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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803
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Via E-Mail: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 008

Dear PCAOB Members:

The Sarbanes-Oxley Section 404 ("SOX 404") requirements on internal control over financial reporting are a key initiative in the effort to restore investor confidence and to ensure integrity in financial reporting. As an SEC registrant, UBS welcomes the opportunity to provide comments on the PCAOB proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements,* (the "Proposed Standard"). The following letter will provide some general comments followed by specific responses to some of the questions on which the PCAOB seeks feedback.

General Comments

As you may be aware, UBS is the world's leading provider of wealth management services, one of the largest asset managers globally, and among the major global investment banking and securities houses. Although it is headquartered in Zurich, UBS is listed on the NYSE and has nearly 40% of its workforce (over 25,000 individuals) located in the U.S. UBS is committed to meeting the leading corporate governance standards worldwide and will comply with SOX 404 for its 2005 financial reports.

UBS believes that it is important that foreign registrants (and particularly financial institutions) have a recognized voice in the comment process related to Sarbanes-Oxley requirements because of the different perspectives (and often different legal requirements) under which such companies operate.
UBS strongly supports the Sarbanes-Oxley legislation and the associated rules that have been developed as they are helping create a level playing field for corporate governance standards globally. In addition, UBS sees a strong connection between SOX 404 requirements and the qualitative aspects of the operational risk requirements within the Basel Accord reform proposals.

Indeed, UBS has combined its efforts to comply with these two regulatory requirements under a broader operational risk management framework and therefore values alignment of these requirements to the extent possible. UBS appreciates the recognition the PCAOB and SEC have provided to the linkage between SOX 404 and the FDICIA process and hopes that the Basel Committee will recognize the linkages between their own efforts on operational risk and SOX 404.

In general, UBS supports the general framework outlined by the Proposed Standard as it will ensure that auditors contribute to the development of sound internal controls over financial reporting. In particular, UBS believes that the approach of requiring a link from financial statement assertions and preventive/detective controls to financial accounts provides an appropriate basis for ensuring that a company's internal controls have been appropriately designed and are operating effectively. The following will provide specific comments in response to the PCAOB questions.

Specific Comments

<u>Question 6</u>: *Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?*

UBS agrees with the PCAOB's proposed scope for the audit because it believes that this will be the only way in which the spirit and intent of SOX 404 can be met. A simple audit of the management assessment process, and not the controls themselves, would be insufficient as it would emphasize form over substance. UBS notes here that the proposed scope appears to go further than what is typically required in other current auditing standards on internal controls (e.g., SAS 70 in the U.S. and FRAG 21/94 in England and Wales).

Therefore, UBS believes it would be helpful for the PCAOB to note explicitly the relationship of the Proposed Standard to SAS 70 to ensure that it is clearly recognized that the Proposed Standard imposes a stronger requirement (i.e., by requiring the auditor to not only evaluate whether management has met its stated control goals but also whether those goals are effective enough to ensure effective internal control over financial reporting) than a SAS 70 certification. This will help ensure clarity between different internal control audit processes and ensure that the SOX 404 audit does lead to greater confidence in financial reporting.

<u>Question 5</u>: *Should the Board, generally or in this proposed standard, specify the level of competence and training of the audit personnel that is necessary to perform specified auditing procedures effectively? For example, would it be inappropriate for a new, inexperienced auditor to have primary responsibility for conducting interviews of a company's senior management about possible fraud.*

<u>Question 7</u>: *Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation?*

UBS sees a linkage between these two questions in that they are related to the ability of auditors to form an independent judgment on the internal management documentation and testing. UBS believes it is appropriate for Proposed Standard paragraph 43 to provide suggested criteria that auditors should look for from management in planning their audit. However, UBS notes that these suggestions need to be considered carefully and clearly labeled as examples only in order to ensure that they do not become a mandatory list of items that auditors require of companies. As such, UBS appreciates the statement in Proposed Standard paragraph 44 that "no one form of documentation is required." UBS believes that this concept should be emphasized even further.

Within the list contained in paragraph 43, UBS has some concerns about the suggestion for documentation of "information about how significant transactions are initiated, recorded, processed, and reported" and "enough information about the flow of transactions to identify where material misstatements due to error or fraud could occur." In particular, UBS is concerned that these suggestions may lead to an auditor expectation for management to have process or transaction flowcharts available for review.

