICFR from their auditors must conform to the more granular and prescriptive PCAOB rules.

## **SUITABLE ICFR EVALUATION FRAMEWORK**

### **SEC Draft Guidance:**

On page 5 it states "In order to facilitate the comparability of the assessment reports among companies, our rules implementing Section 404 require management to base its assessment of a company's internal control on a suitable evaluation framework. ....the Commission identified the Internal Control-Integrated Framework created by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") as an example of a suitable framework". The SEC's Advisory Committee On Smaller Public Companies (SPCs) contradicted the SEC stated view that COSO 1992 is suitable, at least for smaller public companies, when they stated "unless and until a framework for assessing internal control over financial reporting is developed that recognizes their characteristics and needs" they requested an exemption from Section 404.

As far as we are aware, subsequent to the release of the COSO SPC guidance in final in June 2006, the conclusion of the Advisory Committee members on the existence of a suitable assessment framework for SPCs has not changed.

**IMA Analysis/Comment:**

The IMA research report “COSO 1992 Control Framework and Management Reporting on Internal Control Survey and Analysis of Implementation Practice” concluded that COSO 1992 was not designed to meet, nor does it satisfy in a demonstrable way, the “suitability” criteria defined by the SEC. Those suitability criteria are consistent quantitative/qualitative conclusions, absence of bias, comprehensive coverage, and suitability for ICFR. The IMA is a founding member of COSO and has identified the “suitability” for SOX issue to the other members of COSO. Other companies and individuals that have responded to the SEC and PCAOB have also concluded that COSO 1992 is not suitable in isolation as a primary framework to conduct ICFR assessments for SOX.

Other countries around the world, including Canada, the UK and Japan, through their actions, have similarly concluded that existing tools and frameworks are not sufficiently advanced to support the requirements for management and auditor reporting on ICFR defined by the SEC. An FEI research study completed in 2005 on material weakness deficiency reporting also identified the fact that few, if any, registrants were reporting control deficiencies and specifically identifying the relevant COSO framework category or criteria that links to the material weakness or significant deficiency identified. It is important to note that nowhere in PCAOB AS 2 does it define specific audit steps to evaluate a management claim that their ICFR controls are effective in accordance with COSO 1992 or any other control framework. To date, there has been no official acknowledgement of the growing body of evidence, including the rigorous IMA research study, that refutes that COSO 1992 actually meets the specific assessment framework suitability criteria defined by the SEC.

**WHO DECIDES WHETHER CONTROL IS “EFFECTIVE” OR NOT?**

**SEC Draft Guidance:**

On page 8 it states “In response to this feedback, the Commission and its staff issued guidance on May 16, 2005, emphasizing that management, not the auditor, is responsible for determining the appropriate nature and form of internal controls for the company as well as their evaluation methods and procedures”. On page 10 it states with respect to U.S. Government Accountability Office report “That report stated that management’s implementation and evaluation efforts were largely driven by AS No. 2 because guidance was not available for management.”

**IMA Analysis/Comment:**

The intent of the May 16, 2005 SEC guidance is commendable. However, the reality is, under the current rules, auditors are responsible for providing an independent, subjective, parallel opinion on control “effectiveness”, as well as an opinion on management’s assessment. The new draft SEC and PCAOB rules recommend that the audit opinion on management’s assessment be dropped, but the subjective, parallel direct report audit opinion on ICFR retained. This means that, in reality, if the approach used by management does not fully conform to the assessment approach prescribed in PCAOB AS 2, there is a significant risk that the auditor will arrive at a conclusion on control effectiveness which differs from that of management. IMA research clearly indicates the vast majority of companies used PCAOB AS 2 during the first three reporting periods as their primary assessment guidance. We are not aware of a single company in the world that attempted to complete their ICFR assessment using SEC guidance and COSO 1992 in isolation of the granular and prescriptive requirements in PCAOB AS2. The potential that parallel, but different, “how to” ICFR assessment guidance will produce unnecessary complexity and confusion has been identified as a major issue in the main body of our comment letter.

**MANAGEMENT SHOULD USE ITS OWN EXPERIENCE AND JUDGMENT**

**SEC Draft Guidance:**

On page 14 it states “Management should use its own experience and informed judgment in designing an evaluation process that aligns with the operations, financial reporting risks and processes of the company”.

**IMA Analysis/Comment:**

Again, although this is good in theory, the reality is quite different. Management teams that want to minimize ICFR opinion variation risk will base their assessment and evaluation on PCAOB rules and the particular views on what controls must be in place.

**MANAGEMENT FLEXIBILITY REEMPHASIZED**

**SEC Draft Guidance:**

Pages 15 and 16 repeat the contention that management has significant latitude in deciding how to go about assessing and reporting on ICFR and states the approach should be “top-down, risk-based that allows for exercise of significant judgment so that management can design and conduct an evaluation that is tailored to its company’s individual circumstances.”

It goes on to state “This guidance describes a top-down, risk-based approach to this principle, including the role of entity level controls in assessing financial reporting risks and the adequacy of controls.”

**IMA Analysis/Comment:**

We reiterate that flexibility is, in reality, limited to whether management has followed the same steps their auditors will apply in arriving at their parallel, independent and subjective opinion on ICFR. Although the words “top-down, risk-based” are used, it does not state that the exercise should start by identifying and assessing the major risks that are already known to have resulted in materially wrong financial statements and specifically linking the controls in place in the company to mitigate those risks. Informal polls conducted in locations in the U.S. and other countries around the world with SEC registrants confirm that only a very few companies during the first two reporting cycles actually listed major risks at the entity level and specifically identified what controls, if any, were in place to mitigate them. This methodology deficiency was done with the full knowledge and support of their external audit firms on the basis that the current SEC and PCAOB rules do not require this step be done by either management or auditors. It is not clear that the new draft guidance corrects this major deficiency.

**IDENTIFYING FINANCIAL REPORTING RISKS AND CONTROLS**

**SEC Draft Guidance:**

Page 21 states “The evaluation begins with identification and assessment of the risks to reliable financial reporting (i.e. materially accurate financial statements), including changes in those risks.” What is missing in the current draft guidance is any form of tangible guidance how this step should be done at the entity level, subsidiary level, and account/note levels. On page 23 it goes on to state “Management uses its knowledge and understanding of the business, its organization, operations and processes to consider the source and potential likelihood of misstatements in financial statement elements and identifies those that could result in a material misstatement to the financial statements.”

**IMA Analysis/Comment:**

The importance of the entity level risk identification and assessment step, combined with the high frequency this step was not done by either management teams or auditors in many of the ICFR assessments performed to date, suggests that there is a still a major void in the draft SEC and PCAOB guidance. Risk management specialists have recognized that the experiential/brainstorming approach to risk identification that draws solely on participant experience and knowledge, in isolation, regularly produces seriously deficient lists of significant risks.

Given that the dominant entity-level risk in the major scandals to date, including Enron, WorldCom, HealthSouth, Parmalat, Nortel and many others has been “CEO/CFO direct inappropriate accounting entries be booked”, it would seem to make sense that regulators offer this as a specific example of a real-life, high probability/high impact risk. Other examples of significant entity level risks include “CFO/Controller not current on technical GAAP reporting rules”, “CFO/Controller not technically current and up to date on all applicable tax rules”, etc.

The SEC should, without too much work, be able to provide a list of the top ten statistically probable risks that have resulted in materially wrong financial statements. The guidance could then indicate that, at a minimum, these known statistically probable high consequence risks should be identified, assessed for applicability in the specific business sector, and documented as entity level risks. It isn't clear why the guidance appears to go to some lengths avoiding simply stating that statistically probable risks should be documented, likelihood/consequence assigned, and the controls in place, if any, that mitigate the risk identified and evaluated. There is no real guidance offered in the current exposure drafts on how this critically important step should be done, other than referencing management experience, a method which is globally known, if used in isolation, to produce incomplete risk assessments in a significant number of cases.

Some of the globally accepted methods to ensure the completeness and reliability of the risk identification step outlined in the September 15, 2006 IMA discussion paper “A Global Perspective on Assessing ICFR” filed with the SEC include the following:

**1. Loss/Incident Approach** – This uses internal error tracking to identify relevant risk or risks that were key to control failures that have been detected by management, internal and external auditors and others. This is now a mandatory step required by the Basel II reforms for all banks around the world. In practice this would mean systematically creating 3 to 5 years of situations where errors were identified in draft financial statements by the company's auditors – both material and immaterial. These “defects” are analyzed for patterns and trends and root cause and correlated factors identified. There is a huge body of experience globally emerging how to execute this critical risk-based step. The quality movement has an impressive body of knowledge on how defect analysis is key to process improvement.

**2. Risk Source Approach** – This method uses a “risk source” framework that helps the people doing the assessment to ensure they have considered all the key risk sources and evaluated applicability to their circumstances. Examples of risk sources include such things as suppliers, technology, employees, human behavior, customers, economics, contractual, regulators, and others. The September 15, 2006 IMA Discussion Paper “A Global Perspective on Assessing ICFR” provides specific illustrations of a risk source framework. Attachment 1 to this comment letter provides a process summary of IMA's risk-based framework.

**3. Inverse Control Approach** – This method focuses on risks that flow from the non-use of particular controls. An example in accounting would be “employees lack the necessary knowledge/skill” or “employees have not completed a reliable risk assessment”. Control frameworks like COSO and CoCo in Canada identify capability controls as part of an integrated framework. The absence of a particular type of control may be a risk. An example of an inverse control approach in the home environment related to fire safety would be “No smoke detectors are installed”. The real root risk is that a fire in the house has started but occupants are not aware of it.

**4. Brainstorming/Experiential Approach** – This approach is unstructured and draws on the experience and knowledge of participants. The broader and more complete the experience the better the list of risks that have already happened. The approach when used in isolation has a high failure rate in terms of producing reliable lists of all significant risks.

**5. Visualization/process mapping** – This approach requires participants to formally trace the steps involved in an activity/process and to use that knowledge to identify points or steps that may involve risks. This is a very time/labor intensive method but can yield good results.

**6. External Research** – This approach draws on identifying what has already been learned about risks and risk vulnerability in a particular business sector or activity. Vendors such as Audit Analytics and Compliance Week provide detailed tracking of material weakness disclosures of all U.S. listed companies. Problems that impact on more than a few companies in a specific business sector should be specifically examined for applicability in others. Again, the Basel II reforms for banking have made external benchmarking a mandatory risk management process for all major banks around the world.

## **WHAT DOES “ADEQUATELY ADDRESS” MEAN?**

### **SEC Draft Guidance:**

On page 25 the guidance states “the objective of this evaluation step is to identify controls that adequately address the risk of misstatement for the financial statement element that result in a material misstatement in the financial statements.”

### **IMA Analysis/Comment:**

Although the statements in this section are technically correct they could be stated in a clearer way and better convey just how difficult this step is in practice. An example to illustrate the challenge follows:

**Risk:** The CFO directs improper entries to manage period profits in order to maximize personal gains under the company’s stock option/bonus system. Risk likelihood rating – low (over the entire population of public companies but not necessarily in specific companies); Risk consequences rating – severe.

### **Mitigating Controls:**

1. Audit committee reviews financial statements prior to release.
2. Company maintains a concerns reporting hotline that is reviewed and responded to by internal audit.
3. Company has a code of conduct that stresses the obligation of the company to report reliable financial statements.
4. Internal audit department completes an audit of the financial statement close process on a 3 year cycle.

Extending this example to the “residual risk” step a hypothetical residual risk status for a sample company could be as follows:

External auditors identified 3 to 6 material errors in the draft financial statements prepared under the direction of the CFO in each of the previous four fiscal periods. These errors had to be corrected prior to the auditors signing the financial statements. 30% of the errors identified by the auditors were attributed to controllership GAAP knowledge/skill deficiencies, 30% were attributed to flawed transaction processing control design at the subsidiary level, and 40% were attributed to conscious acts and decisions on the part of senior management to manage profit to meet earning forecasts through selective and, at least in the opinion of the company’s auditors, inappropriate interpretation and application of GAAP rules. No process is currently used by management or auditors to document, track, and analyze errors detected over time. Management has regularly reported in response to a range of internal audit findings that they are prepared to accept the risk. Few, if any, external audit firms have formal IT systems in place that systematically log and analyze cause of accounting errors detected during the substantive audit phase of the audit over multiple fiscal years.

It is important to note that neither the SEC or PCAOB current or draft guidance indicates that there is any requirement for management or auditors to formally document and monitor residual risk status. Residual risk is a key element of virtually all generally accepted risk management standards in use around the world.

In practice, the ICFR controls in place always result in some level of residual risk which is more or less acceptable to any given combination of stakeholders. The “RISK-BASED” illustration above would be a fairly common status description, especially in non-accelerated filers. In many cases, subjective views by management and/or auditors on whether a given combination of controls will produce the desired results are proven by the passage of time to be wrong.

There is at least preliminary evidence that many of the companies that are under investigation for accounting errors related to stock option accounting have CEOs and CFOs who have regularly certified that the company has effective disclosure and ICFR controls and at least some received “effective” control ratings from their auditors prior to the disclosure of the problem. Monitoring of changes in residual risk status, including detected error rates found by external audit and management,

reduces the enormous subjectivity in the vast majority of ICFR assessment methods in use today for SOX.

## **IT GENERAL CONTROLS AND RISK**

### **SEC Draft Guidance:**

On pages 27 and 28 there is a discussion of the role of IT general controls and it states on page 28 "For purposes of evaluation of ICFR, management only needs to evaluate those general IT controls that are necessary to adequately address financial reporting risks."

### **IMA Analysis/Comment:**

Although there is a general reference to risk and risk-based, the reality is that IT general controls in the context of SOX should be defined as controls in place to address a specific class of risks that do, or could potentially, threaten the reliability of the financial statements. Relevant IT general controls risks include "Fraudulent modification of program code", "Unauthorized modification of data used in the calculation/preparation of accounting entries", and "Logic and/or calculations performed by computerized accounting systems are technically flawed and/or wrong". The main reason to evaluate what are generally known as IT General Controls is to determine if there are specific controls in place and functioning that are effective enough to mitigate the type of risk described above below a level of residual risk that is currently set in AS 2 at "less than a remote likelihood" and is proposed to be in the draft guidance less than "reasonably possible".

The guidance makes no reference to how to apply a "risk-based" approach to evaluating the effectiveness of IT general controls. In reality, a simple but radical way to test IT general controls is to have a person with strong computer skills attempt to modify key accounting programs and/or data and assess if he/she is successful and whether the controls are strong enough to detect the change. Risks in this area should include the risk that a person working in the IT department that has high level access rights attempts to make unauthorized changes to data or program code undetected. Very few companies submit their IT general controls to this level and harsh type of effectiveness evaluation. In the absence of this type of "real life risk" evaluation, conclusions arrived at as to whether controls are, or are not, effective, while still useful, are inherently subjective.

## **GUIDANCE DOES NOT EXPLICITELY REQUIRE RISK OR RESIDUAL RISK INFORMATION BE DOCUMENTED**

### **SEC Draft Guidance:**

On page 28 it outlines documentation requirements and states that "management must maintain reasonable support for its assessment". Nowhere in this section does it explicitly state that management needs to document relevant risks to reliable financial statements at the entity, subsidiary or account/note levels, or maintain any

documentation related to management's assessment of the likelihood or consequence of the risks identified.

Considerable attention is paid in the draft guidance to the need to document controls. The words "risk characteristics" are used but there is no direct requirement to document risks that threaten the reliability of the accounts at the entity or subsidiary levels. It goes on to state on page 30 "Evidence about the effective operation of controls may be obtained from direct testing of controls and on-going monitoring activities".

**IMA Analysis/Comment:**

Although there is a reference to "monitoring activities" nowhere does it state that management needs to determine the current actual detected error rate related to specific accounting line items or note disclosures in the company's draft financial statements. Control evaluation in the total absence of a focus on the actual error or defect rate is inherently subjective. Current ICFR assessment methods in use during the first three rounds of SOX reporting have shown a high effectiveness conclusion failure rate.

The IIA in its guidance on issuing audit opinions indicates that auditors should be very cautious issuing pass/fail audit opinions in areas where the assessment criteria are open to wide interpretation by knowledgeable experts. A Glass & Lewis study clearly indicated that literally thousands of companies reported having effective ICFR controls right up to the time of their first 404(b) audit report under effective disclosure reporting rules. At that time the auditors determined during their audit that there were material errors in the financial statements that required correction.

Under the current PCAOB rules detection of a material error in the draft statements generally forces management to indicate ICFR controls are ineffective and disclose one or more material weaknesses. It is assumed that in the hundreds of cases identified in the Glass & Lewis research study neither management or auditors had concluded based on their ICFR assessment prior to the time the financial statement defects were found that there were any reportable control deficiencies.

**DETERMINING THE SUFFICIENCY OF EVIDENCE**

**SEC Draft Guidance:**

The diagram on page 32 provides a useful guide in terms of where the most persuasive evidence should be obtained by management. It uses the term "misstatement risk of financial reporting element". Presumably this diagram can apply to the whole of the financial statement filings with the SEC or specific accounts and notes. The x axis is labeled "risk of control failure". If this table was applied to the very real risk that the CEO and CFO often, if not always, have significant financial incentives to manage and/or manipulate profit, it would suggest this risk should be scored as a top right quadrant risk. The controls to manage this very real and

significant risk include the audit committee diligence and competency, confidential concerns hotlines, likelihood and severity of sanctions if caught, and others.

Although SEC ICFR rules do not allow it to be counted in control assessment work or evaluated as to its sufficiency, in reality, the highest impact control to mitigate this specific risk is the ethics and competency of the specific external audit team assigned to audit the financial statements prepared by management.

**IMA Analysis/Comment:**

This table is, in fact, at the root of a significant amount of inefficient work done to date. The table correctly suggests that the most evidence should be obtained on the controls in place to manage the really serious, statistically probable, entity-level risks that are already known to have been at the root of major financial scandals and auditor opinion failures. It is not a stretch to conclude that this means that the most persuasive evidence should be gathered on the diligence and competency of the audit committee, and the competency, ethics, and quality assurance controls of the company's external audit firm.

Research done by FEI on control deficiency reporting during 2004 and 2005 indicates that either 1) virtually all audit committees of U.S. public companies are "effective" as key controls, or 2) explicit SEC and PCAOB requirements to complete this step and sound risk management principles that call for the most rigorous assessment and most persuasive evidence should be gathered on the truly key controls are not being complied with. Given numerous studies undertaken around the world over the past 20 years cast serious doubt on the 100% effective audit committee option, the evidence points to the conclusion that audit committees are not being rigorously assessed in terms of their role as a key control. The reason is simple - it is too dangerous from a career perspective for insiders to complete the step in a rigorous way and it requires external auditors evaluate the very people that have hired them – the audit committee.

In the case of evaluating the likely effectiveness of the external auditor as a control, the current rules do not allow this form of assessment to be completed or counted in SOX reviews. Because it is the external auditor that is currently being asked to form an independent subjective view on management's controls, this would also mean that the external audit would be required to report on management's assessment of their own competency, ethics and quality assurance system. This of course would be a major conflict of interest and under the current rules is impossible to complete as a step for a variety of reasons. This point means that by definition, the current rules do not adequately address, at least in a true risk-based way, one of the most significant risks that have led to major financial misstatements – senior executive directed financial statement fraud.

**ASSESSING CONTROL EFFECTIVENESS – SUBJECTIVE/OPINION-BASED VS FACT-BASED ASSESSMENT**

**SEC Draft Guidance:**



On pages 35-38 there is considerable discussion of examining the operation of controls but very little discussion of evaluating and measuring risks as a key precondition to deciding on the likely effectiveness of the current control design and operation. The words “residual risk” are not used anywhere during this discussion. A key element of residual risk is the current “defect or error rate” or, stated another way, the frequency and magnitude detected where the controls in use did not result in reliable financial statements.

**IMA Analysis/Comment:**

In any true risk-based approach the process starts by identifying and assessing risks that threaten the specific “assurance context” being evaluated. For SOX, the macro assurance context is that the financial statements at the consolidated entity level are reliable. This must then be cascaded down to account and note level at the consolidated level and on down to the entity level at significant subsidiaries, if any, that make up the consolidated statements. Only after this step is completed should the controls, or “risk treatment” mechanisms in risk management vernacular, be identified. Once controls in place have been identified and tested to confirm a correct understanding of the risk mitigation strategy it is essential to then take steps to determine the residual risk status. Residual risks are risks that remain after considering the risk treatment steps taken.

