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

Re: PCAOB Rulemaking Docket Matter No. 008
Proposed Auditing Standard: An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Deloitte & Touche LLP is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, PCAOB Rulemaking Docket Matter No. 008 (the "Proposed Standard") (October 7, 2003), to implement Sections 103(a)(2)(A) and 404 of the Sarbanes-Oxley Act of 2002 (the "Act"). Overall, we are very supportive of the Proposed Standard, and we recognize the efforts of the PCAOB in its development and commend many aspects of it.

While we agree with the overall approach of the Proposed Standard, we also believe there are many issues that must be addressed to permit the standard to be applied and implemented consistently and in a manner that meets the objectives of the Board and the Act.

We strongly agree with the position of the Board with respect to the need for the auditor to audit the effectiveness of internal control rather than solely evaluate management's assessment process. Overall, we believe the scope of the work described for the auditor generally is appropriate but will be subject to wide variations in interpretation, especially in relation to the extent of the walkthroughs, the degree of reliance that can be placed on the work of others, and the implications of company-level controls. We have concerns about the extent to which the requirements in the standard also apply to management's assessment, in particular with respect to the extent of management's documentation and testing.

We have organized our comments into three sections as follows: (I) Overall Comments, (II) Comments Related to Certain Paragraphs, and (III) Responses to Specific Questions.

I. OVERALL COMMENTS

1. Decision Mandating the Auditor to Audit the Underlying Controls as Well as Management's Assessment Process

We believe the aspect most critical to the achieving the purpose of the Act is the decision by the Board to require the auditor to test the effectiveness of internal control over financial reporting as well as evaluate management's assessment process to meet the objective of expressing an opinion about whether management's assessment is fairly stated. This decision, in our view, is in the best interests of investors, who will expect the independent auditor to obtain independent evidence as to whether the public company's internal control over financial reporting is effective, rather than solely evaluating management's process and evidence.

2. Increase the Focus on Areas With the Highest Risk of Material Weaknesses in Internal Control Over Financial Reporting

A study released by the GAO in 2002[1] indicates that the majority of financial restatements of companies relate to nonroutine, complex areas such as revenue recognition, corporate restructurings, and accounting for acquisitions. The risks of material misstatement associated with these areas are not easily mitigated by process-level control activities. The Proposed Standard appears to focus more on the control activities component of the COSO framework, including process-level control activities, than the more judgmental and high-risk areas, such as the control environment, risk assessment, and monitoring. For example the Proposed Standard provides very detailed guidance for identifying and considering the controls related to the significant accounts and processes, many of which, while significant, are typically routine in nature. This focus also is illustrated by the examples provided in Appendix D of the Proposed Standard.

We recognize the Board's attempt to address the more judgmental areas, such as the control environment, as illustrated by guidance on the evaluation of the effectiveness of the audit committee's oversight role. However, we believe that, overall, the Proposed Standard should provide more guidance on the key risk areas such as the control environment; the significant nonroutine, nonsystematic, and period-end financial reporting processes; and the company's risk assessment and monitoring processes to help focus both management's and the auditor's evaluation of internal control over financial reporting on areas of greatest potential risk of material misstatement of the financial statements. For example, the Board's current discussion of risk assessment focuses solely on the transactional level and does not specifically address the entity-level risk assessment process. Such an assessment should specifically consider, for example, the evaluation of the risk of fraud, including the risk of management override, and the company's antifraud programs and controls, including the company's need to identify and review unusual and significant journal entries—areas where most companies have not traditionally focused their efforts.

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[1] U.S. General Accounting Office. *Financial Statement Restatements—Trends, Market Impacts, Regulatory Responses, and Remaining Challenges* 03-138. Washington, D.C., October 4, 2002.

Also, given the increasing importance of fair disclosures, the Board should consider providing guidance relating to the identification and evaluation of control deficiencies that have an adverse effect on the presentation and disclosures assertions.

3. Management's Responsibilities

The Proposed Standard, while establishing requirements of the auditor, also establishes requirements of management (e.g., paragraphs 41-47 in the Proposed Standard). However, throughout the Proposed Standard there are numerous specific requirements established for the auditor that are not explicit for management to consider in paragraphs 41-47. An example is paragraph 57, related to the evaluation of the effectiveness of the audit committee. Additionally there are a number of places within the Proposed Standard where it is unclear whether the guidance applies only to the auditor or to management's assessment as well. For example, in paragraph 55, are company-level controls alone not sufficient for the purpose of management supporting their assessment? In paragraph 126, is it the Board's intent that if the company's internal control identified a fraud of any magnitude on the part of senior management, that would be a strong indicator of a material weakness for management's assessment purposes or does this apply only if the auditor identifies the fraud? Another example is paragraph 144. These are all indicators that a framework, requirements, and guidance should be sufficiently established to describe management's assessment process before auditing standards can be appropriately implemented.

While we agree with the Board that management's assessment must meet the various requirements currently embedded in various sections of the Board's Proposed Standard, including paragraphs 41 through 47, we do not believe the Proposed Standard is the best medium to establish the requirements that management must follow. We encourage the Board to work with the SEC to improve the appropriate evaluation framework, requirements, and guidelines that management should follow in preparing its assessment of internal control over financial reporting. We believe that paragraphs 41-47 of the Proposed Standard represent a good starting point that should be expanded to provide an adequate base for management's evaluation process that will be consistent with the auditor's process. In the course of establishing such guidelines, the Board and the SEC should consider harmonizing differences that currently exist between the definitions of significant deficiency and material weakness in the Proposed Standard and the definitions in the SEC's final rule on Section 404 of the Act. Otherwise, auditors and management might use different definitions to evaluate control deficiencies identified in the audit and assessment, respectively.

Nevertheless, we believe the Board should clarify its guidance relating to the management's responsibilities in the following areas.

a. Management's Assessment Process

The Proposed Standard focuses on procedures that the auditor should follow with respect to significant accounts, major classes of transactions, and other items of importance. It does not provide similar guidance for management in terms of their documentation requirements and assessment process**.** Nor is it clear what should be considered with respect to the insignificant accounts, minor classes of transactions, and other items, which are of lesser importance but are important when considered in the aggregate. We recommend that the Board provide such

clarification in paragraphs 41-47 regarding management's responsibilities, including guidance with respect to identifying significant accounts, processes, locations, and those accounts that remain after the significant and important ones have been addressed.

We also strongly urge the Board to provide guidance relating to the testing by management to promote consistency and to clarify the confusion that exists between evidence that may be derived from a self-assessment process as opposed to independent testing. Companies are seeking specific guidance in terms of: (1) the appropriateness of evidence, including nature, extent and format, from a self-assessment process and (2) the nature, extent, and timing of independent testing by internal audit or by others under the direction of management, presumably to verify that the self-assessment process has integrity.

b. Extent of Documentation

The Board's Proposed Standard discusses two aspects of documentation. One relates to management's documentation of its assessment of the effectiveness of internal control over financial reporting ("documentation of management's assessment"), and the other relates to the documentation of the underlying control procedures and responsibilities for internal control within the company ("documentation of the design of internal control"). As established in paragraph 45, the documentation of the design of internal control is important for purposes of communicating responsibilities and providing a foundation for monitoring the effectiveness of internal control (e.g., to apply company-level controls).

There is confusion over management's responsibilities and the resulting implications on management's and the auditor's reports. For example, some companies are interpreting the Proposed Standard as suggesting that they do not need to document the design of internal control at locations that are insignificant individually or in the aggregate because they are documenting and testing company-level controls. However, without adequate documentation, monitoring activities, such as company-level controls, are unlikely to be effective, as the control will not be consistently understood and accountability will not have been clearly established. Additionally, in paragraph 46, the Proposed Standard adds further confusion by providing that "in evaluating the deficiency as to its significance, the auditor should determine whether management can demonstrate the monitoring component of internal control over financial reporting in the absence of documentation," Accordingly we believe the last sentence in paragraph 46 should be deleted. Further, we recommend that the Board clearly establish management's responsibility with respect to maintaining company-wide internal control documentation.

We agree that the lack of adequate documentation of the design of internal control is a deficiency in internal control over financial reporting, the significance of which should be determined first by management in preparing its assessment and then by the auditor in performing their evaluation.

However, if the auditor concludes that there is insufficient documentation of management's assessment, paragraph 20 requires the auditor to disclaim an opinion, with which we agree. The auditor also should consider whether the insufficient documentation also identifies a deficiency in the documentation of the design of internal control that is judged to constitute a material weakness, in which case the auditor should be directed to issue a report with an adverse opinion

as opposed to a disclaimer (please refer to our separate comment in Section 2 regarding paragraph 20).

Accordingly we recommend the following to replace Paragraph 47 (assuming the guidance in paragraph 20 is modified).

> If the auditor concludes that the documentation of management's assessment is insufficient to support management's evaluation of the operating effectiveness of internal control, the auditor should also consider whether there is inadequate documentation of the design of internal control that constitutes a material weakness and follow the guidance in paragraph 20.

c. Consideration of Extended Relationships

Aside from consolidated entities and other financial interests accounted for as investments, companies engage in an increasing number of relationships, which have a direct impact on their financial reporting. These range from the outsourcing of software applications, application hosting, and in some cases, a portion to all of the financial transaction processing and financial reporting processes. It is unclear whether the guidance in Appendix B of the Proposed Standard with respect to SAS 70 and the use of service organizations also applies to management. We strongly recommend that paragraphs 41-47 be expanded to indicate explicitly the other paragraphs that management also should incorporate in its assessment, such as the guidance in Appendix B related to service organizations.

4. Issues Regarding the Scope of an Audit of Internal Control Over Financial Reporting

a. Significant Accounts

The Proposed Standard provides that a significant account may be identified at a number of different levels including (1) the financial statement line item level, (2) the account or account balance, which is not defined but is referred to in paragraphs 61 and 62, and (3) the account component level, which suggests it is a subset of an account balance in paragraph 62. Identifying significant accounts at multiple levels is likely to create confusion and, thus, we suggest that the identification of a significant account occur only at the account balance level.