In order to ensure effective internal control, UBS believes that management should identify the key control related responsibilities of the functions that make up the organization. Implicit in this is an understanding of key process flows. However, documented process analysis is less important than having clearly identified and documented functional roles and responsibilities, key control objectives, and related control standards that ensure the objectives are met. While flowcharts may be useful training devices in certain cases, they are not necessary tools for ensuring internal control. In addition, flowcharts also may quickly become outdated as processes adapt to changing organizational or market circumstances. Thus, a requirement by auditors for companies to maintain flowcharts merely for the purposes of their audit would be unduly burdensome.

UBS notes by way of contrast that Proposed Standard paragraph 69 would require the auditors themselves to identify significant processes and to "understand the flow of transactions, including how transactions are initiated, recorded, processed, and reported" and to "identify the points within the process where a misstatement – including a misstatement due to fraud – related to each relevant financial statement assertion could arise." UBS believes that this is an appropriate expectation to place on auditors as they must be able to understand where the key control points are in a process. However, auditors should not necessarily expect management to maintain detailed flowcharts (as might occur given the current drafting of paragraph 43) to assist in this.

This is where UBS sees a connection with PCAOB Question 5. UBS believes that auditors engaged in the SOX 404 audits should be required to be sufficiently experienced in the industry that they are auditing to have an understanding not only of the processes of the company that they are auditing but also where the key control points are likely to be located within those processes. This will ensure that the SOX 404 audit, which is expected to be burdensome enough, is as efficient as possible. It will also ensure that auditors are focused on evaluating the effectiveness of the controls themselves and not the efficiency of the processes within which the controls are embedded. An emphasis on flowcharts could result in a focus on documentation of what currently exists as opposed to what controls should exist in order to ensure effective internal control.

<u>Question 9</u>: Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?

<u>Question 10</u>: Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?

Proposed Standard paragraph 48 states that auditors should obtain an understanding of the design of controls via procedures that may include inquiry, inspection, observation, and tracing transactions. In addition, Proposed Standard paragraph 74 states that auditors should obtain evidence of the effectiveness of controls either by performing tests or by using the work of others. However, Proposed Standard paragraphs 79 and 104 both state that walkthroughs should be a mandatory procedure for auditors both as part of the effort to understand and test both the design and operating effectiveness of controls.

UBS does not object to a requirement for walkthroughs per se, but does believe that the currently proposed walkthrough requirements may be overly burdensome and misdirected. Under Proposed Standard paragraph 80, an auditor would be required to conduct a walkthrough that encompasses "the entire process of initiating, recording, processing, and reporting individual transactions, and controls for all five internal control components and fraud, not just control activities." UBS believes that a walkthrough that examines every link in a process chain is more than what is actually necessary to evaluate internal control. In addition, UBS also believes that such a walkthrough may focus on the efficiency of the process and thereby might lose sight of the internal control aspects, which should be the primary focus for SOX 404.

Given this, UBS appreciates the statements in proposed paragraph 79 that the walkthrough should be intended to provide the auditor with evidence to "confirm the auditor's understanding of the design of controls", to "evaluate the effectiveness of the design of controls" and to "confirm whether controls have been placed in operation." However, UBS does not believe that paragraph 79 (and by implication the related statements in paragraphs 80-83) should state that the walkthrough is intended to provide the auditor with evidence to "confirm the auditor's understanding of the process flow of transactions" and to "confirm that the auditor's understanding of the process is complete."

As noted in its comments on Questions 5 and 7, UBS believes that the auditors performing the SOX 404 audits should be sufficiently experienced to understand the process flows within the company that they are auditing without detailed flowcharts or walkthrough procedures. Instead, the SOX 404 audit should focus solely on an evaluation of the key control points that must be designed and operating effectively to ensure the reliability of financial reporting.

<u>Question 11</u>: Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

UBS does not believe that auditors should be required to obtain evidence of the effectiveness of controls over all significant accounts and disclosures via relevant financial statement assertions on a yearly basis. All controls, accounts, and disclosures will not necessarily change on a yearly basis. Thus, there may be many cases where a full re-audit would be redundant. In addition, the requirement for a full audit each year would preclude the adoption of a risk-based audit approach.