For ICFR this is comprised of risks where there were either no controls identified or the controls are not expected to fully mitigate the risk(s) identified in whole or part, as well as the current performance level and error rate being produced by the controls in place. In the case of ICFR, this is comprised of errors, both large and small, detected by external auditors during their audit, errors detected by management both before and after public release of the statements, errors detected by tax authorities and others after financial statements are released, results of comparisons of management estimates made to actual results that occurred in subsequent periods, and other key information.

This approach to evaluating control effectiveness is considered to be “fact-based” as opposed to approaches that are primarily “subjective/opinion-based”. Unfortunately, under the current rules, the vast majority of ICFR assessments being done currently are regulator endorsed subjective/opinion-based. One way to get a sense of the current failure rate of ICFR assessment methods currently in use is to measure the frequency that both management and auditors conclude ICFR control for a specific account or note disclosure is “effective” during their ICFR assessment, versus the frequency that auditors identify material defects in the accounts and notes during their audit of the financial statements provided by management.

Research conducted by the FEI and Glass & Lewis indicates that current subjective/opinion-based ICFR assessment methods have a relatively high failure rate. Limited research, if any, is being done to carefully and systematically identify and track management or auditor ICFR effectiveness prediction accuracy.

**EVIDENTIAL MATTER TO SUPPORT THE ASSESSMENT**



**SEC Draft Guidance:**

Pages 38 and 39 outline the evidential matter necessary to support a conclusion.

**IMA Analysis/Comment:**

Although flexibility in the required assessment approach is a positive attribute from a management perspective, this section, in light of the considerably more granular requirements in the PCAOB standard, provides limited practical help. If management does not approach the ICFR assessment in the same way required by the PCAOB standard the possibility of a control effectiveness conclusion different than that arrived at the company's external auditor increases. The guidance would be greatly improved if it simply stated minimum expectations at the entity, account, note and subsidiary levels. A table for this purpose would be a much better vehicle to communicate this information. It should be possible for the authors to simply review each of the "how-to" sections in the guide and summarize the minimum data that is expected to be assembled. There is no indication that there is any expectation that fact-based residual risk/ICFR system performance data should be obtained and stored on file to provide fact-based conclusions on ICFR effectiveness.

**MATERIAL WEAKNESS EVALUATION**

**SEC Draft Guidance:**

Pages 41 to 46 discuss how to grade control deficiencies including specific guidance on what constitutes "strong indicators" of a material weakness.

**IMA Analysis/Comment:**

While this guidance is a major improvement over what was previously available for management, it still misses a key point that is relevant to users of the information. Research done by the FEI and Glass & Lewis indicates a considerable number of the material weaknesses are being disclosed as a result of auditors finding material errors in drafts prepared by management. This situation is classed as a strong indicator of a material weakness. The list on page 45 includes the following strong indicator:

*Identification by the auditor of a material weakness in financial statements in the current period under circumstances that indicate the misstatement would not have been discovered by the company's ICFR.*

A simple way of expressing where the draft financial statement quality bar is currently set is to simply indicate that "The ICFR controls in place must be capable of preventing a material error in the draft financial statements provided to the company's external auditors. If your assessment indicates that there is at least a reasonable possibility that a material error will be present in the draft financial statements provided to the auditors, the situation must be identified and reported as a material weakness."

The issue of where the draft financial statement quality bar is set for all companies currently is identified as a major issue in the main body of the IMA comment letter. The current rules in use and those contained in the SEC and PCAOB exposure drafts require management produce draft financial statements with zero material defects or face the consequences that flow from publicly reporting that the company has an ineffective ICFR system. This is a quality level that is far beyond that in any other country in the world today and a far more stringent level of internal financial reporting quality than is currently being produced by the majority of smaller public companies. The fact that current and proposed SEC and PCAOB rules require zero material defects in financial statement draft or be labeled as having an ineffective ICFR system will, in all probability, continue to fuel objections from U.S. SPCs, and add fuel to the movement to de-list and/or list securities in countries with lower draft financial statement quality requirements (i.e. lower than zero material defects). At this point there is no empirical research that examines whether the current U.S. rule of zero material defect in draft financial statements or publicly disclose an ineffective ICFR system produces a higher audit opinion reliability rate than that in other countries.

## **PROPOSED RULE AMENDMENTS**

### **SEC Draft Guidance:**

On page 51 it states “an evaluation conducted in accordance with the interpretative guidance issued by the Commission, if the Commission adopts the interpretative guidance in final form, would satisfy the annual management evaluation required by those rules. The proposed amendments would not limit the ability of management to use its judgment to determine the method of evaluation that is appropriate for its company. The proposed amendments would be similar to a non-exclusive safe-harbor in that they would not require management to conduct the evaluation in accordance with the interpretative guidance, but would provide certainty to management that choose to follow the guidance that it has satisfied its obligation to conduct an evaluation for purposes of the requirements in Rules 13a-15(c) and 15d to-15(c).”

### **IMA Analysis/Comment:**

Given that the proposed guidance calls for the auditors to do a separate and independent assessment of ICFR following the procedures in the new PCAOB standard, it would appear to make little practical sense for management to do their analysis in accordance with any rules other than the assessment rules the auditor must follow. We are very concerned that this situation may make the entire SEC document largely redundant. This point is identified as a major issue in the main body of IMA’s comment letter.

## **INDEPENDENT AUDITOR OPINION ON ICFR**

### **SEC Draft Guidance:**

On page 52 it states “Therefore, we are proposing to revise Rule 2-02(f) to require the auditor to express an opinion directly on the effectiveness of ICFR”.

**IMA Analysis/Comment:**

There is no discussion in the draft of the significant groups, including the IMA and IIA and small accelerated filers (e.g., Alamo Group response letter January 3, 2007), that have publicly disagreed with the SEC’s interpretation of section 404(b). IMA research indicates that current ICFR assessment frameworks are inherently subjective and that no control frameworks currently available meets the four specific suitability criteria defined by the SEC. The SEC’s own SPC advisory board indicated “unless and until a framework for assessing control over financial reporting for such companies is developed that recognizes their characteristics and needs, provide exemptive relief from Section 404 requirements of the Sarbanes-Oxley Act”. The SEC position that the Act calls for a subjective and public opinion from external auditors on whether a company’s ICFR framework should be assigned a pass/fail rating amplifies the negative impacts flowing from the current rules. This issue is identified in the IMA primary response letter this detailed analysis supports as a major issue.

**SIGNIFICANT ALTERNATIVES**

**SEC Draft Guidance:**

On page 64 it indicates that “The Regulatory Flexibility Act directs us to consider alternatives that would accomplish stated objectives, while minimizing any significant adverse impact on small entities.”

**IMA Analysis/Comment:**

There is no evidence at this point that the SEC has considered in any serious way two major alternatives that are open to it.

These are:

1. Actually allow and encourage companies to use globally accepted risk management assessment methods such as those outlined in international risk standards, COSO ERM and the discussion paper the IMA filed with the SEC in September to meet the requirements of Section 404 (see Attachment 1 to this comment letter for a process summary of IMA’s risk-based framework). Such an approach would focus on entity level risk identification and assessment and residual risk monitoring to significantly greater extent than the current SEC/PCAOB control-centric rules. This type of approach would require “fact-based” evaluation of control effectiveness as opposed to current criteria which are predominantly subjective, particularly as they relate to analysis of “entity-level controls”, fraud prevention/detection controls and IT general controls.
2. Require that auditors provide an opinion on the reliability of management’s assessment process drawing on well developed and accepted process auditing

methodology used in the quality profession instead of the current path of requiring a subjective, independent auditor opinion on ICFR using different assessment guidance than that offered to management.

It is not clear why these alternative approaches have been rejected as no explanation for rejecting them has been offered to date.

## REFERENCES

1. "A Global Perspective On Assessing Internal Control Over Financial Reporting, Discussion Draft for Comment", Institute of Management Accountants, September 2006.
2. "COSO 1992 Control Framework and Management Reporting on Internal Control: Survey and Analysis of Implementation Practices", Parveen P. Gupta, LLB, Ph.D., Institute of Management Accountants, 2006.
3. "Enterprise Risk Management: Frameworks, Elements and Integration", William Shenkir, Ph.D, CPA and Paul Walker, Ph.D., CPA, Institute of Management Accountants, 2006.
4. "Control Deficiency Reporting: Review and Analysis of Filings During 2004", Parveen Gupta, L.L.B., Ph.D, Tim Leech , FCA·CIA·IT, CCSA, CFE, Financial Executives Research Foundation, 2005.
5. "Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission", Herbert S. Wander and James C. Thyer Committee Co-Chairs, April 23, 2006.
6. "Sarbanes-Oxley: A Practical Guide to Implementation Challenges and Global Response", Sally Chan CMA, ACIS, Parveen Gupta L.L.B, Ph.D., Tim Leech FCA·CIA·IT, CCSA, CFE. 2006.
7. "Control Deficiencies – Finding Financial Statement Impurities: Analysis of the 2004 and Early 2005 Deficiency Disclosures", Glass, Lewis and Co. LLC, June 2005.

Attachment 3

**IMA Technical Analysis and Commentary  
PCAOB RELEASE No. 2006-007 (ASX/5) 12/19/06**

Organized in ascending page order – IMA selected topic headings

**PROCESS EFFICIENCY**

**PCAOB Draft Standard:**

Page 3 states “the Board has evaluated every significant aspect of the audit of internal control to determine whether the existing standard encourages auditors to perform procedures that are not necessary in order to achieve the intended benefits”.

**IMA Analysis/Comment:**

We appreciate the paragraphs in the draft standard that are devoted to explaining the position taken on whether the Act calls for an audit of management’s ICFR assessment versus an independent and subjective audit opinion on ICFR. However, there is no indication that the PCAOB or SEC have examined the impact of their choice on the overall cost of compliance. There is also limited indication that the PCAOB has formally considered what a “top-down/risk-based” ICFR approach would look like based on globally accepted risk management standards such as those in AS/NZ 4360 or COSO ERM.

**GENERAL IMPROVEMENTS TO THE STANDARD**

**PCAOB Draft Standard:**

Page 4 states that the proposals are designed primarily to:

*Focus the audit on the matters most important to internal control*  
*Eliminate unnecessary procedures*  
*Scale the audit for smaller companies*  
*Simplify the requirements*

**IMA Analysis/Comment:**

To achieve these laudable goals, IMA suggests that the current draft be changed to require that management and auditors identify, document and assess the statistically probable macro level risks that are already known to be the cause of materially wrong financial statements. If the goal is to eliminate unnecessary procedures it would seem reasonable to focus on the highest likelihood/biggest consequence risks to unreliable accounts and notes.

If the draft standard is intended to scale for smaller companies one can question why this revision retained a standard that requires management produce draft financial statements with zero material defects or face having to report they have ineffective controls over financial reporting overall. If a key goal is to simplify the requirements one has to question why the draft standard does not simply direct auditors to use the same “how to guidance” management must use to assess and report on ICFR.

## **PCAOB ON TOP-DOWN**

### **PCAOB Draft Standard:**

Page 5 states “When using a top-down approach, the auditor identifies the controls to test by starting at the top – the financial statement and company-level controls – and linking the financial statement elements and company-level controls to significant accounts, relevant assertions, and, finally, to the significant processes where other important controls reside. Following the top-down approach helps the auditor focus the testing on the right controls – those controls that are important to the auditor’s conclusion – while avoiding those that are outside of the scope of the audit of internal control. In a top-down approach, if company-level controls are strong and link directly to process-level controls, or if they are sufficiently precise to prevent or detect material misstatements to relevant assertions, the auditor **will likely** be able to reduce the testing of controls at the process level.”

### **IMA Analysis/Comment:**

This paragraph is indicative of a fundamental problem in the guidance – it is not, in reality, risk-based or top-down by globally accepted risk management standards. Nowhere in the words above does it say the auditor should start by identifying the high level risks that are already known to be the major causes of major financial statement errors in U.S. listed companies and then, only after that step is done, identify the high level controls in place, if any, to mitigate them. Without first identifying and documenting entity level risks, any attempts to document company level controls will be less focused and efficient than it could be. Key entity level risks include CEO/CFO directed manipulation of earnings, CFO/controller staff not current/knowledgeable on GAAP treatment, a senior management reward system that offers massive incentives to falsify earnings, CFO/controllership knowledge of applicable tax rules, etc.

## **PCAOB ON RISK-BASED**

### **PCAOB Draft Standard:**

Page 7 states “The proposed standard on auditing internal control, therefore, requires risk assessment at each of the decision points in a top-down approach. The auditor’s identification of significant accounts and relevant assertions requires an understanding of the related risks and how those risks should affect the auditor’s decision making.

Importantly, the proposed standard makes clear that the evidence necessary to persuade the auditor that a control is effective depends on the risk associated with the control.”

**IMA Analysis/Comment:**

Although this paragraph admirably gives credence to the notion of “risk-based” assessment, it doesn’t actually say that the auditor should either evaluate the completeness of the risks identified and documented by management. Nor does it indicate that the auditors themselves **must** identify and document relevant risks together with their assumptions regarding the likelihood and consequence of those risks and then document and test the specific controls in place, if any, to mitigate the risks identified.

**PCAOB ON RISK TOLERANCE**

**PCAOB Draft Standard:**

Page 12 states “Sometimes, however, the auditor may find that the company evaluated the significant deficiencies and reasonably determined under the circumstances not to correct them. When that is the case, the proposed standard would allow the auditor to conclude the control environment is effective and that no material weakness exists.”

**IMA Analysis/Comment:**

In smaller public companies this comment begs the question “What if the deficiency is that the accounting staff lack the technical knowledge or skill to properly account for the transaction and management is fully aware of this deficiency and has previously relied on their external auditor to compensate?” An analogy would be a GP doctor that recognizes he or she is not qualified for brain surgery and refers their patient to a specialist. Many small and even large companies identify areas and transactions that they don’t feel confident dealing with to their external auditor. The auditors source the necessary expertise to provide direct assistance up to, and including, identifying the necessary accounting entries to handle the transaction properly. If this paragraph is taken literally, what does the auditor do when there are dozens of risk acceptance decisions that have been made and communicated to him/her by management where management knows and candidly acknowledge that their controls in certain defined areas will not prevent a material error in their draft statements?

**PCAOB ON ELIMINATING “UNNECESSARY” PROCEDURES**

**PCAOB Draft Standard:**

Page 14 states “**the proposals would eliminate the requirement to evaluate the process management used to evaluate its internal control**”.

Page 16 states “The Board also believes that the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management’s evaluation process.” On page 17 it states “The proposal eliminates the opinion on internal control on management’s assessment because it is redundant of the opinion internal control itself and because the latter opinion more clearly conveys the same information – specifically, whether the company’s internal control is effective.”

#### **IMA Analysis/Comment:**

The Act states in section 404(b) that “each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer.” It is a question of law whether the SEC and/or PCAOB have the legislative authority to eliminate a step called for by the law on the basis it is “an unnecessary procedure”. The issue of regulatory authority is outside the scope of this comment paper. What is relevant is that the paragraph on page 15 of the draft standard does not acknowledge that a growing number of practitioners, including those represented by the IMA and IIA (nearly 200,000 members combined) have questioned whether the Act intended that auditors provide an independent and subjective opinion on ICFR.

From a technical standpoint it is difficult to understand how sound and fully defensible decisions on how much to rely on management’s ICFR work can be made without doing a reasonably thorough evaluation of whether management’s work can and should be trusted. The draft standard recognizes this when it states on page 16 ***“Although the removal of the evaluation requirement should eliminate unnecessary work, the quality of management’s process is inherently linked to the amount of work the auditor will need to do. For example, the extent of the auditor’s ability to use the work of others will depend on the quality of the company’s annual evaluation process and its ongoing monitoring activities, as well as on the competence and objectivity of those performing the work. For this reason, it will continue to be necessary for the auditor and management to coordinate their respective efforts.”*** One must assume that the PCAOB has decided “coordinate” is quite different from completing audit work to determine if management’s work is reliable and should be relied on. Later in the draft it goes on to emphasize the importance of auditors relying on management’s work and calls for steps to be taken to evaluate how much reliance to place. It is fair to say that our conclusion is that the logic in this area should be revisited.

#### **USING THE WORK OF OTHERS**

##### **PCAOB Draft Standard:**

Page 22 states “the proposed standard would establish a single framework, based on the nature of the subject matter being tested and competence and objectivity of the

personnel performing the testing, for the auditor's decisions about using the work of others (including, but not limited to, internal auditors) as audit evidence....

The proposed standard on using the work of others first directs the auditor to **obtain an understanding of the work performed by others** to identify the activities relevant to the audit. Relevant activities are defined as those that provide evidence about design and operating effectiveness of control over financial reporting or that provide evidence about potential misstatements of the company's financial statements. .... The proposed standard would require the auditor to obtain an understanding of the work undertaken by others to determine how that work might alter the nature, timing, and extent of the work the auditor otherwise would have performed."

**IMA Analysis/Comment:**

It would seem that "obtaining an understanding" is quite different from evaluating and auditing management's assessment process but the distinction in this case appears questionable. It would also seem to imply that at no time does the auditor need to test whether the work product produced by management is reliable. Later the standard talks about evaluating objectivity and competence of the individual staff involved in preparing management's assessment but the draft would appear to suggest that this step can be done without actually verifying the reliability of the work produced.

**SCALING THE AUDIT FOR SMALLER COMPANIES**

**PCAOB Draft Standard:**

Page 28 states "Under the proposed standard, the auditor can use strong company level controls and **financial statement audit procedures** to reduce the level of testing for smaller companies."

**IMA Analysis/Comment:**

What we infer from this statement is that the auditor can count their year end audit work done as a control for purposes of ICFR assessment. This runs counter to core premises in SOX and the SEC and PCAOB standards. The current regulations do not allow management to count virtually anything done by the external auditor as an ICFR control and the AICPA recently issued guidance on that point. This statement also sets the stage for situations where, if the financial statement audit procedures are allowed to be counted as a control by the external auditor in their control evaluation, the auditors would be auditing their own work in arriving at an independent opinion on ICFR, counter to core globally accepted auditing principles.

Our experience is that smaller public companies often rely on and utilizes the expertise and knowledge of their external auditors in areas such as tax provisions, foreign exchange, consolidations, application of complex GAAP (e.g., the new rules on tax provisions), drafting of note disclosures and other difficult/complex areas.

Many smaller companies can ill-afford to retain staff or outside consultants capable of dealing with all complex elements of financial statement accounting and note disclosure.

Another problem is that there is currently an absence of generally accepted methodology to consistently and reliably evaluate company level controls. If there was a reliable entity level ICFR approach it should be capable of producing a specific and repeatable grade on company level controls (i.e., different assessors would arrive at the same conclusions independently). The grade on entity level controls should then drive specific reductions in substantive audit testing, analogous to insurance underwriting wherein the controls in place are evaluated and, subject to the result, premiums are accordingly adjusted (e.g. use of smoke detectors, driver education training for young drivers, etc.). No such reliable and repeatable entity level control evaluation system currently exists anywhere in the world that we are aware of.

## **SIMPLIFYING THE REQUIREMENTS**

### **PCAOB Draft Standard:**

Page 30 states "Taken as a whole, the proposals are intended to simplify the requirements and make them easier to apply while retaining the core principles necessary for an effective audit of internal control."

### **IMA Analysis/Comment:**

While simplification is a laudable goal, the standard should be changed such that the PCAOB directs the external auditor to apply the same SEC ICFR assessment guidance management is instructed to use in arriving at their opinion on ICFR. Using this approach it should be possible to reduce the PCAOB auditing standard to 20 pages or less in length. If this was to occur and external auditors then claim that the SEC guidance is not sufficiently clear for them to arrive at an opinion on control effectiveness, how can management be expected to use the SEC ICFR guidance in isolation? Currently many specialists that have studied the December SEC and PCAOB exposure drafts agree that ASX/5 is considerably more detailed and granular than the SEC guidance for management. Given that auditor must use the PCAOB standard to arrive at their pass/fail opinion on ICFR, it is very likely that PCAOB standard will retain its position as the de facto guidance for management.

