JPMorganChase

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Via email: comments@pcaob.org
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Attention: Office of the Secretary

Re: PCAOB Rulemaking Docket Matter No. 008
PCAOB Release No. 2003-017

Ladies and Gentlemen:

J.P. Morgan Chase & Co. ("JPMorgan Chase") is pleased for this opportunity to comment on the auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (the "proposed standard")*, proposed by the Public Company Accounting Oversight Board ("PCAOB").

JPMorgan Chase is a leading global financial services firm with assets of more than $750 billion and operations in more than 50 countries. JPMorgan Chase agrees with the basic principle enunciated by the PCAOB as to the importance of internal controls. Internal controls add value and mitigate risks, thereby enabling a company's management, board and shareholders to rely, with more reasonable assurance, upon the integrity of a company's financial reports. As a financial institution that has been, for over a decade, applying the framework recommended by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") to satisfy the requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), JPMorgan Chase understands the importance of a strong internal control environment and supports the PCAOB's objective of creating an integrated audit of both financial statements and internal controls over financial reporting.

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The comments which follow highlight four areas of the proposed standard that JPMorgan Chase believes require additional consideration by the PCAOB:

- The definitions of "significant deficiency" and "material weakness" should be modified
- The external auditor should be permitted to use the work of others, particularly that of the internal auditors, to a greater extent
- The external auditor should be given more latitude to determine the level and extent of the procedures and testing to be performed
- The proposed standard should permit the issuance of audit reports with "except for" opinions

1. Definitions of Significant Deficiency and Material Weakness

We agree with the PCAOB that material weaknesses be reported to the public, as we believe it is important to provide investors transparency about a company's internal controls. However, we do not believe that disclosure of such information should be based on a "more than remote likelihood" of occurrence.

We believe that the "more than remote likelihood" standard is too low a threshold by which to evaluate internal control deficiencies. In addition, it is a threshold that is lower than the threshold related to "reportable condition" and "material weakness" articulated under current auditing standards, particularly AICPA Professional Standards AU Section 325 and AICPA Attestation Standards AT Section 501. We believe that since the rules promulgated by the Securities and Exchange Commission pursuant to Section 404 of the Sarbanes-Oxley Act ("SOX 404") refer to AU Section 325 and AT Section 501, those standards should be applied in determining whether a significant deficiency or material weakness exists. Those standards are more appropriate than the “remote likelihood” threshold which is based on the concept of “remote” defined in Statement of Financial Accounting Standards No. 5.

The appropriate threshold for the definitions of “significant deficiency” and “material weakness” is a critical issue. Use of an inappropriately low standard will make the scope of work to be performed by management, the internal auditor and the external auditor too expansive without providing any meaningful benefit. The level of significance drives, among other things, the accounts and processes to be evaluated, the controls to be tested, the level of detail of the tests to be performed and the number of walkthroughs to be conducted. A too-low threshold has the potential of creating a vast range of work to evaluate and test processes and controls that may not be the key drivers of an effective internal control system, resulting in assessments and testing that are not value-added nor cost effective.

In addition, we are concerned a too-low threshold could potentially encompass deficiencies that will not have a significant effect on the financial statements. Disclosure of such deficiencies may actually mislead investors about the integrity of a company's internal controls. Even the most effective internal controls may not be able to prevent the occurrence of a control deficiency to a level that is "remote. " In any complex organization, control deficiencies may periodically arise in the normal course of business; most are detected and corrected in a timely fashion without the company incurring any material loss and without materially affecting the financial statements. While we strongly believe it is important to provide transparency about a company's internal controls, we also believe that setting an appropriate threshold for disclosure is necessary to ensure that investors are not provided information at such a level of insignificance that the disclosure becomes, in effect, a litany of "false alarms."

We therefore respectfully propose that the PCAOB, in defining the terms "significant deficiency" and "material weakness," use a "*reasonably likely"* threshold, a threshold which the PCAOB itself refers to in paragraph 183 of the proposed standard. We believe the "reasonably likely" standard is consistent with the concept of management providing (and auditors obtaining) reasonable assurance in an audit of internal controls. We also believe this term is more consistent with the term "reduce to a relatively low level" used in AU Section 325 and AT Section 501. In addition, we are concerned that the threshold of "more than inconsequential" in connection with "significant deficiency" will not clearly delineate a non-significant internal control deficiency from a significant deficiency. We therefore propose a threshold of "significant" misstatement, which will be clearer and also retain a distinction from material weakness.

