H. W. Willoughby

November 20, 2003

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

Re.: PCAOB Rulemaking Docket Matter No. 008

Thank you for the opportunity to comment on the proposed auditing standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements. In general, the PCAOB is to be commended for attempting to comply with the unrealistic deadlines and requirements imposed by a law that was rushed through the political smoke and haze created by the colossal failure of large public companies and large public accounting firms during the final phases of another classic bubble in the stock market.[1] However, this well intended "rush to comply" has resulted in the publishing of a draft auditing standard that contains several material weaknesses and significant deficiencies that should be remedied before the final standard is issued. A summary of such items is included in Attachment 1, together with comments on selected questions posed by the PCAOB in the preamble to the draft standard.

Plopping down the conceptual COSO framework (1992), which is largely obsolete as measured in 2003 internal control currency, as the gold standard for righting the wrongs of the aforementioned "bubble" is also fraught with significant problems. COSO is an interesting thought piece, which provides very little practical implementation guidance. It stands as hollow shell testimony to the most recent previous significant bubble of S&L failures and financial reporting frauds in the 1980's. This misguided attempt to "right the wrongs" conjures up images of the big parade scene at the end of the movie Animal House, except this time, the PCAOB and SEC staffers are sitting behind the wheel instead of John Belushi and an oversized COSO cube is stuck to the front bumper of the vehicle, which is careening madly down regulatory lane.

Having spent the large majority of my career in the auditing profession, both external and internal, it is almost painful to read the proposed PCAOB auditing standard. Many of the terms of art embodied in the now "capped off" AICPA standards have been twisted almost beyond recognition in the draft standard. To add insult to injury, explanatory footnotes have not been added to

[1] Reference *Extraordinary Popular Delusions And The Madness Of Crowds*, Charles MacKay, 1841

these mutations so that the trained professionals can follow this kitchen sink attempt to write an auditing standard on internal control over financial reporting.

Preparation of financial statements and the related internal control over financial reporting are quintessential derivatives of business operations. Please take the time to consider all of the recommendations made by the various constituencies so that these derivatives are properly accounted for by management and audited by the external auditors.

Sincerely,

H. W. Willoughby

General Comments:

A. Implementation Dates – The extended June 15, 2004 effective date is ridiculous given the enormity of your undertaking. Regardless of election year pressure, do not give in to the long-standing practice of providing sufficient time for transition. At a minimum, consider moving the date back to December 15, 2004.

B. Information Technology - The draft standard is woefully inadequate in its attempt to address the role of information technology in businesses today, including its integral use in preparing financial statements and the related internal control over financial reporting. COSO is also bereft of meaningful guidance on information technology, leaving a huge void in this critical area.

In an attempt to provide something where nothing exists, the Big 4 firms used ISACA to sponsor an October 2003 publication entitled **IT Control Objectives for Sarbanes-Oxley – The Importance of IT in the Design, Implementation and Sustainability of Internal Control Over Disclosure and Financial Reporting –** www.isaca.org.

In keeping with the spirit of rushing a standard in to meet an already extended deadline, PCAOB should strongly consider incorporating by reference, much like the COSO "pull in", the extruded CoBIT thought piece discussed above. Although far from perfect (and ignoring for now the additional billing opportunities teed up by the Big 4 for themselves), something is better than nothing in this case. (The ISACA document contains SEC and PCAOB disclaimers, which ostensibly could be removed if incorporated by the new PCAOB standard.)

C. Internal Auditing – The best positioned Internal Audit departments live in the gray space discussed by Teddy Roosevelt in his famous quote: "Far better it is to dare mighty things, to win glorious triumphs, even though checkered by failure, than to take rank with those poor spirits who neither enjoy much nor suffer much, because they live in the gray twilight that knows not victory nor defeat."[2] Internal Auditors are still generally viewed as "tools of management", regardless of the attempts by the Institute of Internal Auditors (IIA) to insert Internal Auditing at the pinnacle of corporate governance. Even the IIA is currently sponsoring research on the nature of internal audit's role in another well-intended self-promotion effort.[3]

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[2] Speech before the Hamilton Club, Chicago, April 10, 1899

[3] Internal Audit Reporting Relationships – Serving Two Masters, The IIA Research Foundation (2003)

Additionally, none less than that bastion of corporate governance – the New York Stock Exchange - recently updated its listing standards to require an internal audit function for its listed companies.

However (comma) no one outside of (most) internal auditors knows exactly what it is that internal auditors are supposed to do – a game of pinball comes to mind for some reason.

The external audit profession's role has been hardened via the securities law and a recent dunking of the AICPA – not a good year for SRO's. Additionally, PCAOB is now looking to take a new hunk out of the collective hide of the remaining Final Four.