## **ASX TABLE OF CONTENTS – CONTROL TESTING DOMINATES; RESIDUAL RISK NOT MENTIONED AT ALL**

### **PCAOB Draft Standard:**

Page A1-2 references in the planning section the topic of "Role of Risk Assessment", however, when the steps to be applied in a Top-Down approach are listed the requirement to identify macro level risks to reliable financial disclosures is absent.

Nowhere in the draft standard is the concept of the auditor identifying and assessing residual risk status ever mentioned.

**IMA Analysis/Comment:**

The new guidance makes no reference to any requirement directing the auditor to identify, using a 3-5 year history, the accounts and notes that have required adjustment prior to audit sign-off to document the history and pattern of prior failures in the company's ICoFR. The draft standard does not emphasize that during the planning stage the auditor should formally analyze and document the company and industry sector's history of restatements and financial statement audit opinion errors. These steps merit being listed as stand alone content topics. When the steps to be taken for a Top-Down approach are articulated, identifying macro level risks is absent as is the requirement that the auditor take steps to identify and assess the residual risk status being produced by the current control design. This would include identifying and assessing "repair entries". Repair entries are accounting entries booked by management after a quarter or year end disclosure related to transactions or balances already publicly disclosed. This includes analysis of such things as comparing the provision for law suits against the actual settlement amounts, provision for taxes against the amounts filed and/or reassessed by tax authorities, provisions for bad debts against actual bad debt experience, etc.

**THE AUDITOR'S OBJECTIVE**

**PCAOB Draft Standard:**

Page A1-4 states "The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the company's internal control over financial reporting."

**IMA Analysis/Comment:**

IMA respectfully believes that the SEC and PCAOB have misinterpreted the true intent of Congress in section 404 (b) of the Sarbanes-Oxley Act of 2002. The Act passed by Congress does not state that external auditors should publicly express an independent, subjective opinion on the company's ICFR. It is also important to note that, at least to the date of this analysis, no other country in the world has accepted the premise that an independent audit opinion on ICFR effectiveness is a practical and viable approach to more reliable auditor certified financial statements.

**THE FRAMEWORK AUDITORS SHOULD USE**

**PCAOB Draft Standard:**

Page A1-5 states "The auditor should use the same suitable, recognized framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting."

**IMA Analysis/Comment:**

If the intent of this section is to direct the auditor to use the framework used by management, there should be no need for the PCAOB document to describe how auditors should complete their parallel independent ICFR assessment. Since the PCAOB has put considerably more granular detail in the draft audit standard than is currently in the SEC exposure draft, it is almost certain management will use the PCAOB guide as the primary guidance. In terms of the use of frameworks like COSO 1992, CoCo, or Cadbury, the IMA research study on the use of COSO published in 2006 provides conclusive evidence that companies have not actually been using COSO 1992 as a primary framework for SOX ICFR assessments.

**PLANNING THE AUDIT**

**PCAOB Draft Standard:**

Page A1-5/6 lists items to be covered including “knowledge of the company’s internal control over financial reporting obtained during other engagements.”

**IMA Analysis/Comment:**

This section does not explicitly require the auditor to create and analyze the pattern of mandatory audit adjustments identified during the last 3-4 audits to provide objective information on where ICFR has failed in the past. Nor does it explicitly require that the auditor obtain information on which financial statement line items and/or notes where other companies in the same business sector experienced major problems, up to and including restatements. Another omission is that the draft does not require the auditors to make inquiries and execute procedures to identify “repair entries” – entries that are correcting account balances or impact on note disclosures that have already been issued. Both types of information are relevant to fully understanding residual risk and are now widely available at a modest cost as a result of technology advances (e.g., use of software like ACL, data bases offered by Auditanalytics.com, Compliance Week and other sources).

**ROLE OF RISK ASSESSMENT**

**PCAOB Draft Standard:**

Page A1-7 states “the auditor should focus the majority of his or her attention on the areas of greatest risk to substantially decrease the opportunity for a material weakness to go undetected”.

**IMA Analysis/Comment:**

Using a risk based approach derived from globally recognized risk management standards this statement should read "the auditor should focus the majority of his or her attention on the biggest risks that threaten the objective of materially reliable auditor certified financial statements".

By far the biggest single risk that caused SOX to be enacted is that senior management's reward system provided massive incentives to distort short-term profits. Although there is no reliable statistical data in this area, a reasonable guess on the second biggest risk is that key accounting personnel lack the necessary skills to produce draft financial statements with zero material deficiencies without external assistance. A third major risk would be that the audit team assigned to complete the audit is not competent and/or objective. A more granular risk than #1 would relate to management initiated frauds related to stock options. A list of the top ten risks that have caused major errors in financial statements could be assembled fairly quickly from what has occurred in the past. Although a list of only the top ten risks wouldn't be enough for a comprehensive ICFR assessment exercise it would focus attention and resources on the really major risks at a fraction of the current costs.

**SCALING THE AUDIT FOR SMALLER COMPANIES**

**PCAOB Draft Standard:**

Page A1-8 states " the auditor should recognize that a smaller and less-complex company often achieves many of its control objectives through the daily interaction of senior management with company personnel rather than through formal policies and procedures."

**IMA Analysis/Comment:**

This may be a statement that recognizes the need for different approaches for SPCs but it doesn't really help an auditor to sign an opinion indicating that, in his or her professional opinion, ICFR control is effective. Our interpretation is that the auditor is staking his or her reputation and that of their firm that there is less than remote chance that management will produce draft financial statements with zero material defects. The reality is that smaller public companies often are less standardized in terms of business processes, contracting, and accounting policy and have a number of other attributes that can make assessing ICFR very difficult.

**USING A TOP-DOWN APPROACH**

**PCAOB Draft Standard:**

Page A1-11 states "A top-down approach begins at the financial statement level and company-level controls, and then works down to significant accounts and disclosures, relevant assertions and significant processes."

**IMA Analysis/Comment:** A true top-down approach should begin with formal identification and documentation of the major risks to the overarching objective of issuing materially reliable auditor certified financial statements.

## **IDENTIFYING COMPANY-LEVEL CONTROLS**

### **PCAOB Draft Standard:**

Page A1-11 states "The auditor must test those company-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting."

### **IMA Analysis/Comment:**

We applaud the PCAOB's efforts to improve the guidance in this area relative to AS2. The emphasis, however, appears to be on creating and testing a checklist of "company-level" controls. This may result in relatively junior audit firm staff equipped with standard questionnaires making inquiries about the company's strategic planning process, budget review process, code of conduct, audit committee performance, etc. Even a fully accredited CPA at the manager level is still relatively inexperienced in terms of assessing the effectiveness of a company's audit committee to detect management malfeasance, the impact the company's performance measurement/reward structure has on financial statement fraud vulnerability, and the company's risk assessment process. The current CPA examination body of knowledge has very little coverage of core risk management principles and global standards or focus on assessing ICFR using risk-based methods. The standard external audit does not generally include much involvement of the audit partner, the most experienced member of the audit team, in the actual field work. Without assessing likelihood and consequence of specific risks and then asking what company-level controls exist to mitigate it, evaluating company level controls lacks focus and can result in inaccurate conclusions on effectiveness.

## **IDENTIFYING SIGNIFICANT ACCOUNTS**

### **PCAOB Draft Standard:**

Page A1-14 states "the auditor should start by considering financial statement line items or captions. When identifying significant accounts, the auditor should evaluate both qualitative and quantitative **risk factors**."

### **IMA Analysis/Comment:**

To be consistent with the intent of this statement, IMA believes that the auditor should identify and document the most significant risks to reliable disclosure (note: the level of risk significance is determined from specific combinations of likelihood and consequence) that threaten the reliability of accounts and notes to the financial statements.

Identifying “risk factors” is not the same as explicitly writing down significant risks and then considering the ability of one or more controls to mitigate the risk. For a risk-based approach to “resonate” with practitioners (SEC/PCAOB approaches), the use of standard risk management principles and generally accepted ISO risk terminology in the proposals is necessary.

Not employing “generally accepted risk principles” may be because so many accelerated filers have already completed their SOX ICFR assessments in the first 3 rounds without much emphasis on formal risk identification, documentation and measurement. There is no indication in SEC or PCAOB guidance that a company using a risk framework like AS/NZ 4360 or COSO ERM would be considered by the SEC or PCAOB to be using a “suitable” framework to assess the reliability of their ICFR system.

The risk identification and measurement step at the entity, subsidiary and account/note levels is a component that should be mandatory, not discretionary, in a true risk-based approach.

## **IDENTIFYING RELEVANT ASSERTIONS**

### **PCAOB Draft Standard:**

Page A1-15 states “For each significant account, the auditor should determine which of these financial statement assertions is a relevant assertion. – Existence or occurrence, Completeness, Valuation or allocation, Rights and obligations, Presentation and disclosure”. It later states “The auditor should determine the likely sources of potential misstatements by asking himself or herself “what could go wrong”? within a given account.”

### **IMA Analysis/Comment:**

The word “assertion” is a traditional accounting term in use for many decades that has no meaning or relevance in the world of risk management. Even experienced auditors, when confronted with a note disclosure like the stock option disclosure, struggle trying to decide which “assertions” are the key ones. The emphasis on “assertion” identification results in the methodology used to assess ICFR being only relevant to accounting. Because the methodology can only be used to assess accounting reliability, companies cannot use the substantial investment they are making to implement SOX as a sound foundation for broader ERM efforts in other relevant areas that require formal assurance (e.g., safety, product quality, customer service, disaster preparedness, etc.).

## **IDENTIFYING MAJOR CLASSES OF TRANSACTIONS AND SIGNIFICANT PROCESSES**

### **PCAOB Draft Standard:**

Page A1-16 states "The controls over major classes of transactions exist within the company's significant processes. Accordingly the auditor should identify the significant processes affecting the major classes of transactions." It goes on to state that the auditor should "Identify the points within the process at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material; Identify the controls that management has implemented to address these potential misstatements....".

### **IMA Analysis/Comment:**

At no point in the bullets that follow this statement does the draft standard explicitly state that the auditor should identify the controls in the processes that mitigate the risks they have identified. The use of the word risk in the guidance is missing.

## **PERFORMING WALKTHROUGHS**

### **PCAOB Draft Standard:**

Page A1-18 states "At the points at which important processing procedures occur, the auditor should question the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions are essential to the auditor's ability to gain a sufficient understanding of the process and be able to identify important points at which a necessary control is missing or not designed effectively."

### **IMA Analysis/Comment:**

This is another illustration where the authors have not explicitly stated that during the walkthrough the auditor should have a list of the key risks clearly in mind that must be mitigated and focus on identifying where in the process or elsewhere those risks are mitigated, if at all. It isn't clear how an auditor can effectively focus only on key controls in the absence of specifically and visibly measuring risks and making the risk/control linkage.

## **SELECTING CONTROLS TO TEST**

### **PCAOB Draft Standard:**

Page A1-18 states "The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the addressed risk of misstatement to each relevant assertion."

**IMA Analysis/Comment:**

This is a good example of the impact on terminology by requiring the use of the term “assertion”. Another way of stating this in a risk based approach is to simply state “The auditor should test the dominant controls that play an important role mitigating the significant risks to the account or note disclosure being evaluated”.

**PCAOB Draft Standard**

Page A1-19 states “The auditor should focus on whether the selected controls, individually or in combination, sufficiently address the assessed risk of misstatement of a given relevant assertion rather than on how the control is labeled....”.

The auditor should link the controls selected to test with the relevant assertions to which they relate.”

**IMA Analysis/Comment:**

To properly assess the effectiveness of the controls in use using a risk management approach one must look at the “RESIDUAL RISK STATUS” that is being produced. A key element of this step is examining the current PERFORMANCE INDICATORS including detected account/note error rate. The standard makes no mention of residual risk identification or analysis as an explicit required step. These are central principles in all globally recognized risk management standards and the Basel II rules related to management of operational risk in banks around the world.

**Attachment 1 to this comment letter provides IMA’s risk-based framework, with more details contained in the 9/15/06 filing to the SEC.**

**TESTING DESIGN EFFECTIVENESS**

**PCAOB Draft Standard:**

Page A1-20 states “The auditor should test the control design effectiveness of controls by determining whether the company’s controls, if operating properly, satisfy the company’s control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.”

**IMA Analysis/Comment:**

This guidance introduces the term “control objective” which sometimes means mitigating a relevant risk but sometimes means an objective to execute a control. The term “control objective” like the term “account assertion” is part of traditional accounting vernacular in use for many decades that has resulted in generally poor predictive results when assessing the true effectiveness of control design.

This paragraph could read "The auditor should assess control design effectiveness by determining whether, in his or her opinion, the controls in place/use are likely to mitigate the risks that could result in a material error in the accounts to a level that precludes even a reasonable chance of a single material error".

## **RELATIONSHIP OF RISK TO THE EVIDENCE OBTAINED**

### **PCAOB Draft Standard:**

Page A1-21 states "For each control selected for testing, the auditor should assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result."

### **IMA Analysis/Comment:**

In globally accepted risk management terms this statement would read something like: "The auditor must first determine whether the control(s) as described/understood is/are capable of mitigating the significant risks identified. Having completed that step, the auditor must test to verify that the control(s) is/are, in fact, being performed as described/understood. The auditor must then evaluate the residual risk status, or the degree the relevant risks are in fact being mitigated and form a conclusion whether the resulting residual risk position could allow a reasonable possibility of even a single undetected material account/note misstatement in draft financial statements."

## **STRONG INDICATORS OF A MATERIAL WEAKNESS**

### **PCAOB Draft Standard:**

Page A1-29/30 states: "The auditor should treat each of the following circumstances as a strong indicator that a material weakness in internal control over financial reporting exists – An ineffective control environment.....

- Restatement of previously issued financial statements to reflect the correction of a misstatement...
- Identification of the auditor of a material misstatement in the financial statements in the current period in circumstances that indicate the misstatement would not have been detected by the company's internal control over financial reporting.
- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

### **IMA Analysis/Comment:**

The IMA research study completed in 2006 indicates that the ability of auditors to assess and assign pass/fail grades to a company's control environment is not at a level capable of producing repeatable conclusions. The absence of agreed pass/fail criteria at a level of detail capable of producing repeatable conclusions is the key reason.

The large number of restatements and companies under investigation for stock option accounting errors supports this conclusion. Further research should be done to determine how many of these companies that have to restate their accounts had received a passing grade on their "control environment" from their external auditors under AS2 rules.

This is the section of the standard that indicates that if the auditor's examination of the accounts and note disclosures reveals even a single material error (NOTE: this could be defined as an error big enough the auditor will not sign-off on the accounts unless management makes the adjustment) they must, with few exceptions, indicate that the company has "ineffective control" in their SEC filing. This zero material defect standard is a level of quality that is more stringent than that applied in any other country in the world and is well beyond the level currently being delivered by literally thousands of U.S. listed non-accelerated filers.

The goal of zero material defects is laudable but may not be practical, especially in smaller public companies. The zero material defect rule in financial statement drafts and throughout the ICFR process is likely at the root of why smaller companies have sought and will continue to seek listings on exchanges in Canada, London and elsewhere. Both exchanges are considered to have generally good corporate governance requirements but neither has a standard that indicates a single material error in draft financial statements require management and/or auditors publicly indicate the company has an ineffective control system.

## **REPORTING ON INTERNAL CONTROL**

### **PCAOB Draft Standard:**

Page A1-36/37 calls for "The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria ..."

### **IMA Analysis/Comment:**

This is at the heart of the debate whether Congress asked for an opinion on management's assessment or whether the auditor, personally, believes that ICFR is "effective". Reduced to the lowest common denominator, the auditor, under the current draft standards, is putting his or her name on the line, stating that they believe that the current controls will not allow even a single material error in the draft financial statements prepared by management. We believe that a significant percentage of U.S. non-accelerated companies that have not yet reported under Section 404 would fail this test. A large percentage of these companies are currently stating under section 302 rules that they have effective "disclosure controls". It is also virtually certain that if the zero material defect in the draft financial statements standard was applied rigorously in Canada, the UK and Europe, thousands of companies would be forced to publicly report they have ineffective internal control systems.

Whether a zero material defects in the financial statement drafts prepared by management is too stringent a quality standard should be carefully researched, including empirical evidence as to whether investors are better protected.

**Donald H. Chapin, CPA  
53 Water's Edge  
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February 12, 2007

**PCAOB Rulemaking Docket Matter No. 021**

Office of the Secretary, PCAOB  
1666 K Street, NW  
Washington, DC 20006-2803

The internal control standard, AS No. 2, was the Board's first substantive standard. The Board recognized that internal control was an essential underpinning for the effectiveness of all other standards, and that AS No. 2 should address control deficiencies that allowed major frauds.

I am disappointed that the proposals both weaken the effectiveness of AS No. 2 and fail to remedy a major shortcoming in how it addressed those control deficiencies.

This is what I believe happened:

Company executives and investment bankers brought intense political pressure on the SEC to reduce regulation and its attendant costs. The SEC unduly influenced the deliberations of an independent Board. And, the Board listened to the expressed concerns of companies without hearing much from investor groups and defenders of the public interest. There was a rush to do something. The accounting firms, who have a strong influence on the Board, appear to have been satisfied by the liability limiting reduction of specific requirements, more reliance on judgment, and no expansion of their duty to detect fraud.

While a number of cost reductions are appropriate, the Board appears to have overdone it, and has not done it in ways that would protect investors from major frauds.

Each of the following underlined deficiencies in the Board's proposals is accompanied by commentary in *italics*.

1. The chance of success of the Board's many good cost saving proposals depends, in part, on improving the "old" general standards of auditing.

In one form or another, the first two improvements suggested below have long been advocated by those concerned with the public interest. Some aspects of the third have been considered by the SAG:

*(a) Auditors should be made professionally responsible to investors, stockholders and creditors, and some additional specific rules to further reduce pro-management bias should be adopted.*

*(b) Auditors' responsibility for the detection of fraud should be strengthened, with sufficient guidance to accomplish this obligation.*

*(c) Auditors' technical training and proficiency requirements should meet today's demands, with guidance on how to develop and manage the required skills.*

*The good judgments required by the Board's proposals, and acquiring all the necessary facts to support them, make the above mentioned improvements in the general standards even more necessary than they were for SAS No. 2.*

2. In making risk assessments more emphasis should be placed on identifying weaknesses in the control environment.

*This is essential for the success of the "top-down, risk based" approach. The proposed required assessments should be expanded to include all the principles of the control environment addressed in a recent COSO report. The proposed assessment process is founded on observable signs and does not, as it should, require follow-up inquires and additional observations or tests of the implementation of any of those control principles that have the potential to contribute to a material weakness in internal control. At this very top level of internal control, auditors should be encouraged to look for significant weaknesses*

*Weaknesses in the control environment have pervasive effects on all other risk assessments. They have a direct effect on the strength of other company level controls, and increase audit risk at all lower levels of control. Contrary to some views, I believe that limited effectiveness of individual control principles that have a reasonable possibility of contributing to a material weakness, if identified, can help focus the audit on particular areas of control weakness. Sometimes, they can help in identifying specific problematic accounts and disclosures.*

3. The proposed standards fail to emphasize that fraud, especially management led fraud, is a far greater control risk than pure error.

*Failure to adopt a fraud risk priority is hard to justify in view of the fact that fraud was the major reason for the passage of Sarbanes Oxley and the creation of PCAOB.*

*Errors in the choice and application of accounting standards do result in material misstatements, but reduction of that risk is helped considerably by the audits of*

*financial statements. A very good proposal with specific requirements that should help to reduce fraud and also help identify misapplication of accounting standards is the proposal for walkthrough of the period-end financial reporting process.*

*But, strangely and discussed later, another proposal reduces the effectiveness of walkthroughs of operations that have the dual purpose of identifying systematic causes of error as well as fraud. The Board's proposal also fails to identify the inherent weaknesses in IT systems that can be used by management to override controls, and IT systems are an integral part of the period-end financial reporting process.*

*Other types of error ordinarily deserve relatively low priority in both audits because it is probable that they cannot be of such size as to constitute a material error. The major exception to this generalization occurs when company level controls are weak, thus opening the possibility of a great number of small errors.*

*I think the benefit of close coordination of both audits should be emphasized more than it has, and guidance that would assist that coordination should be issued*

*The Board should use this opportunity to set more definitive priorities in ways that will both help to make justifiable reductions in audit costs and provide better protection to investors and stockholders from the disastrous losses of major financial statement fraud.*

4. The “top-down, risk based” model is deficient in its failure to correct the major shortcoming of AS No. 2, namely its failure to require an effective evaluation of the ethics and integrity of senior management.