UBS also has concern with two proposed aspects of the auditor requirements for evaluating operating effectiveness. First, Proposed Standard paragraph 88 states that an auditor should not only evaluate whether the control is operating as designed but also "whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively." UBS is concerned that this is a highly subjective evaluation that could be interpreted as a requirement for a company to justify the qualifications of its staff. UBS does not believe that this is necessarily the intention of the PCAOB and suggests that this merely be clarified.

Second, UBS notes that Proposed Standard paragraph 102 makes a distinction between manual and automatic controls with respect to auditor testing. In particular, the Proposed Standard states that "manual controls should be subjected to more extensive testing than automated controls" and that "the more frequently a manual control operates, the more operations of the control the auditor should test." UBS does not believe that these distinctions are meaningful or useful. When evaluating internal controls, management and auditors should be concerned with whether the control objectives were met. Whether this is done through a manually applied or an automatically applied control is not relevant to the determination of whether the control is operating effectively. The extensiveness and frequency of testing should be determined by the nature of the control itself (i.e., how important it is to meeting the objective) and not the form of the control. UBS believes that the proposed distinctions between manual and automatic controls would only result in additional burdens (from the need to distinguish those controls that are manually applied from those that are automatically applied) without substantial additional benefits.

<u>Question 12</u>: To what extent should the auditor be permitted or required to use the work of management and others?

<u>Question 13</u>: Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?

UBS agrees with the goal of the PCAOB to draft the Proposed Standard in such a way that auditors are provided with flexibility in using the work of others while at the same time preventing inappropriate reliance on the work of others. This requires a fine balancing of interests and a clear specification of guidelines for when auditors should and should not rely on the work of others. In general, UBS agrees with the concept of having three categories of controls (i.e., those where the auditor cannot rely on the work of others when performing the evaluation; those where reliance should be limited because they pose a high risk due to judgmental decisions; and those where reliance is not limited in any manner).

UBS believes that the list of items where reliance is prohibited in Proposed Standard paragraph 104 may be too broad in the following two areas:

- Controls that are part of the control environment, including controls specifically established to prevent and detect fraud that is reasonably likely to result in material misstatement of the financial statements
- Walkthroughs, as discussed beginning at paragraph 74.

With respect to the first item, it may be appropriate to ask auditors to separately evaluate the general control environment separately from management. However, this is an area where it is often difficult to perform specific "tests" of controls as many of the controls relate to corporate culture and other intangible aspects of a company. UBS also is not clear about the significance of the separation of the fraud concerns both in this paragraph and in other paragraphs in the Proposed Standard (e.g., 24-26, 43, 53, 69) when these are part of the Control Environment component of internal control frameworks such as COSO. UBS strongly believes that segregation of duties and the development of key control objectives is part of the process of addressing the risk of fraud. An attempt to separate fraud prevention as another activity appears artificial. Of course, material misstatements that could arise from fraud must be addressed. However, the identification of fraud controls in several paragraphs of the Proposed Standard may lead to the assumption that a separate control process is necessary specifically for fraud issues.

With respect to walkthroughs, please see the comments on Questions 9 and 10.

UBS also notes that Proposed Standard paragraph 53 defines a new term “company level controls” to include the following items:

- Control environment, including tone at the top, the assignment of authority and responsibility, consistent policies and procedures, and company-wide programs, such as codes of conduct and fraud prevention, that apply to all locations and business units.
- Management’s risk assessment process.
- Centralized processing and controls, including shared service environments.
- Monitoring results of operations.
- Monitoring of controls, including activities of the internal audit function, the audit committee, and self-assessment programs.
- The period-end financial reporting process.
- Board-approved policies that address significant business control and risk management practices

Proposed Standard paragraph 54 then suggests that auditors may wish to test and evaluate these controls first while paragraph 55 states that this testing is not sufficient for opining on the effectiveness of a company’s internal control. UBS does not object to this definition and believes it is generally aligned with the term “entity level controls” that has been used by a number of auditors. In general, when following the COSO or other internal control frameworks, it is sensible to start with a comprehensive evaluation of the internal controls. UBS merely seeks clarification around the use of the terms “company level controls” and “entity level controls” and the limitations imposed under paragraph 104.