We therefore propose that the PCAOB modify the definitions of "significant deficiency" and "material weakness" as follows:

- a "significant deficiency" is a "single deficiency, or a combination of deficiencies in the same or closely related reporting areas, that is *reasonably likely* to result in a *significant* misstatement of the annual or interim financial statements; and

- a "material weakness" is a "significant deficiency that, by itself, or in combination with other significant deficiencies, is *reasonably likely* to result in a *material* misstatement of the annual or interim financial statements."

In this way, control deficiencies that would pose a reasonable risk of material misstatement would be appropriately reported to investors and the public, while ensuring that significant deficiencies continue to be reported to management and the audit committee.

We further believe the list referred to in paragraph 126 is too prescriptive, as these items do not necessarily indicate, in all cases, the existence of a significant deficiency. We believe no specific list of circumstances should be presumptively regarded as "significant deficiencies"; rather, a significant deficiency must be evaluated based on all relevant facts and circumstances. For example, the evaluation needs to consider how the control deficiency was discovered, how long the deficiency had occurred before being discovered, and the magnitude of loss, if any, resulting from the deficiency. In addition, the proposed list does not take into consideration the fact that the deficiency was discovered, demonstrating that internal controls were functioning properly, nor does it take into consideration the existence of other controls that might exist that would prevent the identified deficiency from elevating to the level of a significant deficiency or material weakness. In our view, the examples do not permit sufficient exercise of the external auditor's professional judgment.

For the above reasons, we believe the definitions of significant deficiency and material weakness used in the standard should be more judgment-based and contain more realistic thresholds. In this way, the disclosure of the existence of material weaknesses will provide investors with information that is meaningful and material.

2. <u>The Extent to which the External Auditor Should be Permitted to Use the Work of Others, Particularly the Work of the Internal Auditors</u>

As currently proposed, the standard defines three categories of controls and sets forth, for each category, the extent to which the external auditor may – or may not – rely upon the work of others.

We believe that these categories are too rigid. Certain controls defined to belong in one category may more appropriately be included in another. For example, we believe there are controls, such as those that are related to period-end financial reporting (including controls over initiating, recording and processing general ledger entries), that relate to activities that are primarily routine and recurring. Accordingly, these controls should be ones where the external auditor be permitted to rely upon the work of others. In addition, with respect to “controls that are part of the control environment” and “information technology general controls” (controls which the PCAOB acknowledges are pervasive and upon which the effectiveness of so many other controls depends), it is important to recognize that these controls are generally subject to extensive reviews by internal auditors. Therefore, it may not be practicable for the external auditor not to rely upon the work of others; the blanket prohibition in the proposed standard on the use of the work of others with respect to these controls is, simply, not realistic and too costly. Finally, with respect to controls over significant non-routine and non-systematic transactions, the proposed standard does not provide the external auditor with sufficient flexibility in appropriately relying on the testing performed by internal auditors. We therefore believe the limitations imposed by the proposed standard as to how the external auditor must perform its own assessment are too inflexible.

In this regard, we believe the proposed standard does not give appropriate recognition to the work of internal auditors. The competency and objectivity of a company's internal audit function should be evaluated in light of the circumstances of each company, as each organization will differ; therefore, where appropriate, the proposed standard should permit more reliance by the external auditor on the work of internal auditors. For example, where internal audit reports directly to the audit committee, is independent of management, is highly trained and competent, is a significant element of the firm's control environment, is appropriately staffed with the necessary resources, is experienced in detecting control weaknesses, and where the results of internal audits are transparent to both the audit committee and the external auditor, requiring the external auditor to reperform significant amounts of testing done by the internal auditors is duplicative and inefficient.

By limiting and restricting the extent of reliance by the external auditor on the work of the internal audit function, the proposed standard may adversely affect the importance placed on the internal auditors; over time, the standard as currently proposed may have the unintended effect of diminishing the importance of the internal audit function within the organization and, particularly, as it relates to the audit of financial statements and controls over financial statements. This result would be counter to the intent of SOX 404 to improve the internal control environment of companies.