To simplify this structure, we suggest that the standard begin by identifying all "significant" financial statement line items and disclosures. A line item or disclosure should be considered significant if there is a more than a remote likelihood that the financial statement line item or disclosure could contain misstatements that could result in a material effect on the financial statements, considering the risk of both overstatement and understatement. The assessment of a more than remote likelihood should be made without giving any consideration to the effectiveness of internal control. We would expect that virtually all financial statement line items and disclosures will be considered significant.

Next, within those financial statement line items and disclosures, account balances should be determined by aggregating general ledger accounts that have similar risks and share common processes and controls and by disaggregating those general ledger balances that have differing risks and controls. The account balances should be evaluated to identify significant accounts

based on materiality and a more than remote likelihood the account balance could contain misstatements that could result in a material misstatement to the financial statements including both understatement and overstatement considerations. Additionally, accounts that are not material may also be identified as a significant account taking into consideration qualitative factors such as those listed in Paragraph B17 and the expectations of a reasonable user as presented in Paragraph 61. Again, the assessment of a more than remote likelihood should be made without giving any consideration to the effectiveness of internal control.

The intent of paragraph 61 of the Proposed Standard is unclear to us in terms of the aggregation consideration. Is it intended to aggregate virtually all the accounts and disclosures that do not meet the definition of a significant account? This results in a scope that, in our view, is too broad and impractical. Accordingly, clarification is needed. The accounts and disclosures that were not identified as a significant account should be aggregated. If material in the aggregate, the key control(s) over this group of account balances (e.g., an effective monitoring control such as reconciling the account on a monthly basis) should be identified and documented. The rationale for focusing on the monitoring control is that the processing-related controls in these individually insignificant accounts generally are not the important controls. The detective and general controls, such as the monitoring, segregation of duty, and financial reporting controls, generally are the important controls to focus on for these individually insignificant accounts. The tests of design and operating effectiveness should focus on determining that the key control(s) had been placed in operation and is operating effectively by sampling from the group of such account balances and disclosures on a test basis.

Paragraph 63 of the Proposed Standard implies that the identification of potential significant accounts is performed on a location-by-location basis. However, it is not clear how this should be applied when considered in conjunction with the multiple location guidance in Appendix B. Further guidance and an example will enhance consistency in application of this guidance.

b. Performance of Walkthroughs

We agree that the performance of walkthroughs should be required for all of the company's significant processes as indicated in the Proposed Standard. We also agree that it is appropriate to require that the auditor perform the walkthroughs to ensure that the auditor has a sufficient understanding to plan their work. However, we have six concerns with regard to certain aspects of the proposed requirements.

First, the standard should clarify the following with regard to the walkthroughs:

- Whether the term "significant process" referred to in paragraph 79 is the same as the "significant processes" referred to in paragraph 69.
- The relationship between "types of transactions" in paragraph 79 and "major classes of transactions" in paragraph 69. Also, providing examples of "types of transactions" and "major classes of transactions" would be helpful.

Second, depending on the clarifications of the terms above, the scope of the walkthroughs as proposed in paragraphs 79 and 80 may be interpreted by some as overly broad and expansive. Paragraph 79 states the following:

> The auditor should perform a walkthrough for **all** of the company's **significant processes**. In a walkthrough, the auditor should trace **all types** of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports**.** Walkthroughs provide the auditor with evidence to . . . confirm that the auditor's understanding of the process is complete by determining whether **all points** in the process where misstatements related to each relevant financial statement assertion that could occur have been identified.

We agree with the desire of the Board for the auditor to identify and consider the unusual and infrequent types of transactions that may occur within a "significant process." However, the concept of tracing all types of transactions is inconsistent with the guidance the Board provides in paragraphs B12 and B13 of Appendix B relating to locations, which allows for consideration of materiality and risk. We agree with the guidance contained in Appendix B, and we recommend that paragraph 79 be modified to incorporate a similar concept.

Third, paragraph 80 also states that the walkthrough should "encompass 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." Based on this language, it is not clear which processes and transactions are required to be covered by the walkthrough. Paragraph 80 should be clarified such that the walkthrough relates only to those processes identified in paragraph 69, not all processes within the company. Further, the combining of the five internal control components may cause confusion, because many of them are pervasive in nature and do not relate directly to transactional processing. Accordingly, we recommend revising the first sentence in paragraph 80 to read as follows:

> The auditor's walkthroughs should encompass the entire process of initiating, recording, processing, and reporting individual transactions, and controls for each of the significant processes identified. Additionally, the auditor should gain an understanding of the Company's internal control related to the control environment, risk assessment, monitoring, and information and communication components.

Furthermore, the extent of walkthroughs should vary depending upon a number of factors including the nature of the transaction, complexity, and exposure to loss, particularly relating to the more insignificant types of transactions. We believe these factors should be set forth in the standard.

Fourth, also in paragraph 80, the phrase "controls for all five internal control components and fraud" implies that fraud controls are something separate and distinct from controls for the five internal control components. In our view, fraud is an important consideration with respect to each of the five internal control components and, thus, the word "and" should be replaced with "including."

Fifth, paragraph 82 states that "when there have been significant changes in the process flow of transactions, including the supporting computer applications, the auditor should evaluate the nature of the change(s) and the effect on related accounts to determine whether to walkthrough transactions that were processed both before and after the change." This language seems to indicate that it is optional as to whether the auditor should understand the changes that have

occurred. For any significant changes to the significant processes that impact controls over financial reporting, we believe that the auditor should walkthrough transactions that were processed after the change. Additionally, if there has been a significant change, we do not believe it is necessary to perform procedures prior to the change. Moreover, the auditor may not be aware of the change until after it has occurred. Therefore, paragraph 82 should be modified to state that "when there have been significant changes in the process flow of transactions, including the supporting computer applications, the auditor should evaluate the nature of the change(s) and the effect on related accounts and transactions. Additionally, for significant changes in the significant processes that impact controls over financial reporting, the auditor should walkthrough transactions that were processed after the change."

Sixth, in paragraph 83, the guidance only refers to nonroutine and estimation processes. We believe this is guidance is applicable for all processes for which a walkthrough is performed and that the Proposed Standard should so state.

c. Company-Level Controls

We agree with the Board's position in paragraph 54 of the Proposed Standard that company-level controls have a pervasive effect on controls at the process, transaction, or application level. However, we believe further clarification is needed pertaining to certain elements of company-level controls.

First, we believe that further discussion is warranted to clarify that the purpose for evaluating company-level controls is to understand, evaluate, and test the effectiveness with which these controls are applied across locations or business units. The separation of company-level controls as discussed in paragraphs 53-55 from the multiple location guidance contained in paragraphs B4, B8, and B9 of Appendix B creates confusion. Accordingly, the Proposed Standard should clarify that company-level controls are important to consider when determining the locations that management and the auditor should include in its scope. Further clarification also is needed to indicate that the controls presented are illustrative and are not intended to be a complete list of company-level controls nor is a company required to have all the controls in the list to support its assessment of effective company-level controls. However, ineffective company-level controls may be a serious deficiency that will affect the scope of the work performed at the locations.

Second, we suggest clarifying in paragraph 53 that the listing of company-level controls presented are not suggesting that only these controls need to be considered to address the components of the COSO framework but that these controls represent part of one or more of the five components of the COSO framework.

Third, to support that company-level controls are effective at multiple locations, there should be evidence that the relevant controls had been documented and communicated at these locations.

Accordingly the Proposed Standard should state:

> A foundation for the entity-wide controls is the significant controls at the location or business unit. Therefore, these significant controls also should be documented by [management].

Fourth, paragraph B9 of Appendix B states, "The auditor should perform tests of company-level controls to determine whether such controls are operating effectively. The auditor might conclude that he or she cannot evaluate the operating effectiveness of such controls without visiting some or all of the locations or business units." We believe that the term "might conclude" does not adequately state that the auditor (and management) has a responsibility to test company-level controls at some locations. We believe that the Board should be specific in Appendix B regarding performing company-level controls at multiple locations.

d. The Auditor's Use of the Work Performed by Management and Others

We agree with the Board that the auditor should be permitted, but not required, to use the work of management or others. Nowhere else in professional literature is the auditor required to use the work of management or others. We believe that the scope of the auditor's work should be determined by the auditor. However, we also believe that further guidance is needed with respect to certain items in paragraphs 103-109 of the Proposed Standard pertaining to the auditor's use of the work performed by management and others.

First, the Proposed Standard separates work performed by management into three categories. However, it is not clear how the auditor's ability to use the work of management and others reconciles with the requirement that the auditor obtain the "principal evidence" to support its opinion. The Board should clarify how these two concepts work together.

Second, we believe that some may interpret the language in paragraphs 103-109 as a means to inappropriately minimize the level of effort on the part of the external auditor to test the effectiveness of internal control. That is, auditors may conclude that they only need to independently test those areas in which the auditor is not permitted to use management's procedures (paragraph 104) and those areas in which the auditor's use of management's procedures should be limited (paragraph 105). We believe the unintended consequence is that auditors will not perform any of their own tests in regard to the largest category of controls – controls over routine processing of significant accounts and disclosures (paragraph 106). This will result in over-reliance on work performed by management and internal audit. We recommend that in addition to performing tests in those areas designated in paragraphs 104 and 105, the auditor also be required to perform some independent tests of controls over routine processing of significant accounts and disclosures (paragraph 106).

Third, as proposed, auditors are required to reperform "some" of the tests of controls performed by others. We recommend that additional guidance be provided with respect to the meaning of "some" in the context of the areas where the auditor's reliance on the work of management and others should be limited (paragraph 105) and where there is no specific limitation (paragraph 106). We suggest that the Board develop examples for illustration in the appendix.

Fourth, we are concerned that auditors may use the work performed by management not only to satisfy the audit of internal control over financial reporting but also to reduce the level of substantive testing related to the financial statement audit. We do not believe this is the intention of the Board. For financial statement audit purposes, we believe that the auditor should continue to follow the guidance of SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. However, the Proposed Standard does not set any

limitations with respect to the auditor's ability to reduce substantive testing. Therefore, how the Proposed Standard and SAS 65 interrelate should be clarified.

