D O N A L D   N E I L   A N D E R S O N

October 22, 2003

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

Dear Sir,

PCAOB Rulemaking docket Matter No 008

I wish to comment on the new PCAOB draft standard referenced above. I write in the context on an informed private individual having spent my entire career in audit and finance both in Europe and the US. I am particularly motivated because of the loss of trust in financial markets and my own personal pension savings losses.

It is of great comfort to see that he PCAOB is establishing its independence of mind right from the start and is not minded to continue to allow the accounting profession to regulate itself. Indeed in the run-up to the issue of these standards I was following with interest the view of the profession that it would itself set the standards and more importantly it viewed the introduction of S 404 of Sarbanes Oxley as an opportunity to boost sagging profitability on audit work. As I understood it the profession viewed S 404 as a second government mandated franchise to extract much larger fees from its clients by calling the attestation on internal control over financial reporting a second audit engagement and therefore billable as such.

My view of the wording of Sarbanes Oxley is that the attestation of management's evaluation of the effectiveness of internal control over financial reporting is to be considered a necessary part of the audit of financial statements. It is work which enables the independent auditor to opine, in a truly meaningful manner, on the financial statements and is therefore a necessary component of the statutory audit. It should therefore be performed at no extra cost to the client's shareholders.

Indeed the implosion of Arthur Andersen has served only to redistribute the audit pie to an even smaller number of accounting firms. The fact that there are now only 4 firms left is in itself is not a desirable state of affairs, and I have disagreed with the mega mergers that have taken place on grounds of competition.

The audit profession came out of this far better than I or they could have expected, given their role and complicity, and in some cases outright involvement in the manufacture of schemes, which resulted in considerable losses to the shareholders and perhaps more important the stakeholders in the corporations involved.

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It is clear to me that public trust will only return to the markets in the same measure as the PCAOB and SEC visibly and boldly act to protect those markets. In the mid 1980s I spoke to Sir David Tweedie, then David Tweedie, who was just taking over at the IASB from Bryan Carlsberg. His view was that new standards would be ignored until standard setters were willing to publicly hang the first transgressor.

I can see that powerful lobbies have been visiting the PCAOB, and vested interests are being actively protected, notably the issues of additional client services performed by the independent auditor, independence and the issue of foreign jurisdiction. My hope is that the PCAOB will uphold the spirit of al of the provisions of the act. I would like to see non-US audit firms treat the inspections by the PCAOB very seriously indeed, and be aware that very competent people will be reviewing their activities and revealed failures can have dire consequences.

Before I answer the requested questions, I feel that there is one very important omission in the structure of the PCAOB draft standard. The standard often cites the pervasive nature of information systems and in fact notes that even the smallest of companies relies for its financial accounting and reporting on three level computer architectures, software, databases and infrastructures. Since the Treadway Report over 10 years ago the use of IT in financial reporting has expanded exponentially. My own experience tells ma that there are a bewildering number of applications, databases and infrastructures that combine together in layers to arrive at the consolidated numbers for a large international corporation. Even the analytical reviews and substantive tests will have recourse to some IT system output somewhere.

You mention that a standard or model for internal control could be the COSO or Treadway standard. No one would disagree. However I would like to see the Cobit standard added for internal control as applies to IT. It would in my view be a simple addition to the draft standard and would be fully understood by all auditors around the world. The standard points to the advantage of common standard and common vocabulary. The use of Cobit would I believe offer the same standard and reference point as regards IT systems and control. Recourse to Cobit would for example be very useful to resolve IT related control issues where management and audit differ in their view of significant deficiency or material weakness.

Yours sincerely,

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Responses to Docket Matter No 008

1. Yes. It is essential to have one unique definition or title. The wording adequately encompasses the "disclosure" controls envisaged in the Act.

2. No. If the opinion on the financial statements is independent of the S 404 opinion why should the auditor have to perform a financial statement audit? It makes sense of course but the S 404 attestation includes text that refers to possibility or probability as opposed to certainty such as, "more than a remote likelihood" It is possible is it not that internal control over financial reporting could be bad but the reported amounts present a true and fair view?

3. Yes. I view the work on internal control as a component of the work needed to attest to the assertions of management regarding the financial statements. Otherwise what is management basing their assertions on?

4. Yes. By implementing "principle-based" as opposed to "rule-based" standards the appropriate forms applicable to small and medium sized companies should be relatively clear in each circumstance.

5. Yes. It is clear to anyone who has performed an audit or who has been audited themselves that the requirement of the profession to make profit from the work and still cover the compensation of Partners Managers and Staff not to mention overheads, requires that junior staff be used to the maximum. Persons in the profession wish to progress as quickly as possible so there is considerable mobility. The result is that more and more work is done by junior persons who are wholly unfamiliar with the business of their clients.

   Having served in the profession I know this to be true and I know that supervision is not always consistent either. From the client perspective I detect enormous amounts of discontent at the level and competence of staff performing the audits. In Germany a famous saying is that KPMG actually stand for **K**inderen **P**rufen **M**eine **G**eschellscaft, translated "Children Audit My Company". The youth/competence trade off is clearly an issue. I know for a fact that when older more experienced people are auditing the response from management is far higher, as well as the level and depth of explanation. A more experienced person is far less easier to fool and far more tenacious. The huge profits of the profession might be reduced but the stakeholders would be better served if audits were performed by competent experienced persons.

6. Yes. I cannot see how it would be possible to refute an assertion by management at any level without having more than a solid grasp of the internal control environment.