*There is convincing evidence that senior management commits a very high percentage of the frauds that damage investors and stockholders, and that auditors, in large measure, are failing to detect those frauds.*

*Investors and stockholders need auditors to apply an anti- fraud standard that will deter management led frauds as well as detect them, including the new types of fraud that are not now addressed and may not be addressed by PCAOB until long after the damage has been done.*

*To accomplish that, auditors should be required to look for fraud by applying a chain of required processes that start with procedures to appraise senior management's ethics and integrity.*

*I have made a comprehensive remedial suggestion to the Board. It requires that the partner primarily responsible for the audit make a truly informed decision, based on a careful evaluation of the ethics and integrity of senior management, as*

*to whether or not management fraud is reasonably possible. Then, working closely with audit committee and with its agreement and help, it requires inquires whose results would indicate whether of not to conduct more extensive forensic auditing procedures.*

*The details of this suggestion were previously sent to the SEC as well as the PCAOB.*

*Individual audit partners will certainly have liability if they fail to apply the designated processes and fraud is not detected as a result. As I understand it, under the way existing law is being interpreted, auditing firms will probably be exposed to additional liability. But, there is good argument that the firms should not have such liability if they were not complicit in the failure of the responsible individual partners to apply the required processes.*

*Costs of execution of the required anti-fraud processes can be justified by the very substantial reduction of overall audit risk that will permit substantial reductions in other auditing procedures. The benefits of the required processes to investors and the markets are immeasurably great.*

*The procedures of AU 316 (Consideration of Fraud in a Financial Statement Audit) cannot stop management led fraud. AU 316 requires “discussion among engagement personnel regarding the risk of material misstatement due to fraud”, but it does not focus on senior management ethics and integrity. It does not have requirements, as my suggestion has, for specific evaluation processes, decision making, investigative processes and, when indicated, forensic procedures. The need for requirements when it comes to fraud is indicated by recent PCAOB inspections. They found that auditors are not always implementing fraud standards when they should, especially the procedures described in AU 316.*

5. The proposals do not include needed improvements in the audit risk standard (AU 312)

*The AICPA has already adopted changes in this and in a number of other risk related standards in response to recommendations by the former Public Oversight Board’s Panel on Audit Effectiveness. Its new standards mention the need for processes to evaluate risk. I have not had a chance to study their more recently issued implementation guidance, so that I do not know how they suggest applying this requirement.*

*Taken as a whole the Board’s proposals seem to reduce required processes, rather than increase their use to help guide auditor risk assessments. The AICPA guidance should be considered by The Board.*

*Some time ago, that the Board's staff discussed the audit risk standard (AU 312) with the SAG, but no changes have been proposed. And, there is not much in the existing standard about how to make control risk assessments. I can think of questions that might deserve some coverage, e.g. how higher level control evaluations affect lower ones as the auditor works from top to bottom; and whether, or to what extent, attention should be paid to low risk assessments at the bottom in the face of high risk at the top.*

*Risk assessment itself is a risky process, especially when there is limited guidance on how to make these judgments.*

6. Decreased emphasis on the nature and extent of AS No. 2 walkthroughs increases the likelihood of undetected material weaknesses and successful management fraud.

*The impact of the proposed changes goes far beyond what might be thought from just reading the release that accompanies the new proposed standard. They will change what might be considered an audit of transaction flows into a limited review. They will put the auditor more out of touch with what is actually going on, and do not put sufficient emphasis on situations that might accommodate fraud, including controls override.*

*This is one of the most worthwhile parts of AS No. 2, and was written that way because auditors were not finding major fraud and were not looking for it. Managements will object to attempts to go beyond the confines of what is written in this proposal. This is a good example of proposed changes where reliance on auditor judgment to do the right things is unjustifiably risky.*

7. Increased reliance on auditor judgment in lieu of specific requirements in the standards should be coupled with additional evidential requirements and partner level involvement in important judgments

*I do not fully understand what the proposal says about evidence and the use of judgment.*

*It seems to me that evidential requirements for judgments should be similar to those for the audit of financial statements, such as: (a) Auditors should consider all relevant evidential matter, and their judgments should be based on evidence that appears to contradict the company's control evaluation as well as that which supports it, and (b) The evidence for whatever judgment is made should be at least persuasive.*

*Partners should determine what judgments are important, be aware of the evidence for them, and make them. Critical judgments should require concurrence by the partner responsible for the audit and the "concurring partner".*

*But, even if additional evidential requirements coupled with participation by responsible partners were imposed, if auditors act as they have in the past when AICPA standards were in effect, the “principles based” approach applied to this inherently more subjective audit of internal control could contribute to audit failure. The general standards, the audit risk standard and the other standards mentioned in this critique need to be strengthened. Back then, important financial statement audit problems were not always identified by the auditors; and, if they were identified, auditor discussions with management frequently led to waiving “borderline” adjustments and disclosures.*

8. Defining materiality for internal control as the same as materiality for financial statements may serve to continue auditor failures to identify material weaknesses before misstatements occur.

*Materiality for internal control should be determined based in part on what the effects of weaknesses on future financial statements may be, and should always give consideration to weaknesses in company level controls that do not yet relate directly to any particular accounts or disclosures.*

*It should be stated explicitly that identified significant risks of material misstatement that have continuing control implications should always be reported as material weaknesses in internal control, whether or not transactions or adjustments have been identified that could be the result of those risks.*

9. Proposed changes relating to significant weaknesses appear to be problematic; and taken together, they may unnecessarily increase the number of restatements

*(a) A proposed change to stop auditors from searching for significant weaknesses may cause auditors to seek to identify only such control deficiencies that in themselves rise to the level of a material weakness, rather than significant deficiencies that taken together might constitute a material weakness.*

*(b) Defining “significant” as less than material, yet important enough to merit attention by those responsible for oversight of the company’s financial reporting, may limit the deficiencies that are reported in writing to the audit committee, and a result in failure to remedy them on a timely basis*

*(c) Failure to designate a “strong indicator” of a material weakness as at least a significant deficiency should require the auditor to carry the burden of proof that it is not a significant weakness, e.g. have convincing, rather than persuasive, evidence that it is not.*

*(d) The proposal that reported significant weaknesses, uncorrected over a reasonable period of time, may indicate a material deficiency in the control environment is a good concept. But determining whether or not they should be considered as components of a material weakness at later date is overly dependent on good judgment at a time of stress when the basis for the initial reasoning and evidence for it may not be clearly remembered. As written, the proposal will not force the discussion with management and the audit committee as to whether the weaknesses are truly significant back to the time when they were first identified. This, and the consequent possible delay in remediation, tends to allow some truly significant weaknesses to continue longer than necessary, and thus unnecessarily contribute to restatements.*

10. The proposals' advice for "scaling" the audit of smaller companies turns the inherent control risks of smaller companies into a control benefit, by stressing the benefits, more than the risks of greater management involvement in the control environment, the monitoring function, etc.

*There is persuasive evidence that smaller companies are more likely to be subject to fraud.*

*Management must have a high level of ethics and integrity to play a positive role in turning the inherent risks of a smaller company into a controls benefit.*

11. The proposal that the auditor needs only to understand management's control evaluation process, rather than evaluate that process, will increase audit risk unless the company's evaluation is a systematic, adequately tested and well documented evaluation.

*If the SEC requires that companies use COSO's Guidance for Smaller Public Companies, as amended to include the anticipated improvement in its monitoring component, the suggested approach could work. But, if the basic COSO framework or some other requirement that is also less susceptible to auditor understanding is prescribed by the SEC, then the proposal will increase the difficulties auditors face in determining weaknesses in controls' design and effectiveness.*

12. Major problems in applying the proposed standards should be expected.

*The "top-down, risk based" audit and its application in a "principles" based standard will be difficult to implement. Similar approaches in the past were unsuccessful. Even if strengthened as I have suggested, it will need interpretive guidance and more competent audit teams.*

*Large auditing firms using the knowledge and experience of their top professional people may be able develop appropriate interpretive guidance before a new standard becomes effective. The guidance will probably reinstate some of the specifics that the proposals seek to reduce.*

*It will take longer to build audit teams with the necessary higher skill levels and mature judgment to apply the standard successfully. Better training, development of existing staff, bringing in people with experience and putting more partners on the job will all be necessary.*

*The problems of smaller firms will be greater, and those will be accentuated by the demand for “scaling”.*

*Audit failures will be high in what is likely to be a long shakedown period.*

### **Conclusions:**

The Board has used a flawed “top-down, risk based” approach and encouraged the use of audit judgment in a “principles based” proposal in ways that will substantially increase the risk of audit failure.

The proposal does not cure an important existing shortcoming in AS #2, and fails to make changes in other existing standards that are important adjuncts to an effective internal control standard.

All the effects of the proposal are difficult to comprehend.

I think the comment period should be extended to allow time for investors and their representatives to understand it and express their concerns, so that all the necessary amendments can be considered, and hopefully made.

Sincerely yours,

Donald H. Chapin

End Note:

I am submitting a copy of this critique to the cognizant Congressional Committees as a supplement to my report dated January 3<sup>rd</sup> titled “Fraud Related Auditing Standards are Inadequate”.

Investors and their representatives can obtain an E-mail copy of the January 3<sup>rd</sup> report, by sending a request to [DonChapin@gmail.com](mailto:DonChapin@gmail.com).

# COUNCIL OF INSTITUTIONAL INVESTORS

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## Via Email

February 13, 2007

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

*Re: PCAOB Rulemaking Docket Matter No. 021*

Dear Sir or Madam:

I am writing on behalf of the Council of Institutional Investors (“Council”), an association of more than 130 public, corporate and union pension funds with combined assets of over \$3 trillion. As a leading voice for long-term, patient capital, the Council believes that Section 404 of the Sarbanes-Oxley Act of 2002 has been critical in restoring investor confidence and the overall integrity of the United States (“US”) capital markets and welcomes the opportunity to comment on the Public Company Accounting Oversight Board’s (“PCAOB”) proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements And Other Related Proposals* (“Proposal”).

We believe that effective internal controls, long required of public companies by the Foreign Corrupt Practices Act of 1977, are the backbone of high quality financial reports. All companies tapping the public markets to raise capital, regardless of size, should have appropriate controls in place and management should be responsible for assessing those controls with meaningful review by external auditors.

Section 404 is improving companies’ internal controls. A recent study revealed that the number of restatements filed by large public companies, which adopted Section 404 in 2004, fell by nearly twenty percent in 2006, the first such decline since 2001.<sup>1</sup> By contrast, the number of restatements by smaller public companies with a public float of less than \$75 million, companies that have yet to adopt Section 404, increased in 2006 by forty-two percent.<sup>2</sup>

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<sup>1</sup> David Reilly, *Restatements Still Bedevil Firms*, Wall St. J., February 12, 2007, at C7.

<sup>2</sup> *Id.*

In May 2006, following our participation on the US Securities and Exchange Commission (“SEC”) and PCAOB Roundtable on Second-Year Experiences with Internal Control Reporting and Auditing Provisions, we provided several broad-based recommendations to the SEC and PCAOB.<sup>3</sup> Those recommendations were designed to “preserve the investor protections provided by Section 404”<sup>4</sup> while addressing those legitimate concerns raised by some parties about certain difficulties and costs<sup>5</sup> in implementing the Section 404 requirements. They included the following:

. . . *The PCAOB should offer clarification for and/or amendments to Auditing Standard No. 2 while maintaining the underlying principles behind the standard.* Although Roundtable participants appeared to be in agreement about the importance of maintaining the principles espoused in AS2, anecdotal evidence suggests some auditors have yet to fully embrace the related May 2005 Questions and Answers and Policy Statement issued by the PCAOB, specifically the guidance on using the work of others and producing integrated risk-based audits taking into account the scale, scope, and complexity of the companies operations. . . . The Council also supports additional guidance from the PCAOB to address remaining implementation problems and, if deemed helpful, integration of that guidance and the May 2005 Questions and Answers and Policy Statement into AS2.

. . . The Council recommends that guidance tailored to the unique issues faced by smaller . . . audit firms be issued.<sup>6</sup>

The Council believes the Proposal is largely responsive to the Council’s recommendations and we strongly support its prompt adoption and implementation as a final standard.<sup>7</sup> We also offer the following brief comments on four areas addressed in the Proposal that are of particular interest to investors.

### **Scaling the Audit for Smaller Companies**

On average, Council members have more than fifty percent of their US equity holdings invested in indexed funds, including significant investments in the Russell 3000 stock index. Moreover, the evidence indicates that smaller public companies are especially prone to misstatements and restatements of financial information.<sup>8</sup> Thus, an audit of the internal control of the generally riskier smaller public companies is as important to our members and many other investors as an audit of the internal control of larger public companies.

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<sup>3</sup> Letter from Ann Yerger, Executive Director, *The Council of Institutional Investors*, to The Honorable Christopher Cox, Chairman, *U.S. Securities and Exchange* and The Honorable Bill Gradison, Acting Chairman, *Public Company Accounting Oversight Board* 2-3 (May 17, 2006).

<sup>4</sup> *Id.* at 2.

<sup>5</sup> Of note, Glass, Lewis & Co., LLC., has reported that a review of company filings for the Standard and Poor’s 500 indicates that audit fees as a percentage of revenues *declined* in 2005. Lynn Turner, Remarks at the Duke-ILEP Conference on Reform Proposals of Committee on Capital Market Regulation and U.S. Chamber of Commerce 37 (February 2, 2007).

<sup>6</sup> *Letter from Ann Yerger*, at 2-3.

<sup>7</sup> *Cf.* Letter from Jeff Mahoney, General Counsel, *The Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission* 2-3 (September 14, 2006) (Explaining why a “serial extension of the Section 404 requirements” is not in the best interests of investors).

<sup>8</sup> *See, e.g., Lynn Turner*, at 24.

We generally support the Proposal's guidance on "Scaling the Audit for Smaller Companies."<sup>9</sup> We, however, would respectfully request that the final standard emphasize that a scaled audit for a smaller company does not mean a less rigorous audit. For example, the final standard should explicitly state that a scaled audit for a smaller company does not exempt the audit from *any* of the principles set forth for planning the audit, testing controls, evaluating identified deficiencies, and reporting on internal control.

In addition, we generally support the guidance requiring the auditor to evaluate the size *and* complexity of a company in planning and performing the audit.<sup>10</sup> We would therefore oppose any revisions to the Proposal that would permit the scaling of the audit for smaller companies based solely on the rules-based size limits contained in the final report of the SEC Advisory Committee on Smaller Companies.<sup>11</sup> There is no evidence that we are aware of indicating that the size of a company decreases the risks of misstatement.<sup>12</sup>

### Using the Work of Others

We generally support the Proposal's guidance on "Considering and Using the Work of Others in an Audit."<sup>13</sup> We, however, believe that an excessive use of the work of others in performing an audit of internal controls, particularly using work performed by company management, may weaken investor protection and impair the credibility of the independent audit and regulatory processes. Our support for the proposed guidance is therefore conditioned on the final standard containing a framework for evaluating the persons performing the work that is *no less restrictive* than that currently contained in the Proposal.<sup>14</sup>

For example, we would oppose the removal of any of the proposed factors for assessing the competence and objectivity of individuals performing tests, including the proposed factor that focuses on a company's policies addressing compensation arrangements for individuals performing the testing.<sup>15</sup> As indicated in many of the ongoing stock option backdating investigations, compensation arrangements can erode an employees' objectivity about the quality of, or even the need for, internal controls over financial reporting.<sup>16</sup>

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<sup>9</sup> Proposed Auditing Standard, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, ¶¶ 9-12 (December 19, 2006).

<sup>10</sup> *Id.* ¶ 9.

<sup>11</sup> *Id.*

<sup>12</sup> *Cf.* COSO, Internal Control over Financial Reporting—Guidance for Smaller Companies, FAQ, Item 19 (June 2006) ("Size of the organization does not decrease the need for effective internal control").

<sup>13</sup> Proposed Auditing Standard, Considering and Using the Work of Others in an Audit (December 19, 2006).

<sup>14</sup> *Id.* ¶¶ 10-19.

<sup>15</sup> *Id.* ¶ 15(c).

<sup>16</sup> *Cf. Lynn Turner*, at 13 (Noting that 40 of 225 companies that have announced internal or governmental reviews of stock-option backdating have reported material weaknesses and 99 have reported restatements).

### **Special Considerations for Subsequent Years' Audits**

We generally support the Proposal's guidance on "Special Considerations for Subsequent Years' Audits."<sup>17</sup> We agree that the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision making process for determining the nature, timing, and extent of testing necessary in the current year.<sup>18</sup> Those requirements would appear to be consistent with applying sound professional judgment as part of an audit of internal control.

We continue to strongly oppose any form of rotational testing of sections of internal control.<sup>19</sup> The final standard should be clear that auditors are not permitted to assume that the company's controls are functioning each year without testing them. As we have stated in prior comment letters on this topic, rotational testing

. . . is comparable to telling drivers that the state police will only patrol the interstate on Tuesdays and Fridays. Any such alternative would likely only confuse investors and open the process to problems that could harm the investing public.<sup>20</sup>

### **Clarifying the Role of Materiality in the Audit**

We generally support the Proposal's guidance on "Materiality."<sup>21</sup> We agree with the proposed clarification that the auditor should plan and perform the audit of internal control using the same qualitative principles-based materiality measures used to plan and perform the audit of the annual financial statements.<sup>22</sup>

We would oppose any revision to the Proposal that would establish a rules-based numerical formula, such as five percent of net income, for assessing materiality in the audit of internal control. Numerical thresholds for materiality in the context of financial reporting have been extensively studied by many parties over many years.<sup>23</sup> We note that the SEC,<sup>24</sup> the Financial Accounting Standards Board,<sup>25</sup> and the US Supreme Court<sup>26</sup> have all reached generally consistent conclusions indicating that investors are best served by a qualitative principles-based approach to materiality.

In conclusion, we applaud the PCAOB on developing a thoughtful proposed standard that is responsive to the recommendations of the Council. We look forward to a prompt adoption and implementation of the Proposal as a final standard. Investors have long demanded, and have long deserved, a full and cost effective implementation of the requirements of Section 404 by all companies—large and small—that access the public markets.

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<sup>17</sup> *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, ¶¶ 65-69.

<sup>18</sup> *Id.* ¶ 65.

<sup>19</sup> Letter from Jeff Mahoney, General Counsel, *Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission 5* (September 14, 2006).

<sup>20</sup> *Id.*

<sup>21</sup> *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, ¶¶ 14-15.

<sup>22</sup> *Id.* ¶ 14.

<sup>23</sup> See, e.g., SEC Staff Accounting Bulletin: No. 99 – Materiality, 17 C.F.R. § 211 (August 12, 1999).

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 3.

<sup>26</sup> *Id.*

February 13, 2007

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The Council appreciates the opportunity to comment. We would be happy to respond if you have any questions or need additional information.

Sincerely,

A handwritten signature in black ink that reads "Jeff Mahoney". The signature is written in a cursive, flowing style.

Jeff Mahoney  
General Counsel

UNIVERSITY OF ILLINOIS  
AT URBANA-CHAMPAIGN



**Department of Accountancy**

College of Business  
360 Wohlers Hall  
1206 S. Sixth Street  
Champaign, IL 61820

February 14, 2007

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

Dear Sir/Madam:

The purpose of this letter is to provide commentary regarding PCAOB's AS 5 Exposure Draft (PCAOB Release 2006-007). At the outset, I want to state that I find many of the proposed changes in the AS 5 Exposure Draft to be beneficial—particularly the risk-based approach to control testing and the clarifications regarding the role of materiality in planning tests of controls. In particular, the materiality discussion in the AS 5 Exposure Draft should help remove some apparent inconsistencies for planning tests of controls in AS 2.