Fifth, paragraph 104 of the Proposed Standard states that the areas in which the auditor should not use the work of others include "controls that have a pervasive effect on the financial statements, such as certain information technology general controls on which the operating effectiveness of other controls depend." Many companies have an internal staff that is well qualified to perform IT general control work. We believe that testing of IT controls should be moved from the category where the auditor should not use the work of others to the category where the use of the work of others should be limited.

e. General Computer Controls

We suggest that the Board provide more explicit guidance on the types of general computer controls that fall within the definition of internal control over financial reporting versus operational effectiveness and efficiency. For example, we believe that business continuity and disaster recovery, while an important operational control, is not a component of internal control over financial reporting, except to the extent that they relate to the recovery of data to achieve the objective to maintain records.

f. Safeguarding of Assets

While we agree that additional guidance on what is meant by safeguarding of assets is helpful and important, we believe that Appendix C of the Proposed Standard should be significantly enhanced. Appendix C should be specifically linked to the definition of safeguarding of assets set forth in paragraph 6 of the Proposed Standard. It also is not clear how the guidance in Appendix C relates to the COSO Addendum, *Reporting to External Parties*, which is referred to in the SEC's Final Rule for Section 404. The guidance in paragraph C1 also should be specifically linked to the definition in the COSO Addendum.

As proposed, Appendix C does not sufficiently answer which controls over safeguarding of assets are within the scope of internal control over financial reporting and which are not. For example, assume that a company has safeguarding controls over inventory such as inventory tags (preventative controls) and that the company also performs periodic physical inventory counts (detective control) timely in relation to their interim and annual financial reporting dates. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement to the financial statements if performed effectively and timely. Therefore, given that the definitions of material weaknesses and significant deficiencies relate to the likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness because the detective control (physical inventory) prevents a misstatement of the financial statements.

The COSO Addendum also indicates that a company does not have to consider preventive controls over inventory shrinkage if it has sufficient detective controls to measure and record any shrinkage on a timely basis. If the Board intended to extend safeguarding of assets beyond financial reporting (e.g., the ineffectiveness of the inventory tags to prevent inventory theft or loss illustrated above), then the Proposed Standard should indicate areas that management and

the auditor should include in safeguarding of assets, and the definitions of significant deficiencies and material weaknesses will need to be modified to address safeguarding controls.

Also, the first two examples and, perhaps, the fourth example in paragraph C1 of the Proposed Standard arguably may not result in a misstatement of the financial statements and, therefore, seem problematic from a definitional perspective. The intent of the fourth bullet is not clear, because ultimately all costs impact pricing decisions, which seems to sweep in improper allocation as a consideration for all cost categories. We suggest clarifying that this relates only to programs whereby costs are directly recovered from customers. Examples would be helpful to ensure proper application.

Finally, Appendix C categorizes all of the bulleted items as "unintentional misstatement." While some situations may be unintentional, the misappropriation of assets generally is intentional.

5. Reporting

a. Requirement to Issue an Adverse Opinion in Certain Circumstances

The Proposed Standard requires the auditor to render an adverse opinion when a material weakness is identified. An adverse opinion concludes with the opinion that due to the effect of the material weakness on the achievement of the objectives of the control criteria, the company has not maintained effective internal control over financial reporting. We strongly disagree with this approach. We believe that the auditor should render the appropriate type of opinion based on the circumstances that caused the material weakness. This approach would provide better information about the nature and impact of the material weakness identified.

While we agree that material weaknesses that are pervasive to the company should result in an adverse opinion, we also believe that an adverse opinion is not appropriate if the material weakness is not pervasive. For example, a company with effective internal control might make an acquisition of a business that has a material weakness. Users of the report should be permitted to understand whether the material weakness relates only to the acquisition or has a more pervasive impact. A qualified opinion best communicates this situation. The Proposed Standard should be modified to provide for flexibility in evaluating the material weakness based on significance to the entire company and should permit the auditor to issue either an adverse or a qualified "except for" opinion, depending on the circumstances.

In addition, we are concerned that a scope limitation will not adequately inform the public in situations where a material weakness has been identified and corrective action has been taken but insufficient time has passed to determine whether the material weakness has been corrected. In such cases, the auditor should conclude that management's assessment is inadequate, leading to a modification of the auditor's report due to the existence of a material weakness. If the Board decides that such cases should result in a scope limitation, then the standard should require descriptive language of the scope limitation that includes a description of the material weakness and a statement that if such weakness were not corrected, the auditor could not conclude that internal control is effective.

This scenario further supports the need for clear guidance as to what constitutes a "sufficient period" in paragraph 166 of the Proposed Standard. The relevance of evidence subsequent to the

"as of" date should be explicitly addressed. In our view, in the case of a deficiency in the design of internal control, there must be substantive evidence that the control had been implemented prior to the "as of" date sufficient to correct the deficiency. Accordingly, failure to implement adequate controls at the "as of" date is a deficiency without regard to any corrective action that may have been taken after the "as of" date. However when there is not a sufficient period of time to obtain adequate evidence about the operating effectiveness of the new control prior to the "as of" date, then we believe that management and the auditor may consider evidence subsequent to the "as of" date, but before the date of the auditor's report as to whether the control was operating effectively. If such sufficient evidence cannot be obtained, then the condition results in a deficiency as opposed to a scope limitation.

We recommend providing examples of illustrative language disclaiming an opinion on disclosures about corrective actions taken by the company and the company's plans to implement new controls (the first two bullet points of paragraph 174).

b. Explanatory Footnotes to Management's and the Auditor's Reports

Similar to the preparation and audit of the financial statements, an assessment and audit of the effectiveness of internal control involve a number of important considerations. When reading the financial statements, an understanding of the important aspects, which can range from critical accounting policies to segment and other disclosures, is crucial in providing the reader with the proper context to evaluate the financial statements presented. Similarly, we believe information relevant to assisting users to better understand management's assessment and the auditor's evaluation of the effectiveness of internal control over financial reporting should be disclosed in management's report on internal control. We believe that relevant information includes (1) disclosure of what management included in safeguarding of assets, (2) the entities excluded from the scope of management's evaluation (whether or not consolidated) such as provided in paragraphs in B15 and B16, and (3) the nature and extent of the use of service auditor reports as the basis for its assessment relating to outsourcing and other service relationships.

Currently, when relying on the work of other auditors the auditor is able to apportion responsibility in their report. Yet under SAS 70, neither management nor the auditor makes reference in their report to the use of the service auditor's report. SAS 70 was designed for an audit of the financial statement whereby the auditor is also required to perform his or her own substantive tests and, thus was not relying exclusively on the service auditor's report. However, for purposes of the audit of internal control, neither management nor the auditor is required to perform any additional procedures. Therefore, the only evidence with respect to the service organization's controls comes from the evaluation and testing performed by the service auditor. Accordingly we believe that the reliance on a service auditor should be clearly disclosed in management's and the auditor's report to provide transparency as to the source of the evidence.

We believe it is important for users of management's report and the auditor's report to understand the boundaries of the internal control being reported on, in terms of entities covered and not covered. We do not believe that a narrowing of the boundaries should be discussed as a limitation in scope but rather as a means to clarify the boundaries of the company's internal control over financial reporting that their respective reports cover.

6. Evaluating the Effectiveness of the Audit Committee's Oversight

a. Effectiveness of the Audit Committee as an Element of the Control Environment

We agree with the Board's emphasis on the importance of the effectiveness of the audit committee. The audit committee plays an important role in setting the "tone at the top" and providing an important oversight function with respect to financial reporting. Although some may take the view that the effectiveness of the audit committee is outside the scope of the company's internal control over financial reporting, the COSO framework has long recognized the effectiveness of the audit committee as one of the elements of the control environment. However, we expect that the Proposed Standard's requirement will be controversial and difficult to implement. Accordingly, the Proposed Standard should be changed to reflect the effectiveness of the audit committee as an important aspect of the control environment, rather than what appears to be a separate evaluation. In addition, we believe this requirement contains elements that should be significantly changed.

First, the Proposed Standard does not make clear whether management's assessment is required to also include an evaluation of the effectiveness of the audit committee's oversight. Keeping with the construct of the audit of internal control (i.e., management first makes its assessment and then the auditor evaluates and tests that assessment), we believe that management (in conjunction with the Board or the audit committee itself) also should be required to evaluate the performance and effectiveness of the audit committee's oversight considering the requirements set forth for auditors in the Proposed Standard. This requirement is consistent with Section 407 of the Act, whereby boards of directors are required to determine whether members of the audit committee are financial experts. Additionally, newly adopted listing exchange standards require that an annual assessment of the audit committee be performed.

Second, ordinarily the auditor does not have full and complete access to the audit committee. Without full and complete access, the auditor will be unable to identify all of audit committee's activities, interactions with other parties, and conclusions reached. Therefore, we do not believe that the auditor will have available all of the information needed to effectively perform its evaluation and will be unable to adequately assess the effectiveness of the audit committee against the specific requirements of paragraph 57 of the Proposed Standard unless it has full and complete access to the audit committee. We believe that the Board needs to provide guidance as to how this issue should be addressed.

b. Factors Related to the Evaluation of the Audit Committee's Oversight

The Board has provided a list of factors in paragraph 57 of the Proposed Standard for auditors to consider related to the evaluation of the effectiveness of the audit committee's oversight. For the auditor to carry out this responsibility effectively, we believe certain of the listed factors need to be more specific while others should not be included in the list.

First, testing for compliance with laws and regulations, such as applicable listing standards implemented as a result of Section 301 of the Act, is outside the scope of internal control over financial reporting. The SEC rule, *Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports,* defines internal control over financial reporting, and this definition, as stated in the SEC's rule, "does not

encompass the elements of the COSO definition that relate to the effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements."[2] We do not believe compliance with applicable listing standards adopted pursuant to Section 301 of the Act is directly related to the preparation of the financial statements. Therefore, we do not believe this aspect of evaluating the audit committee should be encompassed with the audit of internal control over financial reporting.

