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

Re: PCAOC Rulemaking Docket Matter No. 008

Ladies and Gentlemen:

As a former auditor and accounting standard setter, and as a present member of the audit committee of three large publicly held corporations, I read your exposure draft on auditing internal control with interest. Accounting firms, corporate managers, and others will comment in detail on what is a very comprehensive document. I wish to make just a few general observations and then comment on one specific provision of the draft.

<u>General Concern About the Extensive Amount of Testing</u>

In general, I support independent auditor involvement with and reporting on internal control. However, the current draft strikes me as "overkill," requiring much more specific testing by the independent auditor than is necessary. In particular, my impression is that the draft allows insufficient reliance on the work of internal auditors. Frankly, I believe that internal auditors may be more experienced and better prepared to test some internal controls than external auditors. Another impression is that the independent auditors would have to do unnecessary, frequent re-testing of controls that haven't changed from period to period.

The PCAOB needs to consider the benefits of a required audit of internal control vs. the incremental costs. Costs are relatively easy to measure, at least after the fact. I note that the Committee on Corporate Reporting of Financial Executives International estimates that audit fees likely will increase by 30-50% if the exposure draft is adopted without change. My reading of the draft and general familiarity with the present costs of audits leads me to believe that that range is a reasonable estimate.

What then will be the estimated benefits against which such actual costs should be compared? I have heard two principal arguments for mandating audits of internal control. First, that required audits of internal control will lead investors to place more confidence in financial reports, to counter concerns that such confidence has declined as a result of recent restatements and accounting frauds. And, second, that if we are able to prevent even a single Enron or WorldCom and the resulting loss to investors the money will be well spent. The former reason is hard to evaluate although it certainly seems reasonable. I'm particularly concerned, however, about the second reason.

As a member of the Special Investigative Committee of the Board of Directors of WorldCom, I saw (after the fact) the terrible financial reporting fraud, and I helped the company try to determine what happened and how to prevent reoccurrences. You can view the Special Investigative Committee's final report in the SEC Edgar system. On pages 223 through 263 of that report the Committee discussed the work of Arthur Andersen. Without going into great detail here, it is fair to state that Arthur Andersen had evaluated WorldCom's internal controls as being very strong, such that they could do limited substantive testing using a "controls based audit." I fully recognize that an accounting firm's evaluation of internal control for purposes of planning the audit is nowhere near the same as an audit of internal control. However, I submit that if Arthur Andersen could have been so off base with respect to the general quality of internal control under the "old rules," there is no assurance that they would have caught the problems under the "new rules."

PCAOB Board members obviously have to make a tough judgment as to how much detailed work must be mandated in an audit of internal control. But I make the above observations so you are clear that sloppy auditing or an extremely well designed fraud may still cause some frauds to be undetected. As one observer recently commented, is it necessary for all public companies to have to take chemotherapy because a few of them could develop cancer? I urge you to carefully consider the comments of others who make suggestions to reduce some of the excessive detail in the draft while maintaining the overall objective.

<u>Evaluation of the Audit Committee</u>

My specific comment deals with your questions 22 through 24. I think it would be a mistake to require independent auditors to evaluate the effectiveness of the audit committee and consider an ineffective committee to be a material weakness. First, I think such a requirement would create a direct conflict. Under Sarbanes-Oxley audit committees have to hire and fire independent auditors. The audit committees on which I serve have already adopted procedures for the committee to evaluate the performance of the auditors annually. And, as part of our very open discussions with the auditors, we seek their feedback on how the committee's performance might be enhanced. However, requiring the auditors to specifically evaluate the audit committee's effectiveness creates a situation where either party could, effectively, "vote the other party off the island." That could lead to a very wary relationship between the parties rather than the positive, open communications that are needed.

Second, I am concerned about how the independent auditors would determine what is or isn't "effective performance" by an audit committee. While the draft does provide some limited implementation guidance in paragraph 57, this would inevitably be a tough judgment call. (I suspect that the only time an accounting firm would conclude that an audit committee was ineffective was at the same time the firm had decided to resign from the engagement.) I am particularly concerned about the first sentence of paragraph 58 that says, "As part of evaluating the independence of committee members, the auditors should evaluate how audit committee members are nominated and selected <u>and whether they act independently from management</u> (emphasis added)." Ideally, the audit committee should work closely with both management and the external auditors. The language cited would suggest that each of these parties has separate interests, which shouldn't be the case.

Finally, do you really want to put accounting firms in the position of "validating" the performance of audit committees in the event of subsequent lawsuits resulting from accounting problems? Think of the Enron situation.

Assuming that Arthur Andersen had concluded that the Enron audit committee was operating in an effective manner, when problems later developed would that shield the audit committee from any responsibility and place all of the blame on the auditors?

It certainly makes sense for the independent auditors to consider the work of the audit committee as part of the overall control environment. However, specifically requiring an evaluation and, in particular, possibly considering the audit committee to represent a material weakness just doesn't make sense to me. Chairman McDonough noted in a recent speech to the National Association of Corporate Directors that this particular provision struck him initially as problematic although it grew on him as he thought more about it. I feel that his first impression was correct.

<u>Other</u>

As a final comment, I am concerned about the inclusion, in several places in the draft, of statements that the document only specifies minimum procedures and additional work <u>may</u> be necessary. (An example is paragraph 40 – "The auditor could also evaluate additional relevant factors when planning the audit of internal control over financial reporting.") Those statements could cause accounting firms to expand their detailed procedures even more for fear that the SEC, a court, or some other after-the-fact critic could challenge them. When I was in public accounting we referred to such language as "hanging words" – the verbiage that plaintiff attorneys would seize on to challenge even the most reasonable audit performance. Given that this document already calls for an extremely comprehensive amount of work by the independent auditors, I urge you to reconsider whether these catchall phrases are necessary.

Please note that these are my personal comments and should not be attributed to my university nor to any of the corporations on whose boards I sit. If you have any questions about my comments, please call me.

Sincerely,

Dennis R. Beresford
Ernst & Young Executive Professor of Accounting