However, I have concerns related to two groups of issues: 1) the elimination of the auditor's attestation regarding management's control evaluation process coupled with a lack of guidance to auditors in reviewing management's testing process and 2) the proposed change in guidance to auditors who discover material misstatements during the audit. Both changes have been justified based on cost-benefit considerations. However, irrespective of whether these proposed changes save costs, I believe that the Sarbanes-Oxley (SOX) Act of 2002 will be weakened. I am fearful that the proposed changes may encourage a return to the aggressive financial reporting environment existing prior to SOX. In short, I believe that the negative impact on the reliability of financial statement information from these two changes will outweigh any potential cost savings that might accrue. For this reason, I do not believe that these two changes are in the public interest and I would strongly encourage the PCAOB to reconsider their position. In the following paragraphs, I enumerate my concerns and attempt to present arguments against these proposed changes.

**Elimination of Attestation regarding the Adequacy of Management's Tests**

The Sarbanes-Oxley Act (SOX) of 2002 requires management to perform an evaluation of disclosure controls on a quarterly basis and to evaluate all other controls having a material impact on financial statements on an annual basis. Currently, PCAOB Audit Standard 2 requires the auditor to perform an attestation on management's evaluation process that culminates in the expression of an opinion as to whether the auditor believes that management's evaluation process was adequate in scope and whether the auditor concludes that management's evaluation of the control system fairly presents.

The PCAOB, in the AS 5 Exposure Draft, has recently proposed the elimination of this attestation based on three arguments. The first argument, attributed to comments received from registrants (see page 15 of the AS 5 Exposure Draft) is that, "commentators have expressed concern that auditors were performing detailed testing, such as retesting items tested by management." A second, supporting argument (see page 15) is that, "auditors are inappropriately dictating how management should perform its evaluation." The third and main argument advanced by the PCAOB is that, eliminating the auditor's attestation regarding the adequacy of management's tests, will simplify the auditor's control report and eliminate unnecessary audit test work.

Regarding the first argument against attestation, I would agree that retesting management's work would appear to be excessive. However, one reason that this retesting problem may have occurred is that PCAOB's AS 2 currently provides extremely limited guidance to auditors in performing an attestation on the adequacy of management's tests. Rather, than abandoning the attestation entirely as proposed in the AS 5 Exposure Draft, I would encourage the PCAOB to provide auditors with better guidance in this area. Similarly, the alleged problem of the auditor's dictating to management how controls should be tested can be traced to the absence of guidance being provided to management by the SEC. Thus, AS 2 became (by default) the only guidance available to management. Fortunately, the SEC has responded to this problem by recently issuing new guidance to management in performing their evaluation process.

The central argument advanced by the PCAOB for dropping the attestation, however, is to eliminate unnecessary costs. Implicit in the PCAOB's argument is the assumption that the information being provided (to both the auditor and, ultimately, to financial statement users) from the attestation process is essentially redundant and, thus, does not provide benefit commensurate with its cost. On page 16, the AS 5 Exposure draft goes even further by stating that, "the Board also believes that the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process."

I take issue with the PCAOB's position for several reasons. First, if the auditor's attestation were to be dropped, financial statement users will be deprived of assurance that management has actually fulfilled its control testing obligation under SOX. As I argue below, this has the potential of undermining registrants' compliance with SOX. Second, the PCAOB's position fails to recognize the potential information being provided to the auditor about the effectiveness of controls. I contend that, even if the

attestation report on management's testing process were to be eliminated, auditors still should have reason to evaluate the adequacy of management's testing process. An important component of the COSO framework currently used in evaluating controls includes regulatory compliance. Failure on the part of management to test its controls adequately would lead to a high risk of violating SOX. Furthermore, inadequate testing would also be a strong indicator of a bad "tone at the top" and/or incompetent internal auditing--both indicative of a weak control environment. Thus, the evaluation of management's testing process can provide the auditor with potentially strong evidence regarding management's commitment to maintaining an effective control system and also evidence regarding the capability of the internal auditors who are likely to perform many of the tests on behalf of management. Such an understanding of the control environment is of critical importance in implementing the "top-down" risk assessment perspective now being advocated (an overarching objective of the AS 5 Exposure Draft.) Thus, my response to question 14 (see page 18) of the Exposure Draft is that the auditor cannot perform an effective audit of internal control within the COSO framework without evaluating the quality of management's testing process.

Perhaps an even more serious concern is that the AS 5 Exposure Draft is virtually silent regarding the importance of reviewing management's testing process when evaluating the control environment (see paragraphs 19 and 20). Thus, if the separate attestation requirement were to be removed, there is no reason to believe that auditors following the guidance in the AS 5 Exposure Draft would necessarily perform an in-depth review of management's testing process.

The close parallel between the control evaluation process used by management and the auditor during the past three years may have created the appearance of redundancy and also contributed to the perception by some managers that auditors are dictating how their controls are to be evaluated. However, this parallel structure is unlikely to continue in the future. Indeed, the recent SEC guidance encourages management to develop their own control testing approaches rather than simply following the auditor's guidance in AS 2—a recommendation that I fully support. An important point to keep in mind is that the testing objectives of management are somewhat different from those of the auditor. To ensure that the effectiveness of controls is maintained consistently throughout the period, it is important that management evaluate the performance of its controls on an ongoing basis. Ideally, management's control evaluation process should not be a once-a-year test performed over a narrow time interval like the external auditor's evaluation process. Rather, it should be a continuous, ongoing process that ensures that any control weaknesses are promptly brought to the attention of management and remediated at interim subject to cost-benefit considerations. Absent an ongoing control evaluation process by management, there is no assurance that interim (quarterly) financial statements and disclosures will be reliable. The auditor's attestation report on management's evaluation process should provide assurance to users and regulators that management is in fact performing its fiduciary responsibility of monitoring control effectiveness on an ongoing basis and, in particular that management has performed quarterly evaluations of disclosure controls as required by SOX.

A further argument in favor of retaining attestation is that the auditor's evaluation process drives expectations and, thus, exerts a strong motivational effect on management and internal auditors to get their testing "right." The rigorous and timely testing by management and the internal auditors, in turn, will motivate employees who perform control activities to be more careful and attentive to their responsibilities when they know that their performance is being evaluated. Furthermore, rigorous and timely testing by management makes it more likely that any existing control problems will in fact be identified and, thus, helps to strengthen the overall effectiveness of the control system. If the external auditor's evaluation and report on management's control evaluation were to be eliminated, management may not have the same incentives to test its controls as rigorously or as frequently as is now the case. Thus, the auditor's evaluation of management's control testing process not only enables the auditor to obtain a deeper understanding of the control environment—it also has the potential to help motivate management and, in turn, client employees to maintain a strong control environment.

While I have argued that the auditor's evaluation of management's control testing process is important in encouraging compliance with Section 404 for all corporations, the testing of management's evaluation process is likely to be of critical importance in the future. As the 404 requirements are gradually extended to a wider group of firms, smaller firms will become subject to 404 requirements. Smaller firms are less likely to have the same degree of internal audit capability as larger firms and, thus, are likely to derive an even greater benefit from having their control testing process evaluated than would larger, more mature firms. Thus, as smaller firms become subject to SOX, the benefits of having auditors attest to the adequacy of management's control testing process should grow over time. Furthermore, to the extent that auditors become more efficient in performing this attestation, this attestation cost should decline over time as both management and the auditor become more experienced in performing their respective testing processes. Rather than eliminating this attestation, I would strongly encourage the PCAOB to move in the opposite direction by providing additional guidance to auditors in performing their evaluations of management's testing process.

Given the importance of management's tests of controls under SOX, I would also encourage the PCAOB to add "inadequate control testing by management" as a "strong indicator of a material weakness" or else identify it as a specific example of a weak "general control environment." (Failure by the audit committee and management to remediate significant deficiencies is the example now cited in AS 5 for a "weak general control environment.")

### **Guidance Regarding Strong Indicators of Material Weaknesses**

Under AS 2, a material weakness exists when the auditor concludes that a material misstatement could occur with a higher than remote probability. The AS 5 Exposure Draft replaces the "higher than remote probability" with "reasonable possibility." I have no problem with this definitional change in the AS 5 Exposure Draft. However, I do have major reservations regarding related changes in the guidance to auditors.

Currently, PCAOB's AS 2 (see paragraph 140) identifies six conditions that are "at least significant deficiencies and strong indicators of a material control weakness." The six conditions are: 1) restatement of previously issued financial statements (for reasons other than a change in accounting principles), 2) identification by auditor of material misstatements in the current period's financial statements that were not detected by the control system, 3) ineffective oversight by the audit committee over the financial reporting process, 4) ineffective internal audit function, 5) fraud perpetrated by senior management, and 6) an ineffective control environment.

In my opinion, AS 2 makes a conceptual error in lumping the auditor's identification of an undetected material misstatement together with the other five indicators and, unfortunately, the AS 5 Exposure draft perpetuates this error. My point is that the auditor's discovery of an undetected material misstatement in the current period's financial statements is not merely an indicator of a material weakness, but is by definition a material weakness (under either the existing AS 2 criteria or under the AS 5 Exposure Draft criteria). (The remote probability condition (or reasonable possibility condition) is certainly satisfied whenever at least one material misstatement has already been detected by the auditor.) Thus, I would encourage the PCAOB to recognize this important distinction in its new standard.

A related change introduced by the AS 5 Exposure draft is to remove the statement that the six indicators are "at least significant deficiencies." The AS 5 Exposure Draft supports this proposed change by arguing (see p. 11 of the Exposure Draft) that, "[eliminating the significant deficiency] would reaffirm the degree of judgment required to make these evaluations."

I agree with the point that all control evaluations involve judgment on the part of auditors, but I personally cannot envision any possible scenario wherein the discovery of an undetected material misstatement by the auditor would not imply at least a significant deficiency. Indeed, as discussed above, I believe that the auditor's discovery of an undetected material misstatement provides the strongest possible evidence of a material weakness. How could members of the audit committee or the auditor possibly conclude that controls provide reasonable assurance that financial statements are reliable in the face of the auditor's discovery of an undetected material misstatement? Although the discovery of a material misstatement should not be necessary to conclude that a material weakness exists, it certainly is sufficient. By pooling the undetected material misstatement event into the six "strong indicators" group, and then eliminating the "at least significant deficiency" wording, the AS5 Exposure Draft makes it possible for an auditor to reach the absurd conclusion that controls are effective even after finding a material misstatement. Given that evaluation, the auditor would be under no obligation under the AS 5 Exposure Draft even to notify the audit committee or the public.

I would now like to discuss the material misstatement issue in greater detail. Some have argued that many misstatements are due to GAAP issues and that they do not necessarily imply that there is a control weakness per se. However, AS 2 in its discussion of the six

“strong indicators” is careful to make clear that they mean restatements associated with error or fraud and by stating that restatements associated with changes in accounting principles are excluded. A second argument for changing AS 2 guidance is that misapplications of GAAP are often due to complexity, rather than to control problems per se. Thus, advocates of this position would argue that auditors should be allowed to give their clients passes when they make errors in applying GAAP.

When considering the complexity issue, however, it is important not to lose sight of the fact that firms have a fundamental obligation to disseminate reliable financial statement information. This obligation requires firms who routinely engage in complex financial transactions to recognize the elevated risk of non-compliance with GAAP and to maintain sufficient accounting expertise to manage their financial reporting process in the face of complexity just as is done in the tax reporting domain. SOX also makes explicit the registrant’s obligation to maintain effective controls to protect the financial reporting process in contexts where inherent reporting risks are high. Given the central role of accounting policies in the financial reporting process, management should be cognizant of the elevated risks and impose controls that are commensurate with the elevated risk due to complexity. Thus, a firm’s failure to manage the risks associated with its accounting policies in such an environment is perhaps the strongest possible example of a material weakness in controls over the financial reporting process. For this reason, I do not believe that complexity really provides a justification for failing to conclude that there is not a material weakness—much less a significant deficiency.

Currently, despite the “strong indicator” guidance in AS 2, there are numerous examples where auditors have issued unqualified reports on controls and current period financial statements after the client has restated the prior period’s financial statements. (Compliance Week statistics indicate that many firms making restatements have not received adverse control reports.) Perhaps most of the firms who made restatements changed their GAAP or were able to remediate their control problems in time for the auditor to re-test before year-end. However, I remain a bit skeptical when many of the firms receiving unqualified control reports after restatements have gone through yet another round of restatements during the following year. I fear that the proposed softening of the AS 2 guidance will only weaken the ability of auditors to withstand client pressure and encourage to the aggressive reporting days of the late 1990’s.

In summary, I believe that the auditor’s finding of a material misstatement must be separated from the other material weakness indicators and that guidance should be strengthened rather than weakened. I personally would favor language to the effect that the finding of an undetected material misstatement during the current year’s audit (whether it relates to a transaction in the current year or a prior year) is clearly sufficient (but not necessary) for the issuance of an adverse opinion. I would also state that the presence of one or more of the other five indicators should create the presumption of a material weakness. This would place the burden squarely on the auditor to justify not issuing an adverse audit report in the presence of such indicators. Strengthening, rather than weakening the guidance to auditors will help to ensure that, regulators and other financial statement users will not be deprived of an early warning signal regarding

reliability issues in the client's financial reporting process. I also urge the PCAOB to retain the auditor's attestation report on the adequacy of management's control evaluation process. Maintaining the attestation will help to ensure that auditors obtain a deep understanding of their clients' control environments and also help strengthen their clients' control environments by enhancing managers' incentives to test their controls robustly so that weaknesses can be identified and remediated. Ultimately, this will allow management to develop more efficient and effective audits of control systems to enhance the reliability of the financial reporting system.

I fully support the SEC's position that management should have greater flexibility in testing, but I would stress the need for the SEC to provide guidance about performing control evaluations on an ongoing basis throughout the year rather than attempting to mimic the testing performed by the external auditor near year-end. Similarly, the PCAOB should provide more guidance to auditors in structuring their tests of the adequacy of management's control tests, rather than abandoning the attestation altogether. These changes in guidance would help to make management's control evaluation process complementary to the evaluation process performed by the external auditor. I hope that the PCAOB's current focus on reducing short-term SOX compliance costs does not inadvertently undermine Congressional intent in passing SOX to enhance the reliability of the financial reporting process.

Respectfully,



Paul J. Beck  
Irwin Jecha Professor of Accountancy  
University of Illinois at Urbana-Champaign

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**From:** Ian Lamdin [mailto:ilamdin@symmetricom.com]  
**Sent:** Wednesday, February 14, 2007 6:39 PM  
**To:** Comments  
**Subject:** PCAOB Rulemaking Docket Matter No. 021

To whom it may concern:

I am concerned by your proposal to drop the requirement for external auditors to report on management's assessment of internal control, while keeping the external auditors' report on internal control. It seems you plan to drop the wrong report.

Firstly, investors want confidence that the attestations of the CEO and CFO are actually JUSTIFIED, and it is only the present external auditors' attestation on management's assessment that provides that confidence.

Secondly, the combination of a "clean" audit report on the financial statements and a "clean" attestation on management's assessment of internal control is tantamount to an assessment of internal control by the external auditors anyway, rendering their "Report on Internal Control" somewhat redundant. It nevertheless entails a significant amount of unnecessary and duplicative work being performed annually by the external auditors.

Thirdly, the proposal is in direct conflict with the legislation passed by Congress in 2002. Here's a cut'n'paste from SOX #404:

>>> b. Internal Control Evaluation and Reporting. With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement. <<<

It is evident that the attestation on "the assessment made by the management of the issuer" IS legally required, whereas (to my knowledge, anyway) the external auditors' attestation on internal control ISN'T.

Fourthly, the two reports that the new proposals require would be the same the two attestations from independent auditors that were, in the late 1990s, afforded to the shareholders of Enron only. So you are now proposing that the result of the legislation that was enacted to prevent another debacle like Enron - is that all companies will receive the same attestation reports as Enron! I'm sure your detractors in the press are salivating at prospect of drawing the investing public's attention to the irony of this situation!!

Respectfully submitted.

Ian D. Lamdin, CPA, CFE  
Internal Audit Manager  
Symmetricom, Inc.

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

January 15, 2007

PCAOB Rulemaking Docket Matter No. 021:

The purpose of this memo is to provide response to the 34 questions posed by the PCAOB related to the proposed change in AS 2, as well as to provide general feedback on the pending revisions.

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

*No. It is our belief that the top-down approach is not clearly defined. The proposed standard makes reference to a focus on company-level controls and an overall risk-based approach, indicating that you should “begin with financial statement level and company-level controls, and then work down to significant accounts and disclosures, relevant assertions, and significant processes.” However, it is not clear how this top-down approach would be applied in practice. Some public accounting firms may not be comfortable eliminating detailed process level controls based solely on risk and the existence of effective company-level controls. Additionally, it is important to note that this top-down risk-based approach is not new guidance. It was first recommended by the PCAOB in the May 16, 2005 Staff Question and Answer. Since this method was first formally documented in May 2005 there have been no noticeable changes in the public accounting firm’s approach to identifying and/or testing key controls. Although this guidance is being reiterated in the proposed standard, it seems that in order to ensure that the top-down risk-based methodology is consistently applied across all public accounting firms, further practical guidance is needed.*

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

*Yes. It is our belief that there is an appropriate emphasis on the importance of anti-fraud controls.*

3. Will the top-down approach better focus the auditor’s attention on the most important controls?

*If the top-down approach is applied consistently it could help to focus the auditor’s attention on controls that are perceived to carry the most risk. However, as mentioned in response #1 above, we have not seen any noticeable change in the auditor’s focus since the release of the May 16, 2005 guidance. It is our belief that without further practical guidance the risk-based top-down approach will not be consistently applied across all public accounting firms, and*

*there will be no noticeable change in the auditor's focus. Refer also to the comments outlined in response #1 above.*

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?

*No. Refer to the comments outlined in response #1 above. Although the standard places a clear emphasis on company-level controls by mentioning that the audit should focus on company-level controls and work down to significant accounts, it is not clear how this approach could be carried out in practice. More specific guidance is needed on when the testing of detailed process level controls can be reduced as a result of effective company-level controls. As it stands now, it appears that company-level controls can provide only indirect assurance and will therefore not be sufficient to provide the external auditor comfort at the transaction level.*

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?

*It is clear from the standard that controls with lower risk would require a lower level of evidence to support their operating effectiveness. However, acceptable methods of reducing evidence should be clearly defined. For example, if a control is considered low-risk, does this imply that it can be tested solely through inquiry or observation? Additionally, can the overall sample-size be reduced for low-risk controls? Without clear definitions of "low-risk" and "reduced evidence" the standard will not be applied consistently across public accounting firms.*

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

*Yes. Performing a walkthrough of the control process one time should provide sufficient evidence that low-risk controls are operating effectively. However, it is also important to note that it is our belief that walkthroughs should only be performed over key controls (not over every type of transaction within each key sub-process). Performing a walkthrough of each key control can be carried out in connection with the testing, and would identify any significant changes in controls from prior years as well as any processes that are not working as intended.*

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?

*The revised wording of "significant" appears to be better defined and easier to understand. However, more guidance is needed on how to determine what is "significant" in practice. For example, is "significant" defined in both*

*qualitative and quantitative terms? If so, what quantitative factor must be used? In the past, any deficiency with a potential impact greater than 1% of interim EBT was required to be classified as significant. It is our belief that the updated guidance should allow for more qualitative factors to be considered in assessing the significance of a deficiency.*

8. Are auditors appropriately identifying material weaknesses in the absence of a 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?

*Yes. It is our belief that auditors are appropriately measuring material weaknesses based on the potential impact of a deficiency rather than the actual impact.*

9. Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statements?

*No. No changes in guidance were noted that would reduce the level of effort required for evaluating deficiencies. An auditor will still have to post all deficiencies identified, regardless of perceived significance, to the “Summary of Aggregated Deficiencies” and run each deficiency through a framework to formally assess its significance. As such, no reduction in effort is anticipated.*

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?

*Yes. The presence of a “strong indicator” of a deficiency is not necessarily evidence that a control is not operating effectively. As such, the auditor should be allowed some level of judgment in assessing whether or not a deficiency exists. It is true that incorporating judgment into the process may lead to inconsistency in the evaluation process. However, with uniform guidance for all public accounting firms, the inconsistency should be kept to a minimum.*

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

*Yes. Refer to the comments related to the top-down approach outlined in response #1 above. Additionally, note that guidance between external auditors and management needs to be consistent. Specifically, management and the external auditor must use the same approach to selecting key controls and selecting testing methodologies. If they do not use consistent methodologies, companies will not see any benefits from the changes in the SEC guidance as external auditors will increase procedures (thereby increasing cost) if management does not follow the same guidance.*

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?