Second, the definition of "independence" should be specifically identified so that the same criteria are applied for all evaluations of audit committees. Moreover, it is unclear how an auditor can reasonably evaluate whether the nominating process for the audit committee is appropriately independent or whether management picks "friends."

In response to Question 24 of the Board's request for comments on specific questions, we do not believe that it is in the interest of investors or the public to require the auditor to withdraw from the audit engagement because the auditor has concluded that the audit committee is ineffective. If the auditor is able to form a conclusion regarding the effectiveness of internal control over financial reporting, which includes the assessment of the audit committee, then the auditor should issue the appropriate report. Ineffective audit committees will likely result in adverse opinions based on the guidance in paragraph 126 of the Proposed Standard. The communication of the material weakness that resulted in the adverse opinion is useful information to the public. Furthermore, the auditor always has the option to withdraw from the engagement when the company and the audit committee do not respond appropriately to the situation.

7. Effective Date

We are fully committed to successfully implementing and performing the audits of internal control over financial reporting, and we understand the need to timely implement the new standard to meet the objectives of the Act. We also understand that the SEC has set the implementation date for Section 404 of the Act as the first fiscal year ending on or after June 15, 2004 for accelerated filers and for fiscal years ending on or after April 15, 2005 for non-accelerated filers and foreign companies. We recognize that the PCAOB is striving to meet that time frame under challenging circumstances.

However, this Proposed Standard is extremely significant due to both its complexity and its impact on companies and the auditors. While companies and auditors are preparing for implementation based on the knowledge and understanding to date, we are concerned that this Proposed Standard will not be finalized by the Board and approved by the SEC within a time frame that allows for successful implementation of the final standard for companies with June 2004 fiscal year ends. Indeed, companies with June 2004 fiscal year ends will likely be well into the third quarter of their fiscal year before this standard is finalized. Accordingly, it will be very difficult for companies and auditors to apply the provisions of the Proposed Standard to a fiscal year that is almost completed before the standard is final, especially considering that some

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2 SEC final rule, page 10.

internal controls over financial reporting may operate only on a quarterly basis. When the standard is finalized, companies and auditors will require a reasonable amount of time to understand the requirements, train staff, and implement changes. We urge the Board to work with the SEC and consider delaying the effective date for accelerated filers to fiscal years ending on or after September 15, 2004. This slight delay in the effective date contributes to a more successful implementation of the Proposed Standard and still results in the implementation in 2004 by the vast majority of public companies.

Additionally, if the Board decides to modify the auditor's interim responsibilities through this standard, we believe the effective date for any required changes to procedures performed for reviews of interim financial information should be effective starting the first quarter after the initial audit of internal control over financial reporting is performed.

8. Implementation Guidance

Because of the complexity and importance of properly implementing the Proposed Standard, we believe that a substantial amount of interpretation will be necessary as implementation occurs. Therefore, we believe that the Board should establish a formal process for responding to implementation questions from auditors and companies that will undoubtedly be forthcoming.

9. Impact of the Proposed Standard on Interim Standards

We are concerned with the impacts of the Proposed Standard on the Board's current interim standards, especially in relation to the procedures performed in connection with the financial statement audit, as well as for interim reviews of quarterly financial information. Throughout the Proposed Standard, the Board has incorporated changes that also have a significant impact on the Board's interim standards, creating inconsistencies between the Proposed Standard and the interim standards. However, this is not clearly evident. For instance, paragraph 138 of the Proposed Standard states that "the auditor should perform substantive procedures for all relevant assertions for all significant accounts and disclosures." However, the AICPA Statement on Auditing Standards that have been adopted by the Board as interim standards only require the auditor to perform substantive tests at the account balance or class of transactions level.[3] Another example relates to language in paragraph 141 of the Proposed Standard, which states that the auditor's substantive procedures must include "examining material adjustments made during the course of preparing the financial statements." This statement could be interpreted to mean that auditors are required to test every material journal entry made throughout the year and in the closing process, since they all relate to preparing the financial statements. Currently, auditors are not required to test every material journal entry during a financial statement audit.

It also is not clear how the Proposed Standard impacts the auditor's responsibilities with respect to interim financial information and the requirements under AICPA Statement on Auditing Standards No. 100, *Interim Financial Information*.

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[3] AICPA Statements on Auditing Standards, *Internal Control in a Financial Statement Audit* (AU 119.81).

We suggest that each proposed auditing standard issued by the Board should clearly identify how the proposed changes will impact current standards, and what conforming changes will need to be made to existing interim standards. This will assist the auditor and the public in understanding the intentions of the Board and help to maintain consistency in the application of standards. An appendix with such changes might be a way to communicate the information.

10. Consideration of Small and Medium-Sized Companies

While the nature of controls at large companies may differ from the nature of controls at small and medium companies due to the size of the entity, management's responsibility with regard to assessment, evidence, and documentation should not be different. As indicated in paragraph E9 of the Proposed Standard, "the concept of control activities in a small company is the same as in a larger one."

However, Appendix E of the Proposed Standard does not articulate clearly that management's responsibilities remain the same regardless of the size of the entity and seems to imply that for small or medium-sized companies, management's assessment process, evidence, and documentation may differ from those for large companies. As such, Appendix E may allow interpretation by small and medium-sized entities that their assessment and documentation does not need to cover all significant accounts and all relevant assertions and may have the unintended consequence of the forcing the auditor to rely on inquiries of management regarding higher level monitoring practices rather than on reliable evidential matter.

Accordingly, we believe Appendix E should be modified to indicate that small and medium-sized companies are responsible for supporting the evaluation of internal control with sufficient evidence, including documentation (as indicated in paragraph 19 of the Proposed Standard) and that inadequate documentation of the design of controls and the absence of sufficient documented evidence to support management's assessment of the operating effectiveness of internal control over financial reporting are internal control deficiencies that may rise to the level of a significant deficiency or material weakness based on the auditor's judgment.

II. COMMENTS RELATED TO CERTAIN PARAGRAPHS

1. Specific Comments

Paragraph 14—Committee of Sponsoring Organizations Framework

The reference for more information about the Committee of Sponsoring Organizations (COSO) framework should be to the COSO document itself and not to AU 319.

Paragraph 15—Inherent Limitations in Internal Control Over Financial Reporting

In addition to the inherent limitation of internal control, we believe that the Proposed Standard should discuss the inherent limitations of management's assessment and the audit of internal control over financial reporting. We suggest the following language:

> The practitioner should plan and perform the engagement to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Absolute assurance is not attainable because of the nature of attestation evidence and the inherent limitations of internal control. Therefore, an examination of internal control conducted in accordance with attestation standards may not detect a material weakness. The subsequent discovery that a material weakness exists is not, in and of itself, evidence of (1) failure to obtain reasonable assurance; (2) inadequate planning, performance, or judgment; (3) the absence of due professional care; or (4) a failure to comply with attestation standards. Since the practitioner's opinion on internal control is based on the concept of obtaining reasonable assurance, the practitioner is not an insurer, and his or her report does not constitute a guarantee.

Paragraph 20—Management's Responsibilities and Disclaimer of Opinion

Paragraph 20 contains an unconditional requirement (under proposed Rule 3101) that the auditor disclaims an opinion if management has not fulfilled the four responsibilities enumerated in paragraph 19. We do not believe that a disclaimer is an appropriate form of report in all situations. For example, if management fails to support its evaluation with sufficient evidence but the auditor is otherwise able to conclude that effective internal control has *not* been maintained, we believe that a report expressing an adverse opinion is a more appropriate response. In situations in which fraud is detected, the auditor may be unwilling to continue with the engagement, depending on the magnitude. While we agree that a communication to management and the audit committee is warranted, issuing a report disclaiming an opinion does not seem adequate in such situations.

Paragraph 21—Materiality Considerations

The Board has proposed that the auditor should apply the concept of materiality at both (1) the financial-statement level in deciding whether a significant deficiency, or a combination thereof, represents a material weakness, and (2) the individual account-balance level in deciding whether a control deficiency, or combination thereof, represents a significant deficiency. We believe that

management and the auditor have the responsibility to plan the evaluation to detect a material weakness, which is based on the threshold of a material misstatement, not at the individual-account-balance level. Accordingly we suggest that paragraph 21 of the Proposed Standard be clarified to clearly distinguish that materiality at the financial-statements level is relevant for the purpose of planning the scope of the audit of internal control, not materiality at the individual-account-balance level. We also suggest that the Board clarify materiality at the individual-account-balance level as it relates to the term "more than inconsequential," which is included in the definition of a significant deficiency of in paragraph 8.

Paragraphs 24-26—Fraud Considerations

We agree that both management and the auditor should consider the risk of fraud, as defined by existing auditing standards. However the requirement to evaluate "all controls specifically intended" to address the risks of fraud could be too broad or at least result in inconsistent application in practice. We do not believe it is possible for the auditor to determine which controls were intended by management to address the risks of fraud, nor can one distinguish between some controls to determine whether they are for just fraud or for fraud and error. We recommend that this be highlighted as a key consideration in the risk assessment component.

We believe the requirements set out in paragraphs 24-26, while laudable, do not provide adequate specificity against which the design and operating effectiveness of a company's fraud program and controls can be properly evaluated. Lacking such specificity, there will be wide variation in practice across companies and auditors. We recommend that the Board clarify what the auditor should consider in addition to the requirements in Statement of Auditing Standards No. 99. For example, the auditor must test the design and operating effectiveness of the company's antifraud programs and controls in response to the risks of fraud identified in the audit of the financial statements.

Paragraph 41—Evaluating Management's Assessment Process

We recommend inserting the word "all" in front of "relevant assertions."

Paragraph 43—Evaluating Management's Assessment Process

We recommend inserting the word "all" in front of "relevant assertions" in the first bullet point. Also it appears that bullet points four through six are a subset of bullet point one.