If, in fact, the concepts embodied in SAS 65 are to survive, the standard is in need of significant coordinated (IIA, ISACA) update to provide current context for the internal audit profession, which is currently hamstrung over the moat that exists between Board Audit Committees and the senior management group that signs its paycheck.

D. **Incorporating Internal Audit Reports by Reference – Par. 191** – The concept of incorporating by reference internal audit reports into the external auditor communications is a non-starter. Internal Audit does not follow the PCAOB standard and does not have a three tier control weakness identification system that ostensibly could be "piggybacked" under the proposed scheme. Internal Audit generally spends most of its time in the operational and IT areas, which is the core of a business, not the derived financial reporting area which is a low/no value proposition for internal auditors. The best internal audit shops do as little as possible in the area of external audit assistance as it is well known that the business risks do not live in this domain of the vaunted COSO cube.

See item C. regarding the coordinated update of SAS 65 language.

E. **Impact of Restatements on Internal Control Opinions** – The draft standard does not provide adequate guidance on restating internal reports to address the need to perform multi-period restatements for material financial statement errors. Assuming the goal is to have some sense of parallel, it would appear that each internal control report presented would have to be "restated" and reissued if and when needed.

Similar guidance should be provided with respect to quarterly reporting restatements vis a vis 302/404.

F. **Reliance on Internal Control in Performing a Financial Statement Audit** – as this pending standard will essentially blow a hole in the pre-existing financial statement audit model as it relates to internal control interaction with substantive testing decisions, additional detailed guidance should be provided via a de facto update of SAS 78 and other relevant guidance in the standard. The current guidance in paragraph 136 et al is wholly insufficient, as it does not address depth and breadth of assurance in this pivotal point of the integrated audit.

G. **SAS 70, Trust Services, Agreed-Upon Procedures, Other Internal Control Related (SSAE) Reports** – with a new requirement for an audit of internal control (however ultimately defined), the aforementioned AICPA artifacts have either been wholly or partly subsumed and / or made obsolete. To ensure some semblance of relevancy and reliability, the context for providing these services on an ongoing basis should be updated concurrent with the issuance of the new PCAOB standard. A simple example – does the SAS 70 Type I and Type II distinction sufficiently parallel the design and operational effectiveness language in the draft PCAOB? Paragraph B33 has a "do some stuff" feel in the event SAS 70 is not available – is this the intent?

H. **Requirement for Written Representations** – provide an example representation letter as an appendix to the standard. If this is not done, the representation letters may be longer than the documentation developed in support of the management assertion.

Paragraph 130. states "AU sec. 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updating letter." At a minimum, update AU Sec. 333 or supplement in PCAOB to name the Chief Information Officer (or equivalent – the Principal Information Technology Officer) as a required signature for the representation letter. CEO and CFO generally do not have a specific competency in this area. With all of the focus on lawyers and their noisy withdrawals, consideration should also be given to requiring general counsel (or equivalent) signature as a standard.

PCAOB Questions for Comment – Selected Responses – "No comment" on the other items (excluded from the items listed below).

1. Is it appropriate to refer to the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting asthe audit of internal control over financial reporting?

Yes. The proposed scope change is so significant and so fundamental that there are now two (integrated) audits required for public companies on an annual basis. This fact should be reflected in the characterization of the scope of services.

4. Does the Board's proposed standard give appropriate consideration to how internal control is implemented in, and how the audit of internal control over financial reporting should be conducted at small and medium-sized issuers?

No. In fact, the guidance muddies the water. Just as the big company little company GAAP debate has carried on for years with no resolution, this is a similar topic. A well-written standard and considered professional judgment in the application and interpretation thereof are sufficient.

5. 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 audit procedures effectively? For example, it would be inappropriate for a new, inexperienced auditor to have primary responsibility for conducting interviews of a company's senior management about possible fraud.

No. This is another Pandora's box topic. The next step might be overlaying government employee classifications on the public accounting profession's staffing model.

I believe that SAS 99 may contain guidance in this area on the issue of fraud.

6. 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?

Yes.

7. Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation?

Yes. Reference is made to ISACA's October 2003 Discussion Paper – IT Control Objectives for Sarbanes-Oxley (www.isaca.org) - Page 28 **– How Compliance Should be Documented** section. Without going out on a limb or getting overly specific, the PCAOB standard should adopt a similar approach to that of ISACA – such guidance is generally expected in a "standard".

8. Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of a significant deficiency or material weakness in internal control?

Yes. However, context must be clearer. See item 7 above.

9. Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?