*Yes. The reference to interim statements should be removed from the definitions of significant deficiency and material weakness in order to prevent the auditor from excessive testing. By taking out any reference to interim materiality, the audit would focus on identifying deficiencies within accounts and controls that are significant on an annual basis.*

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

*No. The auditor's review of management's testing was never considered time consuming or cumbersome. In fact, the opinion on management's testing effectiveness was somewhat redundant. As such, cutting out the requirement for the auditor to provide this additional opinion will not reduce the overall workload of the auditor.*

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

*Yes. As outlined in response #13 above, it is our belief that the opinion on management's testing effectiveness was not needed for the auditor to perform an effective audit of internal control. The procedures performed by the auditor will change very little, if at all, as a result of the elimination of this opinion.*

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?

*Yes. See responses #13 & #14 above.*

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

*Yes. Relying on cumulative audit knowledge and experience should reduce the extent of some of the auditor's procedures. However, it would be helpful to have some examples provided that would outline how cumulative knowledge could lead to an adjustment of testing scope.*

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?

*The auditor should rely on walkthrough procedures as sufficient evidence for any control that is classified as "low-risk" in addition to any application controls. However, in order to ensure uniform application of the term "low-risk," further guidance might be required. See also response #5 above.*

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?

*Yes. At large companies, the standard's approach to scoping using a risk-based methodology should allow for significant efficiencies to be gained. However, at small multi-national companies, the use of quantitative metrics may be one of the easiest ways to distinguish risk among various locations.*

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

*Yes. The standard for using the work of others should be the same regardless of the type of audit being performed. Different frameworks are not necessary and would cause confusion.*

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?

*Yes. The definition of relevant activities appears to adequately capture the scope of activities.*

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

*No. It is important for the auditor to be aware of and understand any deficiencies identified through the work of others. However, this is not a new step to the audit engagement. Reviewing results of work performed by others (such as internal audit or consultants) was already a requirement on most public accounting engagements. As such, there will be no new improvements to audit quality by making this requirement a part of the standard.*

22. Is the principal evidence provision that was in AS 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?

*No. The auditor is already aware that prior to signing the opinion they are required to obtain sufficient evidence to support their opinion. The principal evidence requirement may cause the auditor to feel that they are unable to make full use of the work of others on the integrated audit engagement.*

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?

*Yes. The framework for evaluating the competence and objectivity of persons performing testing appears adequate to prevent inappropriate reliance on the work of others. The framework does not appear to be too restrictive in nature.*

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

*Refer to response #23 above. The factors proposed for assessing competence and objectivity appear appropriate.*

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?

*It is important that the auditor consider compensation arrangements when assessing objectivity. However, the factors that would impact a person's objectivity are likely to be contained in an individual's goals and objectives, rather than in a high-level compensation policy. As such, a simple review of overall compensation policies and procedures might not provide the level of detail needed. Instead, it might be necessary for the auditor to perform a more thorough review of each individual's personal performance file. This may be perceived as intrusive to some individuals.*

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

*No. It is our belief that, in practice, auditors were already limiting their walkthrough to transactions that would address key controls within significant processes. As such, the revised wording of the standard, which allows the auditor to avoid testing every transaction in every key process, is not a significant change from the current practice – it will not reduce the number of hours required to perform walkthroughs, nor will it change the overall quality of the audit.*

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?

*Yes. It is appropriate for "others" to provide direct assistance in performing walkthroughs. However, the benefits gained by using the work of others may be limited depending on who the "others" are. For example, if internal audit or management is used to assist in walkthroughs, both the company and the auditor may gain in both knowledge and efficiency. However, if outside consultants who are unfamiliar with the company or do not have ongoing involvement in the company are used to perform walkthroughs, the benefits gained may be minimal.*

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?

*Yes. The standard appears to appropriately address ways in which the audit should be modified based on size and complexity. However, the modified requirements for documentation may be confusing to some companies and auditors. For example, if smaller companies are not required to produce formal documentation as evidence of a control's operating effectiveness, how will the auditor prove that a control is operating as stated? Additionally, how will you measure the involvement of senior management in smaller companies? Further practical guidance may be required.*

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

*No. We noted no additional attributes of smaller companies that should be considered in the standard.*

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. We noted no other differences related to internal control at smaller companies that should be considered in the standard.*

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

*While size is easily quantifiable, the discussion of complexity incorporates some degree of judgment into the scalability provision. It will be important for clear guidelines to be to ensure that all auditors interpret complexity in the same way. Clear guidelines on assessing complexity should prevent any inappropriate limitations to the scalability provision.*

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

*The market capitalization and revenue thresholds outlined in the standard do not appear to be consistent with SEC guidance and previous guidance used in assessing the size of companies. Additionally, under the PCAOB definition, several companies that were not previously considered “small” would fall into the category of small, which could cause confusion. PCAOB guidance should be consistent with SEC guidance and previously issued guidance.*

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?

*No. We noted no additional information that the auditor should provide to the audit committee in its pre-approval process for internal control-related service.*

34. How can the Board structure the effective date so as to best minimize 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?

*Regardless of the effective date of the standard, early adoption of the standard should be allowed for all companies in their FY 2007 reporting cycle.*

Overall, the revised guidance proposed by the PCAOB will, at a minimum, cause both the external auditor and management to perform a re-evaluation of their approach to 404 testing. However, it is important that the PCAOB consider the SEC guidance for management in the proposed revision. For example, page 59 of the SEC’s guidance (“Management’s Report on Internal Control over Financial Reporting”) states that:

“..The benefits of the proposed amendments may be partially offset if the company’s auditor obtains more evidence directly itself rather than using evidence generated by management’s evaluation process, which could lead to an increase in audit costs.”

The PCAOB guidance should be closely aligned with management’s approach to add efficiencies and reduce any potential cost increases that the auditor would incur by performing more direct testing on its own.

Cassandra Scozzie  
Internal Audit  
Keithley Instruments, Inc.

Shelly Trochemenko  
Internal Audit  
Keithley Instruments, Inc.

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**From:** Rod Scott -RGSA [mailto:rodscott@rgscottassoc.com]  
**Sent:** Thursday, February 15, 2007 4:32 PM  
**To:** Comments  
**Subject:** PCAOB Rulemaking Docket Matter No. 021

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, D.C. 20006-2803  
PCAOB Rulemaking Docket Matter No. 21

Sirs:

I developed and teach a seminar entitled “Sarbanes-Oxley Act: Assessing IT (Information Technology) Controls” for the Institute of Internal Auditors. I have taught versions of this seminar over 40 times, involving over 700 companies. My comments and suggestions are drawn from the experiences of these organizations and my own research and consulting experiences.

In general, the individuals assessing the IT controls have had to interpret the implications for information technology from the PCAOB Standards and SEC Rulings, which are written from a financial perspective and knowledge base. They have also had to deal with external auditors who lack the skill set to adequately understand the risks involved in the information technology of the organization. Yet it is estimated that 30-60% of the assessment work requires information technology expertise. The proposed Standards have done nothing to bridge this gap. The following comments and suggestions are provided in the hope that the scope and responsibilities for Sarbanes-Oxley can be clarified while continuing to achieve the benefits of assuring reliable financial information.

**Proposed Standard:** *“An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements”*

**Issue 1-** Section 404 of the Act states *“each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer.”*

The intent of this Section of the Act, clearly, was to require Management to understand their internal controls and provide assurance to the investors that the internal control of the organization resulted in accurate and reliable financial information.

The external auditors’ role has been interpreted by PCAOB to be responsible for an independent audit of the internal controls of the organization, rather than attesting to and reporting on the assessment made by Management.

Section 103 of the Act states that *“each registered public accounting firm shall...*

*(iii) describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b), and present ...*

*(II) an evaluation of whether such internal control structure and procedures—*

*(aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;*

*(bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer;”*

This Section has led to the excessive audit fees for Sarbanes-Oxley which has subliminated the benefits of improved reliability and transparency of the financial reporting information.

In the Information Technology area, Section 103 has been responsible for innumerable tests, required by the external auditors, which do not contribute to Managements' understanding of their 'key' internal controls. External auditors have required the programming of routers to be tested, reviewed system development procedures when the financial systems are 25 years old and many other 'war stories' too numerable to mention.

This proposed Standard continues to make the public accounting firm responsible for assessing the internal controls of the business which is an interpretation of Section 103 and not supported by Section 404 of the Act. Instead, a more reasonable interpretation of the Act should require the public accounting firm to attest to the assessment made by Management. This is the single most costly impact of Standard No. 2 and has not been rectified in the proposed Standard. It has created excessive fees by the public accounting firms and has caused Management, in many cases, to incur excessive costs in trying to satisfy the inconsistent requirements of the public accounting firms. If not addressed, organizations face two internal control reviews, one by Management and one by the external audit firm. This will continue to impose excess costs on the process.

**The proposed Standard should be amended to require only the attestation to the Management Assessment and not require an independent appraisal of the internal controls of the organization by the external auditor.**

**Issue 2-** Additionally, the proposed Standard has been generalized and much of the detail in Standard No. 2 was eliminated. One of the major cost drivers to date has been the inconsistent interpretation by the external auditors of the requirements. It is certain that if the Standards continue to lack detail on critical issues the amount of interpretation done by the external auditors will increase and, if their role is not changed as suggested above, the costs of the Sarbanes-Oxley assessment will not be reduced.

**Issue 3-** The emphasis on the importance of risk assessment is the major improvement in the proposed Standard. While it is supported in the proposed Standard and in SAS No. 109 it is only discussed at a very general level. The ‘devil is in the details’ as far as information technology is concerned.

¶31 of AU sec. 319 states “*The auditor should consider whether specialized skills are needed in the performance of an audit.*” As a practical matter most external audit teams assign the responsibility for information technology to a person trained in accounting and little or no in-depth knowledge or job experience in Information Technology. Even certification via a fifty dollar, two hundred question multiple-choice exam does not prepare such a person for the requirements of analyzing risk and testing the complex information technology environments of most organizations. This makes the achievement of meaningful risk analysis difficult. As a result, the auditor tends to follow a prescribed set of controls rather than apply ¶15 and ¶31 of AU sec. 319.

The proposed Standard does not provide an adequate level of guidance for assessing information technology risk. The staffing of the external audit teams is unlikely to change so the risk analysis of information technology will likely remain contentious and continue to be responsible for excessive costs.

**Issue 4-** The SEC definition of internal controls, in Ruling 8238, states “... *our definition of the term "internal control over financial reporting" reflected in the final rules encompasses the subset of internal controls addressed in the COSO Report that pertains to financial reporting objectives. Our definition does not encompass the elements of the COSO Report definition that relate to effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements.*”

Standard No. 2 did not recognize this exclusion in it’s’ definition of internal control and this has driven behavior in the assessment of information technology internal controls. Standard No. 2 included this statement:

*“50. Some controls (such as company-level controls, described in paragraph 53) might have a pervasive effect on the achievement of many overall objectives of the control criteria. For example, information technology general controls over **program development, program changes, computer operations, and access to programs and data** help ensure that specific controls over the processing of transactions are operating effectively.”*

This section has been interpreted as **the definitive statement** on Information Technology General Controls, yet “program development” and “computer operations” are vague terms from a financial reporting perspective and are primarily issues of effectiveness and efficiency, which contradicts the SEC Ruling 33-8328.

The ISACA organization used this interpretation as the basis for the General Controls in their white paper “IT Control Objectives for Sarbanes-Oxley”. Price Waterhouse Coopers interpreted this wording similarly in their monograph “Sarbanes-Oxley Act: Section 404, Practical Guidance for Management July 2004”. KPMG similarly endorsed this concept in their document "Sarbanes-Oxley Section 404: An Overview of the PCAOB's Requirements". Deloitte has endorsed the PCAOB definition in its document, "Taking Control". Due the broad base of these organizations, a major impact has resulted on the Sarbanes-Oxley assessment effort throughout the country.

The proposed Standard no longer contains this statement but neither does it clarify that issues of efficiency and effectiveness are out of scope. This exclusion of efficiency and effectiveness issues requires emphasis in the proposed Standard to assure that the attestation to Management’s Assessment does not continue to suffer from the scope ‘creep’ that has occurred due to the application of a broader definition of “internal control”.

**Issue 5-** Standard No. 2 put a false reliance on SAS 70 reports and this has been continued in the proposed Standard. The Information Technology services that organizations use today vary from simple payroll functions to the complete outsourcing of hardware, software, security, etc... In many instances these services are provided by a service organization to hundreds, sometimes thousands, of clients. It is reckless to assume that a single sample of controls (SAS 70), by a CPA, could satisfy the assessment of all of the clients’ controls over financial reporting in a heterogeneous environment that characterizes most IT services organizations. Yet, B19-29, in the proposed Standard, continues to ignore this major problem. Instead, simple but infeasible alternatives are prescribed which have generally meant that internal controls over IT at service organizations is not subject to the same rigorous requirements that would be expected if the processing were done within the organization.

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**Proposed Standard: “*Considering and Using the Work of Others in an Audit*”**

This entire proposed Standard supports the assessment of internal controls by the external auditor. As discussed above, this activity is interpreted as a requirement of the Act and the focus should be redirected to attesting to the Management Assessment of internal controls. The elimination of the requirement for principal evidence was a good start but there is a need to go further and eliminate the need for an internal control review by the external auditor under Sarbanes-Oxley.

The proposed Standard has an inappropriate tone to the view of the work of others. In the code of conduct example, competency and objectivity, by those assigned from the organization, allows the external auditor to rely on the determination of the existence of the code of conduct but NOT the judgment on how it is applied. If competency and objectivity are adequate, then judgment should be reliable as well. In the information technology assessment work, quite often the individual assigned by the organization is

the only competent individual to assess controls in their area of responsibility, such as a network engineer.

In my opinion, the proposed Standards are an improvement over AS2 but in their present form, will not achieve the goal of eliminating excessive costs of Sarbanes-Oxley Assessment of internal controls.

**Sincerely,**

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To all,

I first would like to thank you for the opportunity to provide feedback. I think it's very important for the board to hear first hand from people who have been directly impacted by Section 404.

Let me start by saying flat out that my coworkers and I are utterly disgusted and outraged by what Section 404 has done to our workplace. There's really no other way to describe it. It is very unfortunate that what should have been an attempt to address fraud by executives turned into a massive misguided attempt to prevent any time of accounting error from ever occurring. That is impossible, and has resulted in incredible cost to U.S. public companies – not just in terms of audit \$'s, but also in terms of lost efficiency, worker satisfaction, people laid off (to pay for all this), and even increased errors.

It's very important to distinguish between fraud by executives and true errors by accountants. They are very different things. The scandals at Enron and Worldcom were not errors by accountants. They were intentional fraud and/or misstatements by executives at those companies. All of this was directly or indirectly driven by the large sums of money the executives had at stake, which was all dependent on the financial results of the companies and meeting analysts earnings expectations.

The good news is that Sarbanes-Oxley has done a good job of addressing intentional financial misstatements (fraud) by executives. Most people could name the items needed to address this fraud without ever reading or knowing anything about Sarbanes. Definitely it needed to be made very clear to executives that fraud (ie. normally involving manipulation of earnings numbers) will no longer be tolerated. Along with that comes clear guidelines of what the penalties will be and the requiring of positive certification each reporting period that they have not committed fraud. Another big item was providing a mechanism for employees to report fraud without repercussion (although this can be a little dangerous since it can potentially be manipulated – but the good hopefully will outweigh the bad).

Aside from the items above, the other big item that needed to be addressed was the lack of audit scrutiny by the partners in the auditing firms. Again, money was the root cause of audit partners not taking measures to dig deep enough or push high enough on high level issues that normal audit procedures would not detect. The last thing the big CPA firms wanted to do was lose the audit engagement, since it was their doorway into big profit tax and consulting work. But clearly the rules on this have changed, and this problem area has been effectively addressed.

So the good news is that the root causes of what brought about Sarbanes-Oxley have been well addressed. Granted, there will be future intentional misstatements by executives – personal financial greed and pressure to meet the forecasts has not gone away. But at least the expectations and penalties are very clear now. So this is by no means an across the board indictment of all Sarbanes-Oxley.

But the bad news is that Section 404 went way beyond what was necessary and decided to take on the impossible (but extremely expensive) task of trying to prevent not only fraud/financial misstatement by executives, but all possible errors. This is absolutely insane. And it has caused incredible chaos at my company and the companies of my peers.

As I overheard my former boss say to an auditor out of frustration the other day, "I can't guarantee I'll never make a mistake." But unfortunately, that's what Section 404 has attempted to do. Again, this wasn't the problem in the first place. Intentional misstatement by executives isn't a "mistake."

And the sad thing is that my department is actually making mistakes now that we never did – directly as a result of Section 404. We have been mandated to have so much separation of duties that tasks that were once simple and straightforward have now become unduly complicated and involve a number of people. As a result, the work flow is constantly interrupted while waiting for someone else to now do their piece, which forces us to set things down and restart them constantly. And items such as journal entries often get keypunched three times because of the separation of duties/system accesses. We now have to deal with keypunch errors that never existed before.

These types of things have caused us to make numerous mistakes that we've never made in the past. And we've been given no leeway to use judgement anymore as to how much separation of duty we consider necessary for each area. Section 404 is quoted as a blanket statement over everything. It's very frustrating. We at the lower levels were not the problem in the first place, yet we are the ones suffering from the results of all this.

Section 404 has caused errors in many other ways – both direct and indirect. The amount of time it takes away from both the staff accountants and managers is obscene and directly impacts the quality of our work. We now have to find time to go over things constantly with regular internal auditors, our internal Sarbanes compliance people, and the external auditors. And of course now there are two external audits – one compliance and one financial. This time is stolen from the time we used to be able to spend on actual accounting work. As a result, my people are making mistakes they have never made in the past simply because they don't have sufficient time to concentrate on their actual work.

And simply working longer hours is not a quick fix. We have to remember that people only have so much mental energy to use each day. Again, if you have to spend half of every day digging things up and explaining things to the numerous auditors we now have to deal with, you are often half burned out by the time you get to your actual accounting work. It feels like the work itself has taken a huge back seat to the auditing of the work. Several people have noted that it feels like you do one small task, and then numerous auditors come out of the woodwork and audit it to death. And simply adding staff (which is very tough to get approved) isn't always the answer since there is only so much good meaningful work to do. These are real people, not machines.

And specifically for my company and accounting department, we are still slowly recovering from the fact that we were going through a massive systems implementation at the time that we were also implementing Section 404. So instead of our people being able to spend the time they needed learning all the intricacies of the new system and making sure the initial setup was done correctly, we instead spent day after day in rooms with Sarbanes consultants explaining over and over again what we do and how everything works. As a result, numerous things were missed or done poorly in the implementation that would have been no-brainers if we had been allowed to spend the time needed. I think sometimes that people associated with Sarbanes forget that we actually have jobs to do. So now even after a couple years have passed we are still trying to fix the initial systems setup and learn how certain things work – things that would have been done easily while the systems implementation team was in place and ready to help.

Another depressing outcome of Section 404 is the massive amount of administration we now have to go through to do routine tasks. I currently serve as a supervisor, and rather than getting meaningful work done – my days are typically spent reviewing SOX narratives, preparing things to be signed by my manager, signing/dating/initialing paperwork, responding over and over again to the same compliance type questions, pulling items for the various auditors, re-explaining how things work to various auditors, etc. It has taken the quality of my workday and other managers and reduced it to endless administration.

Not a day goes by that someone in my area doesn't think about looking for a job at a non-public company. But we hate to be forced out of jobs that we used to get a great deal of satisfaction out of. Unfortunately, several very good people have left out of frustration over what Section 404 has done to their jobs. And ironically, by losing these intelligent knowledgeable people, our risk of errors has increased. Again, part of Section 404 backfiring.

And perhaps that is what much of this boils down to. Section 404 has inadvertently led to a tremendous decrease in job satisfaction amongst accountants. Every single accountant I know that is impacted by Section 404 (at other companies also, not just mine) absolutely hates it. Hate is a strong word, but that is the sentiment. I have never seen so much frustration as I have with Section 404. We've always had good, motivated accountants that thrive on challenges. But Section 404 has taken a great deal of this away from them. It is punishing them for problems that they couldn't possibly have been further away from causing.