Paragraph 66—Assertions

The term "meaningful bearing" may confuse people in terms of deciding what a relevant assertion is and may result in inappropriate rationalization to exclude assertions that may be applicable but judged not to have an elevated risk associated with it. We believe the term should be replaced with "applicable."

Paragraph 69—Identifying Significant Processes

The concept of a significant process and major class of transactions are not defined, nor is it clear how one should go about identifying a significant process. Also the phrase "groups of accounts"

is introduced here for the first time, but it is unclear as to what is a group of accounts and how it relates to a significant account. This step is important because the designation of a process as significant in paragraph 69 determines the scope of the auditor's walkthrough in paragraph 79. An example demonstrating the intent of these terms would be helpful.

Paragraphs 74-78—Identifying Controls to Test

We believe that the heading for this section of the Proposed Standard may be misleading as the section also addresses the linkage of the assertions and controls. Accordingly we suggest dividing this section into a section to describe the consideration of the linkage of the assertions, control objectives, risks and control activities and a section to provide guidance relating to identifying and planning the tests of controls. Recognizing that the audit process is seldom performed in a finite sequence, nonetheless it appears more logical to place the walkthrough before the identification of controls to test.

Additionally paragraph 75 notes that the auditor should "link individual controls with the significant accounts and assertions." Separately, in paragraph 78, the concept of control objectives is introduced but is it is not clear how this interrelates with paragraph 75. We suggest further clarification as to how the relevant assertions relate to control objectives and the intersection with the identification of risks and the related control activities.

Paragraph 84—Testing and Evaluating Design Effectiveness

Similar to the previous comment related to paragraph 74-78, there is no linkage of the control objectives to the relevant assertions mentioned, nor is there any mention of risks and the linkage to control objectives and control activities.

Paragraphs 94-99—Timing of Tests of Controls

More guidance on the period of time needed to conclude controls are effective at the "as-of" date is necessary, particularly for those control activities that are performed infrequently (e.g., controls performed monthly or quarterly). We also believe that it is important to provide more explicit guidance related to the term "sufficient period of time" in paragraph 99 as it relates to the auditor's responsibility and in paragraph 151 as it relates to management's responsibility. Unless the Board provides guidance on "sufficient period" and the appropriate time frame for obtaining sufficient evidence, there will be inconsistency in evaluating controls, particularly those implemented late in the year to correct significant deficiencies or material weaknesses.

Paragraphs 113-127—Forming an Opinion on the Effectiveness of Internal Control Over Financial Reporting

The first bullet point in paragraph 113 refers only to "the results of tests of controls." To avoid possible confusion, we recommend that the wording be expanded to read "the adequacy of the assessment performed by management and the results of the auditor's evaluation of the design and tests of operating effectiveness."

Paragraph 114 states that the auditor should review "all" review reports issued during the year by internal audit that address internal control over financial reporting and that such review should

include reports issued by internal audit as a result of operational audits or specific reviews if those reports address controls related to internal control over financial reporting. We believe that in certain circumstances it may not be practical or reasonable for the auditor to review “all” reports. For example, a retailer with 1000 stores might perform 50 corporate audits and 400 store audits during a year. Additionally as part of the review of the internal audit function, the auditor should evaluate whether internal audit properly reports its findings to management and the audit committee and whether the company has in place an appropriate monitoring process to ensure that deficiencies identified are accumulated, monitored, and corrected on a timely basis. Accordingly if these processes are judged to be reliable, then we do not believe that the auditor should be required to read each internal audit report.

Paragraph 123 and 126—Examples of Significant Deficiencies and Strong Indicators of a Material Weakness

We believe it important to clarify that the listings contained in paragraphs 123 and 126 are not intended to be all-inclusive (e.g., if a type of deficiency is not listed, then it is not appropriate to presume that the deficiency is not a significant deficiency or material weakness). Furthermore, we believe clarification with respect to the reference in paragraph 126 to the identification of “fraud of any magnitude on the part of senior management” is necessary. The Board should clarify that the type of fraud referred to in paragraph 126 is consistent with the definition of fraud in Statement of Auditing Standards 99.

Additionally, the Board should clarify that the auditor is not required to assess a company’s regulatory compliance function. The Proposed Standard requires the auditor to consider “an ineffective regulatory compliance function” as a strong indicator of a material weakness. However, we do not believe it is the auditor’s responsibility to assess the effectiveness of a company’s regulatory compliance function. COSO, as well as the SEC, recognizes that compliance with laws and regulations is a separate area from internal control over financial reporting. As such, we believe that if the auditor becomes aware of events and circumstances leading him or her to believe company’s regulatory compliance function to be ineffective, then the auditor should assess the impact of such ineffectiveness on the auditor’s own conclusions about the effectiveness of internal control over financial reporting. However, the auditor should not be required to perform procedures to directly or indirectly assess the effectiveness of a company’s regulatory compliance.

Paragraph 128-129—Requirement for Management Representations

We recommend that representations from management also include representations related to the requirements under Section 302 of the Act, including that management has disclosed all significant deficiencies, not just material weaknesses in item d. In addition, similar to the construct for the financial statement audit, we suggest that the auditor be required to include as an appendix to the representations letter a listing of those deficiencies identified by the auditor, which had not been identified by management and, accordingly, include in the letter a representation that, in management’s opinion, the deficiencies identified by the auditor when considered with all other deficiencies do or do not rise to the level of a material weakness and that deficiencies identified by management and the auditors do not result in a material weakness for any of the three interim periods.

We also suggest that a representation be included in the letter that confirms that management has communicated the findings of their assessment, including all deficiencies identified by management, to the auditors, as required by paragraph 41.

If management refuses to provide a representation letter, the auditor should not have the option of issuing a report disclaiming an opinion; rather, no report should be issued and the auditor should withdraw from the engagement. The language used in paragraph 129 appears similar to that in the AICPA Attestation Standards; however, it omits one word that significantly alters the concept of reporting. The AICPA Attestation Standards provides for disclaiming an opinion or withdrawing from the engagement only when management fails to furnish *all* appropriate written representations. If management fails to provide any written representations, we believe the auditor is precluded from issuing a report. Further, the presumptively mandatory requirement in paragraph 128 should be changed to an unconditional obligation (e.g., "must") but specifically linked to the reporting ramifications in paragraph 129 of the Proposed Standard.

Paragraph 138-142—Effect of Tests of Control on Substantive Procedures

The requirement, in paragraph 139 of the Proposed Standard to test the controls over financial information used in substantive analytical procedures appears to prohibit the use of information obtained from an external source (e.g., external indices or ratios). Since substantial analytical procedures are often useful in detecting fraud, we suggest modifying the last sentence in paragraph 140 to read, "the use of analytics alone are generally not sufficient for detecting fraud." Furthermore, the last sentence in paragraph 139 makes reference to the significant risks of material misstatements. We believe the Board should clarify its definition of significant risks by providing a few examples of such risks. For instance, does the Board consider fraud or areas involving estimates and management judgment to represent significant risks of material misstatement?

In paragraph 141, the auditor is charged with the responsibility to examine material adjustments made during the course of preparing the financial statements. As discussed previously, we believe that this provision needs additional clarification. Additionally, we believe that similar requirements should be explicitly included in paragraph 41 relative to the Company's responsibility to identify and review material adjustments, in particular to address the risk of fraud related to management override.

We believe that any changes to the interim standards related to substantive procedures need to be highlighted in the Proposed Standard because they may not be obvious to the reader and may create inconsistencies with the Board's interim standards.

Paragraph 145-146—Documentation Requirements

The third bullet point in paragraph 145 of the Proposed Standard seems to require documentation of every possible risk, which is too far reaching. As stated previously, we believe that the Proposed Standard should more explicitly address the extent of consideration and documentation of risk in terms of both management (e.g., paragraph 41) and the auditor (e.g., paragraphs 74-78).

Paragraph 149—Management's Report

We strongly believe that the guidance provided that "other phrases" of an acceptable management conclusion may be appropriate is *not* appropriate for reporting under Section 404 of the Act and should be deleted.

Paragraph 152—Management's Report

The requirement in item e, "including those corrected during the period" is not required to be included in management's annual report as set forth in paragraph 148. This is a requirement of Section 302 of the Act and is addressed in paragraphs 183-189. Accordingly we believe this provision should be deleted.

Paragraph 161—Management's Report Inappropriate

Paragraph 161 states, "The auditor should modify his or her report to include, at a minimum, an explanatory paragraph describing the reasons for this conclusion" and fails to address whether the auditor should modify his or her opinion.

Paragraph 163 – Material Weakness

Paragraph 163 includes a list of elements required to be included in the auditor's report when a material weakness exists; however, the example in Appendix A does not appear to be consistent with these requirements. Additionally, the last bullet point states that the description of the material weakness should also address the requirements in paragraph 178; however, paragraph 178 requires the auditor to make a determination of whether the auditor's *opinion* on the financial statements was affected, but only requires language when it is *not* affected. We believe that the language illustrated in paragraph 178 should be included in all reports where there are material weaknesses, because it merely puts the reader on notice that the issued auditor's report has considered such matters and is appropriate. Accordingly, we recommend that a separate bullet point be added to paragraph 163. Further, we recommend that the Proposed Standard provide illustrative wording in paragraph 178 for a combined report rather than the current instructions to "revise this wording appropriately for use in a combined report."

The third bullet point requires the auditor to provide specific disclosure regarding any material weaknesses identified. We believe, that consistent with existing reporting models, such disclosure should be the responsibility of management in their report and that the auditor will provide supplemental disclosures only if management's disclosures were concluded to be deficient.

Paragraph 180—Subsequent Discovery of Information

Paragraph 180 "presumes" that if the financial statements are restated, the report on internal control should also be restated. This seems inconsistent with paragraph 126, which establishes a restatement as a "strong indicator," not a presumption. Further the wording "based on these considerations" appears irrelevant, as there are no considerations; it is a presumption.