7. Yes. If adequacy of documentation can be considered as a control deficiency then the PCAOB should assist management and audit alike to determine what those criteria are. Without such criteria conflicts of opinion can easily arise.

8. Yes. Inadequate documentation demonstrates a lack of will on the part of management to engage in the spirit of the Act. Documentation is testimony to commitment and professional execution. It is also auditable and reviewable by all parties and should take a position in the "Control Environment" as defined by COSO.

9. Yes. Walk-through is a standard procedure. Making it mandatory only formalizes it.

10. Yes. The walk-through is a key audit procedure. If the auditor has to rely on his own opinion then this part of the audit should not be delegated.

11. Yes. Every year, every relevant assertion for all significant accounts and disclosures. To do otherwise would introduce a very serious flaw in the audit and the related opinion.

12. This is another one of those questions that needs to be answered. If all things were simple, or auditors were all –knowing then the auditor would not need the knowledge, expertise or experience of others. The world alas is otherwise. The auditor should be advised to rely on the work on Internal Auditor where that function is properly staffed and constituted. That is to say it is independent, expert and experienced and shares the reporting structure enjoyed by independent auditors. That is to say with access and reporting to the Audit Committee, staffed by qualified individuals .The same may be true of outside experts in specialized areas. The cost of the audit should be as low as possible and avoid duplication or parallel checks.

13. Yes. Systemic controls. Specialized controls such as Health and Safety, Expert controls such as Tax or Legal.

14. No. The standard should be more explicit about the work of internal audit. It should ascribe criteria that define what constitutes an internal audit department whose work can and should be relied upon. See above. CFOs will expect to see a cost effective coverage not duplication and confusion.

15. Yes. Flexibility in this domain brings in professional judgment, which is fine.

16. Yes. The auditor should collect the principal evidence on which the opinion is based.

17. No. The definitions are problematic. Firstly they are negatively stated. I think there should be more straightforward and not couched in unusual terminology. After all this is the critical part of the process. Definitions should more appropriate to internal control reports. Most reports rate deficiencies as low medium or high, each with its own simple definition. One High need not be significant but if accompanied by 25 Mediums the whole risk profile changes. In any audit of internal control there are going to be lots of issues and items, so it make s sense to look at a cumulative view of all of the issues ranked y importance. If The PCAOB wished there are already a number of ranking criteria available. If these same criteria were used by all auditors independent as well as internal, a great deal would be achieved at no cost, and great benefit to Boards and shareholders alike.

18. Yes. Audit reports are tightly worded in any case.

19. Yes. Without some idea of severity there is no consequential idea of importance and hence relevance. See 17 above for ranking criteria.

20. Yes. I have participated in many audit meetings when the true impact of a control weakness has in fact been either missed or over-stated. It is essential to get it all out on the table.

21. No. I think the PCAOB can go further with what constitutes the High risk or material weakness. The more comfortable people become with the criteria the less likely will be the misclassification of any deficiency.

22. Yes. The PCAOB will however have to issue guidelines on exactly what is expected, so Audit Committees can fulfill their obligations and how auditors should go about their annual check of the fulfillment of these obligations. The same applies to smaller entities although few of these will find themselves "issuers" and caught by the Act.

23. Yes. It depends on the quality of the guidelines set by the PCAOB. I am positive Audit Committees would like to have authoritative guidance on this subject.

24. No. No purpose is served by withdrawing from the engagement other than to create confusion, and introduce the possibility of "shopping around" for opinion. If the Audit committee is not competent surely this is exactly what shareholders need to know and what trust in financial statements is all about. Who should/will pay for a withdrawal?

25. No. A <u>single</u> material weakness should <u>not</u> be enough. Internal control consists of many issues some interlock and amplify other compensate and dilute. There may be one single "crock of gold" as in WorldCom and Ahold but this is rare and overly simplistic. An internal control report will not have a single material weakness, unless it is couched in very generic terms. What is more likely is that there will be a number of issues and the skill is to see what they all mean when put together. It is the weight of the issues in the final control matrix which is important to determine if control is effective or not, not one single large item. Auditors will have to look at and opine on softer issues like competence, compensation and motivation, estimation techniques and possible value ranges, complex assertions such as hollow swaps.

26. No. I think you describe control just as it is. That way you can opine on changes in the level and quality of control and demonstrate continued improvement which is something of more value to shareholders and markets. The High Medium Low matrix referred to earlier can be part of a balanced scorecard approach.

27. Yes. Where opinions differ the shareholders have aright to the expert opinion they have paid for. If they disagree with management's assertion the job is only half done in my view and adds a) no value b) considerable confusion c) considerable ill feeling d) constructs nothing. What is key to this issue is that management and the auditors share the same conceptual and practical view of what constitutes an internal control deficiency for the purpose of the Act. Management must be aware of the laws they are breaking, or the rules to which they are not conforming. Otherwise it gets to a difference of opinion and subjective interpretation as opposed to matters of fact.

28. Yes. Everything is to be gained by being as specific as possible.

29. Yes. There are many of these.

30. Yes. The idea of quarterly certifications is OK for the CFO and CEO on the numbers but for internal control it is over-kill. The only time the quarterly certification should demand independent audit work is a) the first opinion b) the follow up to an adverse opinion or qualification. For the rest the previous annual report suffices unless something new and of consequence has arisen ad interim.

31. Yes. See 30 above. Getting audit involved each quarter will mean that staff never leaves the client. This happens today for big clients viz Enron but increasing the quarterly obligation will only exacerbate this.