We therefore respectfully propose the PCAOB incorporate in the proposed standard an approach similar to that set forth in Statement on Auditing Standards No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("SAS 65"). SAS 65 permits the external auditor to rely upon the internal auditor's work in light of, among other things, the external auditor's assessment of the competency and objectivity of the internal auditors.

For the above reasons, we believe there should not be any rigid, tiered categorizations of areas defining the extent to which the external auditor may or may not use the work of others; rather, we believe the external auditor should be permitted to exercise its professional judgment as to the appropriate level of its reliance on the work of others, particularly the use of the work of the internal auditors.

3. The Extent to which the Proposed Standard Should Permit More Latitude to the External Auditor to Use its Judgment to Determine the Level and Extent of the Procedures and Testing to be Performed

We believe the external auditor should be permitted more flexibility with respect to the procedures and testing strategies employed. The nature, timing and extent of the procedures and testing should be based on the specific circumstances of the company. Factors to be considered should include the external auditor's evaluation of the entity's internal control processes, the effectiveness of the entity's internal audit function, the complexity of the transactions or processes being evaluated and whether there have been changes in the control environment.

With regard to testing, the external auditor should be given the latitude to determine whether it is necessary to perform testing each year with respect to each significant control function. If, for example, there has not been a significant change from the prior year in the process flow of transactions with respect to a routine control function, the proposed standard should permit the external auditor to determine if it would be appropriate to rely upon the prior year's evidence, in full or in part, with respect to the particular assertion being tested.

Likewise, more discretion should be permitted to the external auditor to determine the nature and extent of procedures to be performed in order to gain an understanding of process flows and the design and effectiveness of controls. In this regard, walkthroughs should not be mandated for every significant process. While walkthroughs are valuable tools, they are only one method of providing important audit evidence for external auditors; alternate audit procedures that meet the audit objectives should also be acceptable if deemed appropriate by the external auditor.

The prescriptive nature of the proposed standard will increase audit fees in a way that will not add value nor be cost effective to the control environment. Redundant work and burdensome procedures will not help companies or their investors. We believe the proposed standard should permit the external auditor to focus on the areas where, given its professional judgment and its knowledge of the company and its processes, there is the greatest potential for risk and where the costs to be incurred in connection with the audit have the greatest likelihood of identifying internal control deficiencies. The proposed standard should grant the external auditor the necessary latitude to use its professional skepticism in designing and executing the audit.

4. The Proposed Standard Should Permit the Issuance of an "Except For" Opinion in the Auditor’s Report

The proposed standard should permit the issuance of a qualified, "except for" opinion, in the audit report. We recognize that a company's management, in its Section 404 certification, may not provide a qualified certification; that is, if a material weakness in internal controls exists, management must conclude that the company's internal controls are not effective. In that situation, however, management would have the opportunity within the Management’s Discussion and Analysis section of its SEC filings to fully discuss the material weakness and management’s assessment of its impact.

We therefore believe that the external auditor should have the latitude, when the material weakness is not deemed to be so severe and pervasive as to warrant an adverse opinion, to issue an “except for” opinion. For example, if the material weakness is limited to a specific account or disclosure that does not taint the entire internal control environment, an "except for" opinion may be appropriate. Similarly, if the material weakness were discovered in the latter part of the fiscal year, there had been a prompt response by the company to develop corrective action, and good progress had been made to remedy the weakness, the external auditor might deem it appropriate to issue a report with an "except for" opinion. Additionally, an "except for" opinion may be the only viable opinion that an external auditor can deliver when an entity was recently acquired by the company.

For the reasons set forth above, we believe an "except for" opinion may provide a more appropriate assessment of a company's internal control environment. It allows the external auditors to describe any material weakness and its likely consequences to the financial statements, as well as the steps being taken by the company to correct the weakness. Disclosure of more information in this regard would be more helpful to investors than a "blanket" adverse opinion.

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JPMorgan Chase appreciates the opportunity to provide our views on this important matter. We believe our proposed modifications would improve the ability of companies to comply with the proposed standard, without weakening its effectiveness. We would be pleased to discuss our comments or answer any questions you may have.

Very truly yours,