Paragraphs 188-189—Auditor Evaluation Responsibilities

An inconsistency exists between paragraphs 188 and 189. Paragraph 189 requires the auditor to modify his or her report (a presumptively mandatory obligation), whereas paragraph 188 permits the auditor to resign from the engagement, in which case no report will be issued. An auditor concluding that withdrawal is necessary will not be able to comply with paragraph 189.

Appendices—General Comment

The Board has stated in its Statement of Authority that appendices to the Board's standards are an integral part of the auditing standards and carry the same authoritative weight as the body of the standard.[4] However, the status of appendices in AICPA Professional Standards, which the Board has adopted as interim standards, is different. AICPA Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards* (AU 150), which is incorporated into the Board's interim standards, includes appendices as interpretive publications that the auditor should be aware of and consider but are not required to apply. Under Statement of Auditing Standards 95 (AU 150.6), if the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such guidance. As such, while the auditor is responsible for following the interim standards themselves, the auditor has a lower level of responsibility for following the guidance in the appendices. Therefore, we believe the Board should clarify that the Board did not elevate the appendices as they exist today in the interim standards adopted by the Board to the same authoritative level as their related interim standards.

Appendix A—Illustrative Reports on Internal Control Over Financial Reporting

We have the following comments with respect to the illustrative report examples in Appendix A:

- We recommend that the definition paragraph be placed immediately preceding the inherent limitations paragraph. Such placement will significantly improve the readability of the reports, particularly when material weaknesses are reported or the report is a combined report on both the audit of the financial statements and the audit of internal control.

- The statement about management's responsibility is inconsistent. Some examples include a very narrow responsibility statement (e.g., that management is responsible for its assessment about the effectiveness), while other examples use a broader responsibility statement (e.g., that management is responsible for maintaining effective internal control). We believe that the latter should be used in all report examples.

- Paragraph 153e requires the report to include "a statement that the auditor's responsibility is to express an opinion on the *written* assessment based on his

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[4] Proposed Standard, "Statement of Authority," Page A-2.

or her audit" [emphasis added]; however, the illustrated examples lack the word "written."

- We believe that the definition paragraph should refer to "accounting principles generally accepted in the [identify the country]". Additionally, the second sentence of the definition paragraph is misleading, as it implies that any internal control provides reasonable assurance, including those with material weaknesses. We believe such language should read as follows: "Effective internal control over financial reporting includes those policies and procedures. . . ."

- The inherent limitations paragraph does not address the unauthorized acquisition, use, or disposition of assets discussed in the definition paragraph. Accordingly, we believe that users of the report will inappropriately assume that there are no inherent limitations with respect to such matters.

- The auditor cannot opine on the management's assessment (process), which includes additional details that are not included in the company's report. We believe that the opinion paragraph should refer to "management's *written* assessment" [emphasis added] or "management's conclusion."

- We believe the following revisions should be made to the explanatory paragraph in Example A-2: (1) "will not be prevented or detected" should be added to the end of the first sentence, (2) the reference to management's assessment should be to "management's written assessment," and (3) the elements required by paragraph 163 should be described or illustrated. Further, the references in footnote 1 should be to management's *written* assessment.

- We noted the following additional inconsistencies in Example A-3: (1) "will not be prevented or detected" was omitted from the end of the definition of a material weakness in the explanatory paragraph, (2) the definition of a significant deficiency does not conform to the definition proposed by the Board in paragraph 8, (3) the reference to management's assertion in the introductory paragraph fails to recognize the material weakness referred to in the explanatory paragraph, and (4) footnote 1 provides an illustration as to how to modify the explanatory paragraph when the auditor detects additional material weaknesses; however, the opinion paragraph illustrated in the report appears to be the wrong opinion for such situation (i.e., the auditor should express an adverse opinion and not a qualified opinion).

- We believe that the introductory paragraph of Example A-4 should refer to the PCAOB's standards, given that there will be two different standards for auditing internal control (e.g., "We were engaged to audit*, in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board,* management's assessment. . . ."). Further, we believe that the opinion paragraph should read "we were unable to apply other procedures to satisfy ourselves as to *the effectiveness* of the

company's internal control"; we believe the phrase "the effectiveness" was inadvertently omitted from the AICPA illustration for such situation.

- In Example A-6, we believe that the last sentence should refer to "opinion" singularly, consistent with reporting when the auditor reports on both the financial statements and financial statement schedules in a combined report.

Appendix B—Paragraphs B1-B16

While we agree with the framework set forth herein, it is not clear how this guidance intersects with the identification of significant accounts, significant processes and requirements to perform walkthroughs and tests of controls in the main body of the standard. We believe that, in multi-location situations, the locations or units will be selected first based on the guidance in Appendix B and then the guidance for identification of significant accounts, significant processes, and performing of walkthroughs, and tests will then be applied to each location, as applicable. An example of how the Board intends for this guidance to be applied is necessary; distinguishing between scenarios in which a common process/system is utilized for more than one location versus a scenario in which each location utilizes a different process/system.

We recommend that the Board provide guidance as to their view of "some" in paragraph B2 and "large portion" in paragraph B11. In addition, the terminology in Illustration B-1 should be conformed to the terminology used elsewhere in the Proposed Standard (e.g., "significant controls," "specific significant risks," and "specific risks").

Paragraph B10, which states that "if management does not have company-level controls" should be clarified to address whether the absence of common company-level controls is indicative of a deficiency. Additionally we suggest adding to the end of the first sentence "considering each of the 5 control components." We also suggest that additional guidance be added that although company-level controls may not exist at the overall company-level, they may exist, and therefore can be separately evaluated, at a level below the overall company-level (e.g., for one or more of the segments or line of businesses, etc).

We recommend that the Board clarify what is meant by the term "ordinarily" in paragraph B15 and "sufficient control" in footnote 1 to paragraph B16. Due to the lead times needed for coordination with third parties, it is important that companies and auditors clearly understand what is included in the public company's assessment and what is not. We believe that the scope for two companies with the same investees should not have different conclusions, just because one of them has access to evaluate the controls of the investee (e.g., via a contractual provision). Accordingly we support the determining factor as whether the Company has voting control, which is the lowest threshold at which companies are reasonably be expected to have access and the ability to evaluate the investee's controls.

Similar to the concept in paragraph B15, paragraph B16 should provide that for those entities not included in management's assessment, the Company and the auditor should include the controls over the reporting in accordance with generally accepted accounting principles of the company's portion of the income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures.

Appendix B—Paragraphs B24-B39

The criteria set forth in paragraph B26 list factors (the bullets in paragraph B26) for determining whether a service organization is considered part of the company's internal control over financial reporting. However there are no criteria for establishing what is a service organization, which is a very important decision for purposes of determining the scope of management's assertion. Additionally it is unclear how these factors relate to the similar items in AU324.03 of the Board's interim auditing standards.

Given the pervasiveness of the "extended enterprise" whereby outsourcing of processes and systems is commonplace, we suggest that clear guidance and examples of service organizations be provided including addressing the following types of relationships that are common today:

- Application systems
- Computing environments
- Transaction oriented processes (e.g., customer service, collections, manufacturing, warranty claims, coupons)
- Other back-office processes or support functions (e.g., legal, internal audit, taxes, environmental, actuarial, financial reporting).

The guidance does not establish any limitations of an auditor's use of service auditor reports. For example, if a company outsourced their entire accounting function including systems, processes, and financial reporting and the service organization makes an appropriate service auditor's report available, is it appropriate for management or the auditor to conclude on the effectiveness of the company's internal control solely on the basis of the service auditor's report? Our view is that guidance should be provided that establishes when it is appropriate to obtain and use a service auditor's report versus when it is not.

The second bullet point of paragraph B27 should refer to controls that are relevant to the company's internal control and not to controls that are relevant to management's assessment and the auditor's opinion. Additionally, paragraph B27 refers to AU Sec. 324.07, which describes procedures that auditors should perform, not management. The Board should separately provide guidance (e.g., paragraph 41 as to the procedures management should perform with respect to service organizations).

Paragraph B28 inappropriately refers to a service auditor performing a "review" of systems; however, the term "review" is reserved under the AICPA *Professional Standards* for services that are permitted when analytical procedures can be performed. As analytics cannot be applied to systems, we recommend that the word "review" be replaced with "apply procedures" or "examine."

The first sentence in paragraph B35 states, "If the auditor believes that he or she also *must* obtain evidence about the operating effectiveness of service center controls, one way an auditor can obtain such evidence is by obtaining a service auditor's report on controls placed in operation and tests of the operating effectiveness, as described in paragraph .245b of AU sec. 324." The

use of the term "must" does not appear appropriate in this sentence given that this sentence implicitly requires auditor judgment (hence, the reference to "if the auditor believes") and, therefore, it cannot be considered an unconditional obligation as the PCAOB has described the meaning of the term "must."

The description of a report on operating effectiveness in paragraph B35 fails to recognize that such report also provides an opinion on the suitability of design of the controls.

Paragraphs B37-B38 discusses the procedures that the auditor should perform with respect to changes in controls at the service organization and presumes that management is aware of any and all changes. We believe that inquiries should include such matters as inquiring of management what they have done to ascertain whether there have been any changes in the service organization's controls. Paragraph B37 also incorrectly categorizes errors identified in the service organization's processing as a change in controls; this situation is better presented as an indicator that a change may have occurred. Accordingly, we expect the auditor to focus on how management investigated such matters, including the cause of the errors, and then evaluate the implications on management's assessment and the auditor's evidence.

For purposes of performing an audit of internal control over financial reporting, it is not clear whether the considerations of a service organization's controls include only control activities or the other control components as they relate to the service organization as well. We also suggest the Proposed Standard provide guidance as to the impact on management's and the auditor's report, if management and the auditor are unable to obtain sufficient evidence as to controls at a service organization.

Appendix B—Paragraphs B40 and B41

We suggest that the Board clarify whether the examples included in the appendices, which are deemed to be authoritative, are also authoritative or only illustrative in terms of the nature, extent, or timing of the procedures. For example, has the Board established that a sample size of 25 items for a manual control and one item for a programmed control, in conjunction with inquiry and observation, is the minimum scope?