The reason I have taken the time to write the above items is that I think it's important to understand this in order to talk about the auditing standard. Ideally we would want much of Section 404 to be abolished and

return the control of the Accounting Departments back to the controllers. The best way to minimize true accounting errors is the same as it has always been – hire intelligent motivated accountants and have intelligent motivated managers in place to oversee things. You can put all the rules and controls and narratives, etc., in place that you want, but "you can't legislate stupidity." True mistakes can and will continue to happen no matter how many controls you have. But if you have good people in place – and give them sufficient time to do their job (ie. not spending all their time on admin) – you should be able to minimize the materiality of most errors.

So the single biggest improvement we can make with regards to auditing is to minimize the time impact on the accounting departments. Having to explain the same things over and over again to multiple auditors – internal and external – steals time away from actually doing the work properly. Every minute spent making copies and pulling backup and re-explaining things is a minute we've taken away from our accountants concentrating on doing actual work. The media appears to only be focused on the external \$ cost to companies – we seem to have completely ignored the incredible drag on our people's time and their own internal motivation to go to work and do a good job every day.

So anything you can do to decrease the time impact on our accounting departments will be incredibly appreciated. Again, most of the controls that have been added have little to do with the real issue of the large \$'s at stake that drove executives to manipulate financial results and that drove CPA firms to not address the real risk areas in the first place. I guess the new joke is "how many accountants does it take to change a lightbulb?" Unfortunately, after Section 404 the answer might be quite high. You'd probably need one to authorize the lightbulb change, one to supervise the change, one to physically twist the bulb out, one to bring the new bulb over, one to screw the new bulb in, one to check off that the bulb was changed, and then a minimum of three auditors to verify that everyone checked the right boxes – regardless of whether the bulb was properly changed or not. So I guess the answer would be nine. But unfortunately this is no joke.

We will be anxiously awaiting news on what will hopefully be some good changes. Thank you for your time.

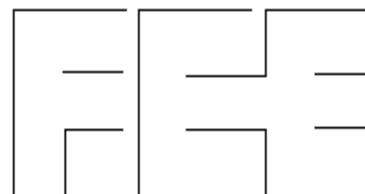
Date  
16 February 2007

Le Président

Fédération  
des Experts  
Comptables  
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AISBL

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Nancy M. Morris  
Secretary  
Securities Exchange Commission  
100 F Street, NE  
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J. Gordon Seymour  
Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
USA - Washington D.C. 20006-2803  
Email: comments@pcaobus.org

Dear Ms Morris and Mr Seymour,

**Securities and Exchange Commission Release on Management's Report on Internal Control over Financial Reporting**

**Public Company Accounting Oversight Board Proposed Auditing Standard on An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals**

FEE (Fédération des Experts Comptables Européens – European Federation of Accountants) is the representative organisation for the accountancy profession in Europe. FEE's membership consists of 44 professional institutes of accountants from 32 countries. FEE Member Bodies are present in all 27 Member States of the European Union and they represent more than 500,000 accountants in Europe.

FEE is pleased to comment on:

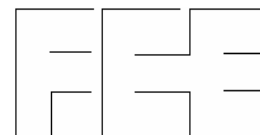
- the Securities and Exchange Commission (SEC) Release Nos. 33-8762 and 34-5476 on Management's Report on Internal Control over Financial Reporting (the SEC's proposals); and
- the Public Company Accounting Oversight Board (PCAOB) Rulemaking Docket Matter No. 021 of 19 December 2006 – Proposed Auditing Standard on An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals (the PCAOB's proposed standard).

In the case of the PCAOB's document, FEE has only commented on the Proposed Auditing Standard in Appendix 1 of that document and not on the other appendices in the PCAOB's document.

FEE notes with interest the SEC's proposals and the PCAOB's proposed Auditing Standard in view of FEE's own substantial contribution to recent discussions in Europe over the future direction of requirements and guidance relating to risk management and internal control. In particular FEE:

- published in March 2005 its Discussion Paper "Risk Management and Internal Control in the EU"<sup>1</sup>;

<sup>1</sup> [http://www.fee.be/publications/default.asp?library\\_ref=4&content\\_ref=351](http://www.fee.be/publications/default.asp?library_ref=4&content_ref=351)



held a high level conference on 25 October 2005<sup>2</sup> (at which a senior staff member from the SEC spoke) on the issues raised by the Discussion Paper; and

- issued in May 2006 a Comment Paper “Analysis of Responses to the FEE Discussion Paper on Risk Management and Internal Control in the EU”<sup>3</sup>.

We are supportive of the proposed objectives of the SEC and the PCAOB which we believe include:

- improving the effectiveness and efficiency with which management and auditors assess a company’s internal control over financial reporting;
- adopting a top down, risk-based approach with emphasis on the control environment;
- providing flexibility in the approach to assessing internal control;
- increasing the focus on the exercise of judgement, rather than encouraging a check-list mentality; and
- considering issues related to the scalability of the requirements as applied to different companies.

Overall, whilst FEE considers the initiative of both the SEC and the PCOAB to be a step in the right direction, particularly the aim of providing high-level guidance to management which was previously a major omission, we have a number of concerns about the two documents and question whether the proposed objectives will actually be achieved in practice. Matters may not have been resolved and everything depends on how the words in the SEC’s and PCAOB’s documents affect the behaviour of people in registrants’ management teams, audit firms and the regulatory agencies’ inspection functions.

## **Overriding principles based on existing FEE policy**

In preparing this response, we have applied three overriding principles which are based on FEE policy previously established in our Discussion Paper *Risk Management and Internal Control in the EU* and which FEE continues to fully support:

1. Internal control over financial reporting is primarily about the people at the top of a company who manage the business. The focus should be on management.
2. Whatever work auditors undertake, it must be performed within the context of the work that management undertakes and it should be aligned with that work and based on evidence of what management has done.
3. FEE supports the application Assurance Framework for Assurance Engagements of the International Auditing and Assurance Standards Board (IAASB) for any auditor involvement in respect of internal control over financial reporting.

## **Main Comments**

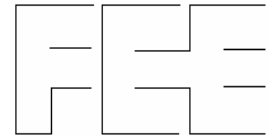
### **1. One approach versus two separate exercises**

The SEC’s May 2005 guidance emphasises that management, not the auditor, is responsible for determining the appropriate nature and form of internal controls for the company as well as their evaluation methods and procedures. The work that auditors are required to undertake should be performed within the context of, and aligned to, the work that management undertakes.

Under the current proposals, both the auditor and management will undertake separate exercises to assess internal control over financial reporting using their own methodologies, guidance and frameworks. We think that the SEC and PCAOB proposals are at variance with our principles 1 and 2 noted above.

<sup>2</sup> [http://www.fee.be/news/default.asp?library\\_ref=2&content\\_ref=518](http://www.fee.be/news/default.asp?library_ref=2&content_ref=518)

<sup>3</sup> [http://www.fee.be/publications/default.asp?library\\_ref=4&content\\_ref=564](http://www.fee.be/publications/default.asp?library_ref=4&content_ref=564)



We believe that there should be one approach to internal control over financial reporting, not two separate exercises.

## **2. The elimination of the requirement on the auditor to evaluate management's process**

We [strongly] approve of the SEC's and the PCAOB's objective of improving the effectiveness and efficiency with which management and auditors assess a company's internal control over financial reporting.

In attempting to bring about this objective, changes are proposed to the current requirements that the auditor form two opinions on internal control over financial reporting; the first being on management's work (process) and the second being the auditors' own assessment of the company's internal control over financial reporting. Whatever the words used in the documents for management's work – be it management's assessment or management process – the essential matter is that it is the work undertaken by management. We note that the SEC and the PCAOB both propose the elimination of the auditor's opinion on management's process – i.e. the work undertaken by management.

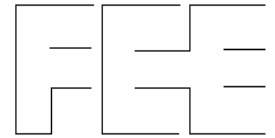
Our second principle, noted earlier in this letter, in practical terms means that whatever work the auditors undertake, it must be performed within the context of, and aligned to, the work that management undertakes and should be based on evidence of what management has done.

We note that, on page 52 of the SEC Proposed Release, the SEC states that it is “proposing to revise Rule 2-02(f) to require the auditor to express an opinion directly on the effectiveness of internal control over financial reporting” and goes on to state that “We believe this opinion necessarily conveys whether management's assessment is fairly stated.”

It is questionable whether the above-quoted belief is well-founded. Section 404 (b) of the Sarbanes-Oxley Act states (our emphasis in italics) “Internal Control Evaluation And Reporting - With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues an audit report for the issuer shall attest to, and report on, *the assessment made by the management* of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.”

Additionally, we note that, on page 16 of the PCAOB Proposed Auditing Standard, the PCAOB “believes that the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process”. However later on that page the PCAOB Proposed Auditing Standard notes that “an auditor still would need to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which he or she will use the work of others”. These statements appear to contradict each other.

We believe that the removal of the requirement on the auditor to evaluate management's work/process does not follow our second principle noted above and in conjunction with our comments in the first section above (re ‘one approach’) we suggest that the wrong opinion has been proposed for elimination.



### **3. PCAOB regulatory and enforcement functions - lack of symmetry between them**

The focus of the inspection reports published by the PCAOB on audit firms is on auditor shortcomings, inadequacies in audit work, on the *under-audit* of financial statements. The focus of the PCAOB Proposed Auditing Standard however, is on the prevention of the *over-audit* of internal control over financial reporting as evidenced by a significant number of notes referring to the fact that auditors ‘need not’ or are ‘not required to’ perform a particular procedure.

It is important that the PCAOB sends out a consistent message to auditors. Auditor behaviour is likely to be more sensitive to the approach taken by the PCAOB in its enforcement activities than it is to changes in auditing standards and it is therefore important that one reinforces the other.

If the enforcement approach focuses on detailed disclosure errors in published financial statements and compliance with the letter of standards rather than on the manner in which the audit was conducted and audit quality, and in particular the quality of significant audit judgements, then changes to auditing standards will have a very limited effect on auditor behaviour.

The PCAOB Proposed Auditing Standard does not prevent auditors from ‘over-auditing’ in that it does not say that auditors must not perform a particular procedure. It is quite possible that auditors will continue to ‘over-audit’ despite the changes if their behaviour is being driven by an enforcement approach that encourages defensive auditing.

### **4. SEC’s guidance to management is rooted in an audit approach**

It is the management of an organisation that is responsible for its internal control over financial reporting, and therefore the guidance should be user-friendly for them.

The SEC interpretive guidance included in the SEC Proposed Release is unlikely to resonate with management. The approach taken by the guidance, and the language used therein, is rooted in an auditors’ approach to internal control over financial reporting instead of language that may be better understood by management. For example, the proposed guidance makes reference to the ‘design’ and ‘operation’ of controls which is perceived as ‘auditor’ parlance

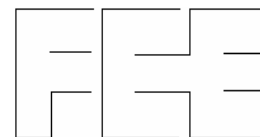
The PCAOB proposal makes reference to ‘identifying’ and ‘testing’ controls – language which is not used in the SEC guidance. It would be helpful that the terms are more aligned when discussing the same areas.

### **5. Potential implementation problems**

The SEC’s Proposed Release anticipates cost savings, both for the entity directly and indirectly in respect of consulting and audit fees. For example, in removing the necessity for auditors to test management’s assessment process, the SEC hopes to eliminate unnecessary duplication of work. Whilst to some extent this is likely to be true, given that management’s assessment process constitutes an internal control over financial reporting from the auditor’s point of view, the auditor will not be able to discount the process entirely and thus cost savings may not be as great as anticipated.

The PCAOB proposed Auditing Standard is built upon the assumption that audit costs can be reduced. We are not sure that this can be the case in every audit and are concerned that entities may have overly optimistic expectations as to the magnitude of cost savings that can be achieved in practice. When, and only when, management has designed and is operating, an effective and well-documented system of internal controls (including documentation of management’s assessment) can audit costs be kept to a minimum.

Therefore, an impact assessment of the proposals is recommended to test in the field whether the anticipated cost savings will materialise in practice.



## 6. Consistency issues

We believe that it is important that both the SEC and the PCAOB documents are aligned and consistent within themselves. If they are not, this could cause confusion and may result in unintended consequences such as unnecessary costs.

As the documents currently stand, there are a number of inconsistencies both within each document and between the two documents. Although we only highlight two such matters, we are sure that other commentators will identify a number of other matters that will need to be rectified by the SEC and PCAOB working together.

### Definition of material weakness

The SEC's definition of 'Material Weakness' (page 13) is:

*A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's internal control over financial reporting.*

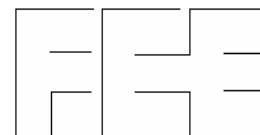
The PCAOB defines 'Material Weakness' (paragraph A8) as:

*A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.*

We believe that a control deficiency, as part of the auditor's definition, can be wider than a deficiency in internal control over financial reporting, which forms part of the SEC's definition of a material weakness for management. We also note that the concept of prevention or detection on a timely basis is included in the SEC's definition of material weakness for management but not in the PCAOB's definition of material weakness for auditors. [Both of these differences violate FEE principle 2 as further detailed above.] On a matter as important as this, we suggest that the SEC and PCAOB adopt one definition of material weakness with primacy being given to the SEC. Having inconsistent definitions is problematical and unnecessary.

### Controls with lower risk

There is an apparent discrepancy between the auditor's required treatment of controls regarded as having a lower risk in the PCAOB proposed AS 5 and that proposed in the SEC guidance for management. In the latter, for example on page 36, self-assessment may be used by management, whereas the auditor is not afforded similar treatment for controls regarded as having a lower risk in the proposed AS 5. Another such example is paragraph 36 on page A1 – 17 of the PCAOB document whereby the auditor should perform a walkthrough for each significant process. The SEC has not proposed a similarly stringent measure for management's assessment of internal control.



## **Questions asked by the SEC**

We comment below on some of the questions posed by the SEC:

- Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process? Does the proposed guidance allow for management to conduct an efficient and effective evaluation? If not, why not?

*We refer you to our main comments number 1 on ‘One approach versus two separate exercises’, number 2 on ‘The elimination of the requirement on the auditor to evaluate management’s process, number 4 on ‘SEC’s guidance to management is rooted in an audit approach’ and number 5 on ‘Potential implementation problems’.*

- Considering the PCAOB’s proposed new auditing standards, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Considering and Using the Work of Others In an Audit, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to resolve the incompatibility?

*We refer you to our main comments number 6 on ‘Consistency issues’.*

## **Questions asked by the PCAOB**

We have chosen to answer a selected number of the questions asked by the PCAOB – as detailed below:

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?

*We refer you to our main comments number 3 on ‘PCAOB regulatory and enforcement functions – lack of symmetry between them.’*

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

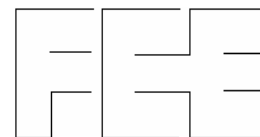
*We refer you to our main comments number 6 on ‘Consistency issues’ on controls with lower risk.*

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?

*We refer you to our main comments number 6 on ‘Consistency issues’ on definition of material weakness.*

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

*We refer you to our main comments number 1 on ‘One approach versus two separate exercises’.*



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?

*We refer you to our main comments number 2 on 'The elimination of the requirement on the auditor to evaluate management's process.'*

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?

*We refer you to our main comments number 5 on 'Potential implementation problems'.*

We would be pleased to discuss with you any aspect of this letter you may wish to raise with us and to send you copies of the two papers produced by FEE if these would be of interest to the SEC or PCAOB.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Jacques Potdevin'. The signature is written in a cursive style with a long horizontal stroke at the end.

Jacques Potdevin  
President

February 16, 2007

Cynthia M. Fornelli, Executive Director

**GOVERNING BOARD**

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Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, DC 20006-2803

**RE: PCAOB Rulemaking Docket Matter No. 21 – *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals*, PCAOB Release No. 2006-007**

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is a newly formed group created by the public company auditing profession to help foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. The CAQ consists of approximately 800 member firms that audit or are interested in auditing public companies. We welcome the opportunity to share our views on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals* (December 19, 2006).

The CAQ supports the PCAOB's proposed auditing standard on internal control over financial reporting and the related proposals. Overall, we believe that these proposals will facilitate continued progress in upholding the investor protections that are so fundamental to the success of the Sarbanes-Oxley Act (the Act) and the market vitality that has been the result of its passage in a manner that better balances costs with benefits. These changes also will serve to improve the effectiveness and efficiency of the processes related to the internal control reporting provisions of the Act.

Since its passage, the Act has served to enhance the integrity of our capital markets and restore investor confidence. It has done so in part by recognizing that effective internal controls are the bedrock of reliable financial reporting. As the PCAOB contemplates issuance of the new standards and related proposals, we strongly believe that change should flow primarily from the desire to reinforce the significant benefits of Section 404 of the Act and the audit of internal control over financial reporting rather than a drive to cut costs.

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Investors are the lifeblood of our capital markets system, and that system can not thrive without investors' steady, unwavering belief that legislative and regulatory safeguards are designed for their protection. We believe that the PCAOB's proposals support our mutual and deep commitment to investors and the markets.

We expect the proposed changes, along with the proposals by the Securities and Exchange Commission (SEC), will result in a reduction of total Section 404 efforts, due to various specific, positive changes in the proposals. These would include the ability of an auditor to (a) determine audit coverage based upon risk, without any pre-established quantitative coverage requirement, relative to an issuer's operations; (b) adjust, under certain conditions, the nature, timing and extent of testing of particular controls, based in part on cumulative experience gained in prior audits; and (c) increase the use of the work of others, if certain conditions are met.

We believe that the scope of these reductions in effort, and their relative balance between management effort and auditor effort, will likely vary significantly based on facts and circumstances for each particular company. Factors that will impact these reductions include: (a) the degree to which management undertakes a thoughtful, comprehensive effort to rationalize the controls that it includes in its assessment; (b) the state and quality of an issuer's control structure, as well as the degree of centralization and complexity of its operations, and the risks inherent in its business model; and (c) the quality and commitment management demonstrates in its assessment process, including the quality of its documentation, its tone at the top, and the consideration it gives to various activities it performs, in order to maximize the degree to which these could be used by the auditor.

Because of these and other factors, it is not possible to set the expectation of a specific or across-the-board reduction that the proposals by the PCAOB and the SEC will cause in Section 404-related costs for all companies. Although the effect of the new guidance will vary from company to company, the maximum opportunities for efficiencies and cost-effectiveness in Section 404 implementation can be obtained when management and auditors work together to conduct their assessments in a complementary manner, and when the auditor can make effective use of other's work. We also believe that the benefits from the SEC and PCAOB proposals will be greatest to companies that have not yet initially implemented the requirements of Section 404, such as non-accelerated filers and new public companies. We also expect that the cost of complying with Section 404 can decline as companies and members of the auditing profession become more familiar with the legal and regulatory requirements.

We support the PCAOB's increased emphasis and flexibility on the auditor's use of professional judgment, and its decision to apply a single model of auditor reporting on internal control over financial reporting, that is scalable to companies of varying size *and* complexity.

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We also applaud the PCAOB's project to develop guidance and education for auditors of smaller public companies that is supported by many of the member firms of the CAQ. This project will facilitate scalability of the proposed standard in an effective and efficient manner for audits of these smaller public companies.

The CAQ also supports the PCAOB's plan to require that auditors obtain evidence regarding the operating effectiveness of controls to determine whether the controls in place actually work as intended. Requiring auditors to apply a risk-based approach to testing controls and annual tests of key controls supports the reliability of the audit.

The CAQ appreciates the PCAOB's emphasis on more flexibility in determining the extent to which the work of others may be used by the auditor. However, we believe that changes in the proposed standard on internal control over financial reporting in this area, coupled with the existing standard "*The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*" (AU sec. 322), can achieve the Board's objective of effective and efficient implementation of Section 404. Accordingly, we do not support the Board's proposed standard that would supersede AU sec. 322, as it is unnecessary to achieve the Board's objectives in this area, and may reduce audit effectiveness through the inappropriate use of the work of others.

However, if the Board determines that it is necessary to have a separate standard for considering and using the work of others in an audit that supersedes AU sec. 322, we believe that the Board should incorporate the paragraphs of AU sec. 322 identified in the appendix to this letter, which are missing from the proposed standard, as we consider these to be fundamental to reliance on the work of others, to help ensure both effective and efficient use of the work of others in execution of all aspects of an integrated audit.