<u>Question 14</u>: Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

UBS sees a clear need to give appropriate recognition to the work done by internal audit and other internal independent control functions regarding assessment of the effectiveness of the design of the control framework and its operation. A global financial institution of the size of UBS has a high number of significant processes across many legal entities and geographical locations that impact the significant accounts and disclosures. A validation of these activities is achieved through a large number of control activities carefully located in the front-to-back process chain. Internal audit is particularly well suited to ensure the integrity and the overall effectiveness of the processes and the reliability of the financial information flow.

UBS has an internal audit function that is fully independent, has unrestricted audit rights, and reports significant results to the Board of Directors and the Audit Committee. The head of internal audit reports to the Chairman of the Board of Directors and has regular meetings with the Audit Committee. The methodologies and the quality of work of internal audit are assessed by the Audit Committee and by external auditors and regulators (e.g. UK FSA, FED).

UBS agrees with the concept of having three categories of controls that differentiate the extent to which the external auditors may rely on the work of others when evaluating internal control in any individual instance. UBS also uses different categories for the definition of the internal review processes (e.g., the highest level requires an assessment by a control function independent of the business which is the owner of the control). The internal audits conducted over time are risk-based and include an assessment of the overall design of the control framework in the audited area, its documentation and its effective operation.

The recognition of the work performed by internal audit and other internal independent control functions would not only provide clear benefits from an efficiency point of view, but also increase the overall effectiveness of the evaluation of the internal controls in the front-to-back processes across geographical locations. While UBS understands the rationale for imposing high standards on the external auditor to obtain independently an unbiased opinion, UBS believes that the work performed by its internal audit function - highly independent from business management - reflects to a high degree the aims of the walkthroughs described in paragraph 79 through 83. Therefore, the recognition of the testing performed by internal audit should be better reflected in the relevant sections of the Proposed Standard where reference is made to the use of the work performed by management and others (including internal audit).

<u>Question 17</u>: Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

UBS appreciates the effort by the PCAOB to provide definitions of key terms such as deficiency, significant deficiency, and material weakness (Proposed Standard paragraphs 7-9 and Appendix D Examples D1-D3) and to provide guidance on significant locations and accounts (Proposed Standard Appendix B paragraphs B4-B19 and examples B1- B4) and materiality considerations (Proposed Standard paragraphs 21-23). UBS takes note of the fact that the participants at the PCAOB roundtable did not express concerns with the existing understanding regarding these definitions in the U.S. accounting profession.

However, UBS finds the proposed terms confusing and their use within the Proposed Standard difficult to reconcile. It is logical to distinguish between those control failures that pose only a slight risk of misstatement in the financial statements and therefore should be reported to a company's internal management and audit committee and those control failures that are deemed so material that they pose a severe risk of misstatement and therefore should be disclosed to investors and other third parties. It is unclear, however, why a simple materiality concept cannot be used to distinguish these two types of control failures and why there needs to be three levels of control failures plus additional guidance regarding materiality. UBS would prefer a simple materiality standard that is used to distinguish those control failures that merely indicate some questions regarding the financial statement reporting process from those control failures that call into question the reliability and validity of the financial reporting process.

No matter what definitions are adopted, UBS agrees that the guidance provided in Appendix B and D of the Proposed Standard are vital to understanding the concepts that should be applied. As far as UBS is aware, this is the first concrete examples of the appropriate scope and nature for the SOX 404 evaluations by management and/or auditors. Therefore, UBS believes that this guidance should be reviewed carefully as it will likely become the leading reference source for those seeking practical examples when designing SOX 404 compliance and auditing programs.

<u>Question 22</u>: *Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?*

UBS believes that the Proposed Standard should encourage companies to have strong internal audit functions. UBS believes that companies should be motivated to have internal audit functions that are well-staffed with qualified individuals that have demonstrable independence from management and who comply with best practice standards. For example, UBS has a clear separation between its Executive Board, which has management responsibilities, and its Board of Directors, which has oversight responsibilities. The independent internal audit function reports to the Board of Directors only. This has provided a sound structure for ensuring the quality of internal auditing practices. To the extent possible, the Proposed Standard should encourage companies to develop sound governance structures around internal audit functions as this will help strengthen the internal controls over financial reporting generally.

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UBS appreciates the opportunity to comment on the Proposed Standard. If you have any questions on the matters we have raised in this letter or would like to discuss any of them further, please contact:

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Yours sincerely,

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