The following comments relate to Example B-1:

- Page A-91, first paragraph, item c, distinguishes between a programmed control and a detective control. We believe the distinction is a programmed control versus a manual control.

- Page A-93, item a, carried over from previous page states that "items that typically appear on the Daily Unapplied Cash Exception Report" suggests that the auditor's focus is only on the "typical" items, not the unusual and infrequent.

- Page A-93, since the Daily Unapplied Cash Exception Report is a cumulative listing, we believe that it is necessary to observe it only once to update the tests to year-end, which could be done as a dual-purpose test for both the audit of internal control and the audit of the financial statements.

The following comments relate to Example B-2:

- Page A-94 it appears that the example, in the second paragraph, carves out other receivables from testing. It is not clear what the basis for that decision is based on the guidance provided in the standard.

- Page A-95, the first bullet point describes observing the control being performed. While observation is helpful for controls performed infrequently such as reconciliations, it is unlikely, within practical limits, that the auditor will be able to observe the employee performing the reconciliation.

- It is unclear why it is necessary for the auditor to scan the file of all reconciliations prepared during the year for the audit of internal control, since the auditor's report is "as of" a point of time, unless the intent is to portray this as a dual-purpose test for the benefit of the audit of the financial statements. Otherwise the auditor's responsibility is to determine whether the control has been operating for a sufficient period of time, the whole year seems to be too far reaching. We support testing the control for two months, once at interim and once at year-end.

The following comments relate to Example B-3:

- In Example B-3, it suggests that if "the auditor had encountered a control exception, the auditor would have tested an additional number of items." We suggest that testing more items is not necessarily the best response, particularly if the exception relates to a very large population. We suggest that a better response is to identify the root cause of the exception and then design tests to specifically search for additional exceptions.

- On page A-96, the first paragraph states, "the auditor expected no errors based on the results of company-level tests performed earlier." It is not clear how company-level controls in this example may impact the auditor's scope. Is this implying that there is a common process/system across multiple locations? Why does that impact the sample size? Further, the example goes on to say, "If the auditor had encountered a control exception, the auditor would have tested an additional number of items." It is unclear what control exception is being referred to—does this mean that if company-level controls were not adequate, the auditor should increase the sample size for testing cash disbursements?

The following comment relate to Example B-4:

- Page A-98 implies that the auditor has uncontrolled access to the company's systems in its description of the auditor's attempts to record the receipt of goods without a purchase order, to approve an invoice for payment, to process duplicate invoices, etc. We recommend that such procedures be described as being performed in the presence of appropriate individuals of the company. Had the auditor's attempts been successful, the auditor could be at risk for having altered the client's records; accordingly, such attempts should only be

made in the client's presence so that the client can be immediately notified of any breach to their systems.

2. Pervasive Comments

Use of Consistent Terminology

We noted the following items, which we believe are examples of inconsistencies that should be addressed by the Board:

a. Management's assessment, management's written assessment and management's conclusion

Throughout the Proposed Standard these phrases are used. We believe that the phrase ***management's assessment*** encompasses various phases of management analyzing the design of its controls, testing and evaluating their operating effectiveness, forming its conclusion, documenting its work and preparing its written report. We also believe that the report that management prepares might be referred to as ***management's written assessment*** that contains, among other things, ***management's conclusion*** on the effectiveness of its internal control. The Proposed Standard, however, appears to use management's assessment interchangeably for both the process and the written report, resulting in confusion or factually inaccurate statements.

For example, management's assessment is much more than what is contained in the report of management. Paragraph 2 states that "The report of management is required to contain management's assessment . . . including a statement as to whether the company's internal control . . . is effective" while paragraph 5 states "the auditor evaluates the assessment performed by management." While only a description of the process (activities) can be included in the report, the auditor should be evaluating the process rather than the report. Accordingly, we recommend that the phrase "management's report" or "management's written assessment" be used when referring to the written communication of management required under Section 404.

Another inconsistency appears in paragraph 128b, which uses "evaluation" instead of "assessment" (i.e., the auditor should obtain written representations "stating that management has performed an evaluation of the effectiveness"). Evaluation is also used in paragraph 148.

b. Internal control over financial reporting, internal controls over financial reporting, controls, and internal controls

The Committee of Sponsoring Organizations of the Treadway Commission ("COSO") refers to internal control (singular) as a process; systems and controls make up the process. Individual controls or subsets of controls are referred to by COSO without the term "internal." The Proposed Standard will create confusion by using inconsistent terminology. For example, "internal controls [plural] over financial reporting" are used in paragraph 10-12 (although such paragraphs also contain the appropriate singular usage of "internal control over financial reporting"); "internal controls" is used in paragraph 11, 32, and 133.

c. Specific risks and significant risks

The term "specific risks" in used in paragraph B1, "significant risks" in paragraph 139, and "high risks" are referred to in the explanatory material and existing interim standards. We recommend consistently using "significant risk" throughout.

Compliance With Proposed Rule 3101

The Board's proposed Rule 3101 sets forth certain terms to describe the degree to which the Board expects auditors to comply with professional obligations included in the Board's Auditing and Related Professional Practice Standards. This Proposed Standard uses terminology that is inconsistent with the proposed Rule 3101 or describes procedures in a manner in which it is unclear as to the level of obligation. Paragraph 79 of the Proposed Standard discusses performing walkthroughs and states both "walkthroughs are required procedures" (a possible unconditional obligation) and "the auditor should perform a walkthrough for all of the company's significant processes" (a presumptively mandatory obligation). Other examples where it is unclear as to the auditor's obligation and that should be clarified include the following:

- Paragraph 85, "procedures the auditor performs to test and evaluate design effectiveness"
- Footnote 20 and paragraph 184, "need to evaluate"
- Paragraph 52, "should focus on combinations of controls"
- Paragraph 98, "should balance performing the tests"
- Paragraph 101, "should vary" the nature, timing and extent of tests
- Paragraph 180, "should presume that his or her report on the company's internal control over financial reporting . . . should be recalled"
- Paragraph 181, "the direction of AU sec. 711.10 to inquire of and obtain written representations . . . should be extended to matters that could have a material effect on management's assessment."

For presumptively mandatory obligations, the procedures "should inquire about and examine, for this subsequent period," various types of reports and "information about the effectiveness of the company's internal control over financial reporting obtained through other engagements" are far too vague.[5] Whom should the auditor inquire of—management, internal auditors, regulators? Is it some or all? And to what is "obtained through other engagements" making reference? It will be difficult for the auditor to comply with something that is not clear and subject to extensive interpretation.

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[5] Proposed Standard, paragraph 171.

Although consulting the auditor's legal counsel about further actions to be taken when the auditor is addressing problematic situations is always advisable, we do not believe that the standard should create any presumptively mandatory obligations for the auditor to do so. We believe that documentation to demonstrate that the auditor considered consulting (as is currently be required under paragraph 176) and evaluated whether to consult (as is currently be required under paragraph 188) serves no useful purpose.

Paragraph 176 contains various other presumptively mandatory obligations that are again lacking in specificity, including such phrases as the auditor "should propose that management consult with some other party whose advice might be useful" and imply that the auditor should also discuss the matter with "those management has consulted." Further, we believe this paragraph should address whether the auditor should refrain from issuing a report.

We recommend that the Board analyze the use of the above phrases within the Proposed Standard and conform the terminology used so that it is clear which procedures the auditor is obligated to perform, presumptively required to perform, and required to consider.

References to Auditing Standards Issued by the AICPA

We question the extensive references to the AICPA *Professional Standards* throughout the Proposed Standard, as the PCAOB has only adopted the standards as in effect at a certain date. We recommend that references be made to the codification of the Board's interim standards, because the AICPA may subsequently amend its standards and, if so, the amended AICPA standards will differ from those adopted by the PCAOB.

III. RESPONSES TO SPECIFIC QUESTIONS

***Questions Regarding an Integrated Audit of the Financial Statements and Internal Control Over Financial Reporting*:**

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

Yes. It is appropriate to refer to the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting as the audit of internal control over financial reporting.

2. ***Should the auditor be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements?***

Yes. Section 404(b) of the Act and the related SEC rule require that the attestation on management's assessment of internal control over financial reporting be performed by the registered public accounting firm that prepares or issues the audit report. We do not believe it is appropriate for an auditor to report on internal control over financial reporting of a public company unless the auditor performs the financial statement audit for the same period.

3. ***Rather than requiring the auditor to also complete an audit of the financial statements, would an appropriate alternative be to require the auditor to perform work with regard to the financial statements comparable to that required to complete the financial statement audit?***

No. As stated above, the auditor that performs the audit of internal control over financial reporting should also be the auditor that performs the financial statement audit. In addition, we see no practical basis to define "work comparable to that required to complete the financial statement audit."

***Question Regarding the Costs and Benefits of Internal Control*:**

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 companies?***

No. Please refer to our comments in Section I, Overall Comments, Item 10, "Consideration of Small and Medium-Sized Entities."

Question Regarding the Audit of Internal Control Over Financial Reporting:

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 auditing 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.***

Interim auditing standards as adopted by the PCAOB require that, through the first general standard, the audit be performed by a person or persons having adequate technical training and proficiency as an auditor, and, through the first standard of field work, assistants to be properly supervised. The decision to allocate tasks to assistants involved in an engagement is a professional judgment made by the auditor, after taking into account various factors including the level of experience of the staff involved and their knowledge of the company's operations. Supervision of assistants includes instructing assistants, keeping informed of significant problems encountered, and reviewing the work performed. Therefore, we do not believe it is necessary to specify the levels of competence and training necessary to perform certain auditing or attest procedures, as existing standards already require appropriate assignment and supervision of auditors.

Questions Regarding Evaluation of Management's Assessment:

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. Please refer to our comment under Section I, Overall Comments, Item 1, "Decision Mandating the Auditor to Audit the Underlying Controls as Well as Management's Assessment Process."

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

Yes. The auditor is responsible for determining whether management's documentation provides reasonable support for its assessment. Because the auditor is required to evaluate the sufficiency of management's process and documentation, we believe it is appropriate to provide the auditor with guidelines for performing such evaluation. However, the Board should provide more extensive and detailed criteria on this subject. Please refer to our comment under Section I, Overall Comments, Item 2.