A more detailed discussion of our perspective is included in the appendix to this letter, and many of the public company auditing firms that are members of the CAQ will submit their own comment letters.

We appreciate the PCAOB's efforts to improve integrated audits and implementation of the provisions of Section 404, and look forward to working with all market constituents to identify enhancements that improve efficiency without diluting investor protections. We believe that these changes should be implemented as soon as practicable in 2007, allowing for sufficient time for auditors to conduct training and develop methodologies for complying with the final standard and guidance. In this regard, we encourage the Board's accelerated consideration of these proposals, so that the revisions can impact audits for the current year ending December 31, 2007.

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Page 4

We appreciate the opportunity to comment on the PCAOB's proposals and would welcome the opportunity to meet with you to clarify any of our comments.

Sincerely,



Cynthia M. Fornelli  
Executive Director  
Center for Audit Quality

cc: PCAOB  
Mark W. Olson, Chairman  
Kayla J. Gillan, Member  
Daniel L. Goelzer, Member  
Willis D. Gradison, Member  
Charles D. Niemeier, Member  
Thomas Ray, Chief Auditor and Director of Professional Standards

SEC  
Chairman Christopher Cox  
Commissioner Paul S. Atkins  
Commissioner Roel C. Campos  
Commissioner Annette L. Nazareth  
Commissioner Kathleen L. Casey  
Conrad Hewitt, Chief Accountant  
Zoe-Vonna Palmrose, Deputy Chief Accountant for Professional Practice  
John W. White, Director of Division of Corporation Finance

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## **Appendix**

The Center for Audit Quality recognizes that there were various requests for comments within the PCAOB's Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals*. However, we would like to state that we have limited our comments to the significant matters noted below on behalf of our member firms. Please refer to the individual public company auditing firm letters for additional comments.

We are very supportive of the direction of the proposed standards, particularly their increased emphasis on appropriate exercise of auditor judgment. However, we offer the following comments intended to improve them to meet the overall goal of making implementation of Section 404 more effective and efficient.

### **Considering and Using the Work of Others in an Audit**

We believe that the changes in the proposed standard on internal control over financial reporting (ICFR) coupled with the existing standard "*The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*" (AU sec. 322) can achieve the Board's objective of effective and efficient implementation of Section 404. Accordingly, we do not support the Board's proposed standard that would supersede AU sec. 322, as it is unnecessary to achieve the Board's objectives in this area, and may reduce audit effectiveness through the inappropriate use of the work of others.

Conversely, if the Board concludes that a new standard is necessary, one very important principle in AU sec. 322 that has not been included in the proposed standard relates to the auditor's ability to use the work of others, where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, and the notion that in these circumstances, the auditor's evidence should not be derived solely from the work of others. We have noted the relevant specific paragraphs from AU sec. 322 below and recommend that the Board add this very important concept to the proposed standard.

**.21** For assertions related to material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, the auditor should perform sufficient procedures to fulfill the responsibilities described in paragraphs .18 and .19. In determining these procedures, the auditor gives consideration to the results of work (either tests of controls or substantive tests) performed by internal auditors on those particular assertions. However, for such assertions, the consideration of internal auditors' work cannot alone reduce audit risk to an acceptable level to eliminate the necessity to perform tests of those assertions directly by the auditor. Assertions about the

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valuation of assets and liabilities involving significant accounting estimates, and about the existence and disclosure of related-party transactions, contingencies, uncertainties, and subsequent events, are examples of assertions that might have a high risk of material misstatement or involve a high degree of subjectivity in the evaluation of audit evidence.

.22 On the other hand, for certain assertions related to less material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is low, the auditor may decide, after considering the circumstances and the results of work (either tests of controls or substantive tests) performed by internal auditors on those particular assertions, that audit risk has been reduced to an acceptable level and that testing of the assertions directly by the auditor may not be necessary. Assertions about the existence of cash, prepaid assets, and fixed-asset additions are examples of assertions that might have a low risk of material misstatement or involve a low degree of subjectivity in the evaluation of audit evidence.

In addition, recognizing that the “principal evidence” concept previously included in *PCAOB Auditing Standard No. 2, “An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements”* has been eliminated, the auditor still must be in a position to positively state in the opinion that he or she has audited the financial statements and management’s assessment of ICFR. The ability of the auditor to state such an opinion implies that he or she has obtained principal evidence. As noted in paragraph 9 in the proposed standard on considering and using the work of others in an audit, judgments about the sufficiency of evidence obtained, assessments of risk, the materiality of misstatements, and evaluations of test results must be those of the auditor. We believe that replacing AU sec. 322 with the proposed standard likely will lead to confusion regarding the auditor’s implied obligation to obtain principal evidence in support of his or her opinion.

Paragraphs 3 through 6 of the proposed standard describe the auditor’s responsibility to determine whether there are activities performed by others that can be used in connection with the audit. We believe that these paragraphs likely will lead to unnecessary effort expended searching for activities significantly removed from those of internal auditors and similar groups described in AU sec. 322 that, upon consideration, will not be useable because of issues related to competence and objectivity or are not tests that provide audit evidence as described in the proposed standard. Accordingly, we see no benefit to adding these paragraphs. If the Board decides to adopt the proposed standard, then we recommend that the discussion of competence and objectivity precede the consideration of relevant activities in order to more appropriately reflect the thought process of the auditor in considering the work of others. In addition, the Board should describe the extent of documentation it would consider appropriate when conducting the activities required in paragraphs 3 through 6.

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### **Consideration of Fraud and Company-Level Controls**

We believe it is important that when an auditor assesses risk when planning the audit, the interaction between the assessed risk of fraud for certain assertions be addressed when scoping the audit of ICFR. We recommend that this notion be clearly articulated in the proposed standard. For example, we believe the Board should better articulate this notion in the interaction between the risk that the control might not be effective as described in paragraph 51 and whether the control is intended to address significant fraud risk.

Another example is that the Board's proposed standard lacks clarity with regard to the consideration of the precision of company-level controls as it relates to the risk of fraud. In other words, we believe that the concept regarding company-level controls cited in paragraph 43 of the proposed standard should be reiterated earlier in the standard – around paragraph 17, the section on Identifying Company-Level Controls – to better address the auditors' consideration of fraud and to better integrate fraud considerations consistent with the concepts in AU sec. 316 "*Consideration of Fraud in a Financial Statement Audit.*"

### **Considering the Effect of Company-Level Controls**

The evaluation of company-level controls is an important part of a top-down, risk-based approach and should occur early in the audit. However, we are concerned that, at times, such controls may not operate in a manner that would identify possible breakdowns in lower-level controls. For example, company-level controls may not be designed at a level of precision that would sufficiently address the risk that material misstatements to a relevant financial statement assertion will be prevented or detected.

We believe that the final standard should acknowledge that in many circumstances company-level controls only indirectly relate to relevant assertions (e.g., those controls that primarily operate within the control environment) and do not operate in a manner that would be sufficient to address the risk of material misstatement to specific accounts and disclosures in the financial statements. In addition, we would welcome examples that illustrate the linkage between company-level controls and relevant assertions and the benefit that could be derived from them in determining the nature, timing, and extent of testing of lower-level controls.

### **Multi-location Scoping Decisions**

We are supportive of the Board's refocus of the multi-location testing requirements on risk rather than coverage and likewise are supportive of the deletion of "large portion" from the proposed standard on ICFR. However, we believe that the auditor should not lose sight of the need to obtain sufficient audit evidence to support the auditor's opinion. Accordingly, we suggest that guidance

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be added to paragraph B13 acknowledging that the responsibility for the opinion expressed in the auditor's report rests solely with the auditor.

### **Strong Indicators of Material Weaknesses**

We have observed that the description of strong indicators of material weaknesses in the Board's proposed standard on ICFR differs from the SEC's proposed management guidance. As indicated in our letter to the SEC on its proposed management guidance, we believe that the SEC should conform its description to the PCAOB's description of such factors. Conforming the two documents will help to reduce potential confusion, inconsistencies, and possible inefficiencies that may occur as a result of differing evaluations by management and auditors of the same control deficiency. Please refer to our comment letter to the SEC on the proposed management guidance on ICFR.

### **Documentation**

We note that there may be possible unintended consequences relative to the interaction between the requirements of the proposed standard on ICFR and the Board's Auditing Standard No. 3 "*Audit Documentation*," as a result of the use of the words "should" and "must" throughout the proposed standard. For example, paragraph 51 of the proposed standard under the *Relationship of Risk to the Evidence to be Obtained* includes a requirement that "[f]or each control selected for testing, the auditor **should** [emphasis added] assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result." Compliance with this requirement could generate a level of documentation relating to the auditor's assessment of risk as it pertains to documentation required, that may not necessarily add to the level of effectiveness of the audit. Therefore, we recommend that the Board reconsider the use of the words "should" and "must" throughout the proposed standard to ensure that disproportionate auditor effort is not unnecessarily devoted to documenting consideration of items that ordinarily would be incorporated into the auditor's overall methodology.

### **Precedent of Mandatory Efficiency Requirements**

We support the objective of conducting an efficient as well as effective audit, but we are concerned about the precedent established with the inclusion in an auditing standard of presumptively mandatory performance requirements relating to efficiencies. We are concerned that this is inconsistent with the nature of professional standards, and that it may detract from the overarching objective of performing high quality audits – audits that ultimately help protect investors.

**Thomas I. Selling PhD, CPA**  
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February 16, 2007

Office of the Secretary  
PCAOB  
1666 K Street, NW  
Washington, DC 20006-2803

VIA ELECTRONIC MAIL

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir/Madam:

I appreciate this opportunity to comment on the proposed PCAOB Auditing Standard No. 5 (AS 5), which would supersede AS 2. I am responding to Question 9 in PCAOB Release 2006-007 (Release). Specifically, my comments pertain to the use of the term “reasonable possibility” in the proposed redefinitions of “significant deficiency” and “material weakness.”

**Recommended Revisions to Proposed AS 5**

1. Revise Paragraph A8 to delete the term “reasonable possibility” in the definition of “material weakness” and insert the appropriate number, as follows:

A **material weakness** is a control deficiency, or combination of control deficiencies, such that there is at least a *[insert number between 0.0 and 1.0 here]* probability that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected.

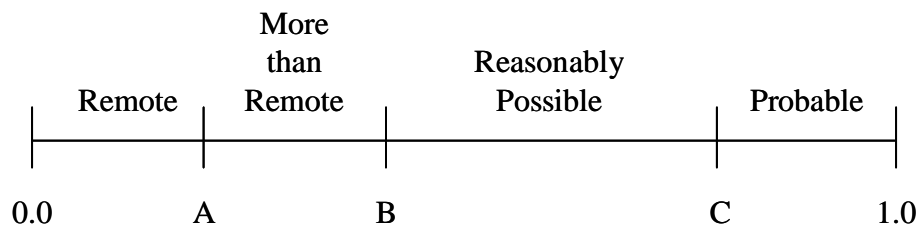
2. Delete the note to Paragraph A8.
3. Revise Paragraph A12 to delete the term “reasonable possibility” in the definition of “significant deficiency” and insert the appropriate number, as follows:

A **significant deficiency** is a control deficiency, or combination of control deficiencies, such that there is at least a *[insert number between 0.0 and 1.0 here]* probability that a significant misstatement of the company’s annual or interim financial statements will not be prevented or detected.

4. Delete the note to Paragraph 73 of proposed AS 5.

### Analysis

In the Release, the PCAOB has stated that it is adopting terminology from Statement of Financial Accounting Standards No. 5 (SFAS 5), which employs the qualitative terms “more than remote”, “reasonably likely [or possible]” and “probable.” The points A, B and C in the diagram below denote unspecified probabilities that must, of necessity, demarcate the ranges of uncertainty used to apply SFAS 5:



Before proceeding further, it is important to note that Points A, B and C do not change. In other words, the points are unaffected by the facts and circumstances of a particular transaction; similarly, no publication of the PCAOB that I am aware of provides any indication that the PCAOB believes that the points should vary across audit engagements for the purpose of determining whether a significant deficiency or material weakness exists.

Regardless of the FASB’s motives for promulgating SFAS 5 as it did, it is neither in the public interest, nor is it consistent with the PCAOB’s mission, to continue to follow the unnecessarily vague approach to dealing with uncertainty set forth in SFAS 5. The FASB did not disclose any information concerning the process by which “probable” and other qualitative terms for describing uncertainty were selected in the Basis for Conclusions section of SFAS 5; or whether quantitative probabilities were even considered. Arguably, many of the well-known problems in application of SFAS 5 have resulted from the absence of explicit points of demarcation—particularly Point C in the above diagram. The ambiguity and inevitable disagreement between auditors, preparers and users as to the appropriate demarcation Points B and C has had two effects: (1) substantial lack of comparability of financial statements, and (2) windfalls to auditors and preparers by allowing them to avoid being held to account for misleading financial statements.

With regard to auditing standards, investor protection is less than adequate by ambiguous specification of the point between “more than remote” and “reasonably possible” in AS 5 (i.e, Point B in the above diagram). Blurring the demarcation point with vague terminology adds judgment and cost to financial reporting while providing no discernible purpose that is consistent with the mission of the PCAOB. While I am sympathetic to a desire to avoid bright-line rules in principles-based standards, it is not always appropriate to do so. In respect to thresholds in the form of probabilities, the normative economic

principles that address the use of judgment in decision making require that subjective probabilities be quantified. These principles have been widely applied for generations, taught in all accredited schools of business and accounting, and incorporated into more recent accounting standards.<sup>1</sup>

As applied to auditing, risk assessment is inherently quantitative and structured, even though an assessment of materiality may be more judgmental and dependent on facts and circumstances. Along these lines, the Board's contention that "evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made *without* [emphasis supplied] quantifying the probability of occurrence as a specific percentage or range"<sup>2</sup> runs counter to norms of rational decision making. For example:

*Assume that Point B in the earlier diagram represents the probability 0.4. In the terms of proposed AS 5, this is the lower bound of "reasonably possible." Further assume that the auditor determines the materiality threshold for a misstatement of revenues to be \$1,000,000. Therefore, \$400,000 (0.4 x \$1,000,000) represents the maximum allowable expected misstatement (given that a misstatement is at least reasonably possible) such that an ICFR weakness would not be disclosed as material.*

I am not sure how the Board can expect an auditor to obtain reasonable assurance for its opinion within the framework of AS 5 without undertaking a process substantially similar to the one described by the above example. Stated another way, as AS 2 was written, and as proposed AS 5 is currently written, it should be unacceptable for auditors to adopt different threshold probabilities for different clients, or even for different financial statement amounts<sup>3</sup> (although materiality or significance thresholds may reflect these factors). The unavoidable conclusion from the PCAOB's language in these auditing standards is that it should not be necessary, or required, for each auditor and client to come to separate conclusions on each engagement, and negotiate the threshold probability for "reasonably possible." Yet, the vague specification of Point B is an invitation for such negotiations to occur.

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<sup>1</sup> SFAS 144 on impairment of long-lived assets recognizes that probability-weighted cash flows may be used to test the recoverability of long-lived assets (§17). SFAS 109 on income taxes specifies a probability threshold of 0.5 when measuring the deferred tax asset valuation allowance (§17). Perhaps most germane is the auditing literature, wherein it is stated in AU Section 350 on sampling, "...the auditor should determine an acceptable audit risk and subjectively *quantify* [emphasis supplied] his or her judgment of the risk of material misstatement." (§20).

<sup>2</sup> Note to ¶73 of proposed AS 5

<sup>3</sup> To illustrate a problem of static thresholds, consider the following extension of my numerical example: if a particular control over revenues had a probability of misstatement of 0.39, the control would never be reportable as a material weakness even if the resulting misstatement would be significantly greater than \$1,000,000. Thus, thresholds *per se* in proposed AS 5 lack a foundation in principle.

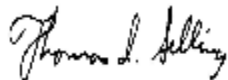
In summary, the probability threshold in the definitions of “significant deficiency” and “material weakness” can be, and therefore should be, explicitly quantified. A change from qualitative terminology (i.e., “more than remote” in AS 2, or “reasonably possible” in proposed AS 5) would simplify auditing standards, increase reliability of ICFR audits, and reduce audit and compliance costs. Such a change would better protect the interests of investors and further the public interest through greater clarity and transparency of auditing and financial reporting. Especially since the PCAOB’s position is that probability thresholds should not change with facts and circumstances, I know of no reason for intentionally blurring the lines with ambiguous language when precise thresholds are feasible.

**About the Commentator**

I am an emeritus professor of accounting of the Thunderbird School of Global Management and a former academic accounting fellow at the SEC, Office of the Chief Accountant. At present, I provide professional education, consulting and litigation support services. I also serve on the advisory board of the Association of Audit Committees, Inc.

If the PCAOB staff has any questions concerning this submission, please feel free to contact me at 602.228.4871, or via e-mail at [tom.selling@grovesite.com](mailto:tom.selling@grovesite.com).

Very truly yours,



Thomas I. Selling PhD, CPA



## North Carolina State Board of Certified Public Accountant Examiners

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February 19, 2007

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

RE: PCAOB Rulemaking Docket Matter No. 021

To Whom It May Concern:

The North Carolina State Board of CPA Examiners (the Board) has reviewed the proposed auditing standards, *An Audit of Internal Control over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals*, and *Considering the Work of Others in an Audit*, as well as the proposed new independence rule, *Audit Committee Pre-Approval of Services Related to Internal Control* and the related amendments to the PCAOB's interim standards. The Board believes that the proposed Statements, rule, and amendments contribute toward improving the audit of internal control over financial reporting.

The Board offers the following comments:

Page A1-11 (18.)

Company-level controls should include controls over the execution, recording, and reporting of related-party transactions since, unfortunately, experience has shown that business structure and operating style are occasionally deliberately designed to obscure these type transactions.

Page A1-16 (34.)

The Board recommends that to ensure that the auditor understands the flow of major classes of transactions completely through to financial reporting the first bullet point be revised to read, "Understand the flow of major classes of transactions, including how these transactions are initiated, authorized, processed, recorded and reported."

Page A1-21 (52.)

The Board recommends adding a bullet point that reads, "Whether there have been programming changes during the reporting period that might affect the performance of an automated control."

Page A1-24 (62.)

The Board recommends that the first note be revised to read:

Testing a single operation of an automated control might result in sufficient evidence that the control operated effectively, provided that relevant information technology general controls also are operating effectively and there were no programming changes affecting the automated control during the reporting period.

The Board wishes to commend the PCAOB for its work to make audits more efficient, effective, and useful. The PCAOB's regulations and standards are improving the areas of corporate governance, the quality and efficiency of important corporate processes and controls, and public company financial reporting.

Sincerely,

*Leonard W. Jones, CPA*<sub>lrh</sub>

Leonard W. Jones, CPA  
President

JMB/lrh



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Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021

February 16, 2007

Dear Laura,

San Jose Water Company is in full support of the new proposal on the subject of switching from rule-based to principles-based accounting; putting more focus on risk and materiality, and help management make their evaluation process more efficient and cost-effective.

Our company's annual revenue is under \$200M; however, we have to spend approximately half a million dollars per year just to comply with SOX, not including the 2+ dedicated in-house staff working on SOX, as well as the significant time I spend on the topic. On top of that, every single one of our staff has to work longer and harder because of the extra burden of SOX compliance. Because our industry is heavily regulated, we cannot pass on the extra cost to our customer without prior approval, and the approval process is vigorous and takes place once every 3 years.

The current SOX approach of documentation and testing do not allow procedures and processes to be properly evaluated for their overall effectiveness. At smaller companies, segregation of duties is often more difficult to accomplish due to limited staff and resources, so excessive documentation and testing is burdensome for smaller firms. We believe the most important control is the "tone at the top," and we fully support the streamlining and simplifying the whole process of SOX for small companies.

Based on the above explanation, we believe that PCAOB should coordinate with the SEC's efforts and rewrite audit guidelines for auditing firms to provide the use of better judgments and appropriate audit procedures in auditing smaller companies. We also believe that auditors should be able to rely on the work of others (such as company's internal auditor, as well as 3<sup>rd</sup> party testers), and make the audit more scalable for smaller and less complex companies. Our audit fee has increased significantly after SOX due to the increased scope of work, and some of the focus is unnecessary and inefficient.

Thank you very much for your attention regarding this matter.

Sincerely,

A handwritten signature in black ink that reads 'Angela Yip' in a cursive script.

Angela Yip