The term “Walkthroughs” is so generic as to be almost meaningless, much like the term Gateway in the information technology world. Frankly, this lingo sounds like it came out of an academic who never engaged in the professional practice of auditing. Its current positioning over emphasizes the importance thereof and should be significantly toned down. Walkthroughs, however defined, are not a panacea and should be considered one element of a good start in understanding internal control.

10. 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?

No. If a requirement is needed in this area, it would be much more logical to require management to document the ‘walkthrough’. The control owner should be in a much better position to document the internal control process, much as a registrant prepares its own financial statements, which should then be tested by the auditor as part of the engagement.

11. 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?

Yes. The world claims internal control is dynamic and ever changing, why permit reliance on stale information when defining this assurance service? Avoid the urge to backslide on this one.

12. To what extent should the auditor be permitted or required to use the work of management and others?

To the same extent that Arthur Andersen should have been allowed to rely on the work of Scott Sullivan, Andy Fastow and the former Andersen employees at Waste Management. Who are you kidding???

As discussed above, Internal Audit currently lives in the gray twilight between management and the Board audit committee. Nonetheless, SAS 65 concepts should be updated and carried forward into the new standard if any forward progress is to be made in this bifurcated arena.

13. Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?

No. This approach is broken. See comment 12.

14. 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?

No. See comment 12. Additionally, there is no workable basis for tying 'other third parties' into the mix at this time. Keep it simple by focusing on modernizing standards guiding the interaction of external and internal auditors.

15. Is the flexibility in determining the extent of reperformance of the work ofothers appropriate, or should the auditor be specifically required to reperform a certain level of work (for example, reperform tests of all significant accounts or reperform every test performed by others that the auditor intends to use)?

Yes. See comment 14 regarding adding additional clarity to the interaction of internal and external audit.

16. Is the requirement for the auditor to obtain the principle evidence, on an overall basis, through his or her own work the appropriate benchmark for the amount of work that is required to be performed by the auditor?

Why is this question even being posed? There's only one firm signing that integrated audit report. The firm must be in full control of the nature, timing and extent of testing to be performed to accomplish the stated objective. Cleaning up the draft standard to determine what is allowable on the internal audit reliance front will assist the external auditor in this process.

17. 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?

Reference an Internet quote - Work that some call “obscene” may be “art” to others. Justice Potter Stewart once said he couldn't define obscenity, but "I know it when I see it." The ambiguity of definition still exists and is becoming even more problematic with the Internet.”

The same situation exists with the shades of gray used to paint internal control “weaknesses”. Good luck on your current attempt.

18. Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? Are there other specific examples that the commenters could suggest that would provide further interpretive help?

See item 17.

19. Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies?

How can the proposed three-tier classification scheme otherwise be complied with? See item 17.

20. Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?

Yes. The vehicle for such reporting should be clear because current management letter practices (for internal control deficiencies) are scattered and not all “weaknesses” (to be better defined by PCAOB) currently make their way from the working papers into the “management letter”, which will no longer be an optional deliverable. Additional guidance in the standard language is required. Perhaps a parallel can be drawn with SAS 61 and disclosure of ‘passed adjustments’ – this may even be considered as context for delivery of “Tier 3” weaknesses…

22. 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?

No. Provision of such service is beyond the current competency of most auditing firms, creates a direct conflict with the Committee and is generally nonsensical. The listing standards and regulatory Charter requirements should guide efforts in this area. Consideration should be given to creating a checklist of audit committee best practices that would be completed by the Audit Committee, signed by the Audit Committee Chair and Chairman of the Board and filed as part of either the 10-K or the annual proxy statement. No need for a separate audit or attestation would be necessary.

23. Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?

See item 22.

24. If the auditor concludes that ineffective audit committee oversight is a material weakness, rather than require the auditor to issue an adverse opinion with regard to the effectiveness of the internal control over financial reporting, should the standard require the auditor to withdraw from the audit engagement?

See item 22. Firms should follow their existing and soon to be revised practices to manage their risk with respect to audit committee effectiveness. Resignation with the resultant 8-K filing provides an adequate vehicle for raising issues in this area if and when needed.

27. Do you agree with the position that when the auditor issues a non-standard opinion, such as an adverse opinion, that the auditor's opinion should speak directly to the effectiveness of internal control over financial reporting rather than to whether management's assessment is fairly stated?

See item 1.

28. Should the Board provide specific guidance on independence and internal control-related non-audit services in the context of the proposed standard?

Yes. There is such a billing bonanza and variety of services been driven into the existing client base right now, including establishing dependencies on the incumbent external audit firm. Registrants need to know as soon as possible if their existing arrangements violate independence standards so that new arrangements can be made on a timely basis to comply with the stringent pending deadlines.

29. Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client?

See item 28.