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 significant deficiency or material weakness in internal control?***

Please refer to our specific comment in Section 1, Overall Comments, Item 3b, "Management's Responsibilities: Extent of Documentation."

Questions Regarding Obtaining an Understanding of Internal Control Over Financial Reporting:

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

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?

For questions 9 and 10, please refer to our specific comments in Section I, Overall Comments, Item 4b, "Issues Regarding the Scope of an Audit of Internal Control Over Financial Reporting: Performance of Walkthroughs."

<u>Question Regarding Testing Operating Effectiveness:</u>

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?

With regard to performing an audit of internal control over financial reporting, we believe it is necessary for management and the auditor to obtain sufficient evidence each year to form conclusions about the effectiveness of the design and operating effectiveness of internal control over financial reporting. In general, we do not believe it is appropriate to rely principally on audit evidence obtained in previous years in order to support a subsequent opinion. However, we do think the locations that are not individually significant could be tested by the auditor through the annual testing of company-level controls combined with testing at the location on a cyclical basis. This concept is consistent with the views expressed in Appendix B of the Proposed Standard. As such, we believe paragraph 101 of the Proposed Standard should be modified accordingly.

<u>Questions Regarding Using the Work of Management and Others:</u>

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

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

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?

15. Is the flexibility in determining the extent of reperformance of the work of others 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)?

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?

For questions 12-16, please refer to our specific comments in Section I, Overall Comments, Item 4d, "Issues Regarding the Scope of an Audit of Internal Control Over Financial Reporting: The Auditor's Use of the Work Performed by Management and Others."

Questions Regarding Evaluating Results:

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?***

It is unclear to us whether the proposed definitions will provide for increased consistency. However, we do believe that the proposed definitions will result in more significant deficiencies and material weaknesses than the existing definitions. We believe the Board should clarify certain aspects of the proposed definitions.

First, the concept of immaterial is familiar to most users of financial statements; however, the concept of inconsequential is not as widely used or understood. Therefore, the Board should define inconsequential, clarify the relationship between inconsequential and immaterial, and explain how inconsequential relates to materiality at the account-balance level.

Second, the definitions of a significant deficiency and material weakness both refer to annual as well as interim financial statements. We agree that deficiencies identified in the audit of internal control should be evaluated for both the annual and interim impacts. However, some may read this to also imply that the auditor should plan and perform the annual audit of internal control, as well as evaluate any control deficiencies found, in the context of a materiality related to interim periods rather than the annual materiality. This appears to be inconsistent with the auditor's responsibilities with regard to management's certifications. Accordingly, we suggest the Board clarify that the auditor is not required to plan the audit of internal control to identify material weaknesses or significant deficiencies relating to interim periods; the annual or interim financial statements language applies only to the evaluation of deficiencies identified.

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 commenters could suggest that would provide further interpretive help?***

In general, the examples provided in Appendix D of the Proposed Standard provide helpful guidance in the application of the definitions of various levels of control deficiencies to particular fact patterns. However, we believe the Board should clarify several issues.

First, while the Board specified that the examples in Appendix D are only for illustrative purposes, the Board also separately stated that appendices to the Board's standards are an "integral part of the standard and carry the same authoritative weight as the body of the standard."[6] It is unclear as to whether an auditor will be in violation of the Proposed Standard if he or she failed to arrive at the same conclusion as in the Board's examples, given similar fact

[6] Proposed Standard, "Statement of Authority."

patterns. Additionally, Appendix D uses the terminology "should" in several places; the word "should" signifies a presumptive obligation. Given the above, the Board should clarify the authoritative level of the illustrative examples included in Appendix D.

Second, the Board specified in paragraph 118 of the Proposed Standard that the significance of a deficiency in internal control over financial reporting does not depend on whether a misstatement actually has occurred however, the Board's examples D-1 and D-2 (Scenario B in both cases) includes within the fact patterns that a history of actual misstatements played a significant role in elevating a significant deficiency to the level of a material weakness in each case. To support the guidance in paragraph 118, we suggest that the fact patterns in one or more of the examples be revised to result in a material weakness when a misstatement has not occurred.

Third, the definition of internal control over financial reporting adopted by the SEC in its final rule contains considerations that expand beyond the reliability of financial reporting to include, among other considerations, the maintenance of records, as well as safeguards against unauthorized acquisition, use, and disposition of company assets. The Board should consider providing examples of control deficiencies in those areas, as well as the process and considerations for evaluating such deficiencies within the framework of the definitions of significant deficiency and material weakness proposed by the Board.

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

Because any one control deficiency could be a material weakness and a material weakness causes the auditor to issue an adverse opinion, the auditor must evaluate the significance of all internal control deficiencies identified as well as those internal control deficiencies identified by management. Otherwise, the auditor may fail to appropriately modify his or her report on management's assessment of the company's internal control over financial reporting. Furthermore, because an audit is conducted on a test basis, control deficiencies identified have actual as well as indicative significance. The actual significance of a control deficiency should be evaluated in terms of likelihood and magnitude, and its indicative significance should be evaluated to determine whether the existence of such deficiencies implies, points to, or raises the likelihood that other control deficiencies exist.

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. We believe it is appropriate to communicate all internal control deficiencies found in the course of the attestation engagement to management in writing. Communicating all deficiencies identified (and not just material weaknesses and significant deficiencies) in writing to management assists the company in improving its internal control over financial reporting. Management's propensity to correct all identified control deficiencies is also an indicator of the tone at the top and the control environment.

In terms of communicating with the audit committee, the Proposed Standard requires that the auditor communicate in writing all significant deficiencies and material weaknesses identified during the audit. We agree with this approach; however, we are not clear as to how this reconciles with the SEC's rule, *Strengthening the Commission's Requirements Regarding*

Auditor Independence, as it relates to required communications with the audit committee. The SEC's rule requires that the auditor provide the audit committee with copies of all material communications with management; therefore, it seems that the auditor will be required to provide the audit committee with a copy of the letter to management describing all deficiencies in internal control over financial reporting. The Board should reconcile the guidance in paragraph 190 with the requirements under the SEC's rule regarding audit committee communications.

21. Are the matters that the Board has classified as strong indicators that a material weakness in internal control exists appropriately classified as such?

In general, the Board should consider clarifying the meaning of the phrase "strong indicator" by providing examples or additional factors to consider for determining when a deficiency represents no more than a significant deficiency despite the existence of the strong indicator that a material weakness exists. For example, when might a restatement of a prior period or a material misstatement in the current period not be considered a material weakness? Further, the Board should clarify that the list of strong indicators of a material weakness is not meant to be an exhaustive list and that other issues that may not be on the list may be determined to be material weaknesses. With respect to individual strong indicators, we believe that a restatement of prior period financials should be a strong indicator that a material weakness existed *in the prior period*, but not necessarily in the current period.

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?

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

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?

For questions 22-24, please refer to our specific comments in Section I, Overall Comments, Item 6, "Evaluating the Effectiveness of the Audit Committee's Oversight."

Questions Regarding Forming an Opinion and Reporting:

25. Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?

26. Are there circumstances where a qualified "except for" conclusion would be appropriate?

For questions 25 and 26, please refer to our comments in Section 1, Item 5a, "Reporting: Requirement to Issue an Adverse Opinion in Certain Circumstances."

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

Yes. We believe the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting in all situations. It can be confusing to users if the auditors issue a "clean" opinion on management's report that contained a material weakness. Indeed, the AICPA Statements on Standards for Attestation Engagements were modified by the Auditing Standards Board to require that the auditor's opinion speak directly to the effectiveness of internal control in order to address practices that developed among users who were not reading management's assertions but were only reading the auditor's report, and because initially the auditor's report only referred to management's assertion, users were not aware of the existence of material weaknesses in management's assertions. Accordingly, due to prior experience in practice, we believe it is important for the auditor to also disclose the material weakness by reporting directly on the effectiveness of the internal control rather than on management's process.

Questions Regarding Auditor Independence:

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

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

Strengthening the Commission's Requirements Regarding Auditor Independence, recently adopted by the SEC, modified rules with respect to auditor independence and set forth new limitations regarding the provision of nonaudit services by auditors. We do not believe further guidance is necessary.

Questions Regarding Auditor's Responsibilities with Regard to Management's Certifications:

30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

We believe there is a general inconsistency in requiring the modification of the auditor's report on the effectiveness of internal control over financial reporting as of the company's fiscal year end (a point in time) based on procedures performed to determine changes to internal control over financial reporting during the fourth quarter (a time period.) The Board should consider separating the auditor's responsibilities with respect to quarterly certifications from the auditor's responsibilities with respect to the annual assertion by management. We suggest that the Board devise a reporting mechanism for the auditor to follow for any quarter in which the auditor believes material modifications should be made to management's quarterly certification.

31. Is the scope of the auditor's responsibility for quarterly disclosures about the internal control over financial reporting appropriate?

The extent of work to be performed by the auditor in regard to quarterly disclosures about internal control is not clear in the Proposed Standard. Paragraph 186 requires the auditor to *determine* through "a combination of observation and inquiry" whether significant changes in internal control over financial reporting may introduce significant deficiencies or material weaknesses in the design of internal control over financial reporting.

Under current standards, procedures performed by auditors with regard to an interim review of financial information do not require the auditor to "determine" whether there are misstatements; rather, only to consider, based on the procedures performed, whether material modifications are necessary to the financial information as presented. The term "determine" implies that the auditor has a duty to identify all significant changes in internal control over financial reporting, which is likely to significantly increase the scope of the auditor's work. Furthermore, "observation" is a substantive procedure that is not currently part of the auditor's responsibility in the context of an interim review of financial information.

Further it is unclear what responsibility, if any, the auditor has with respect to management's conclusion at an interim period that a material weakness or significant deficiency previously identified and reported has been corrected. Does the auditor perform sufficient procedures to satisfy themselves that the deficiency has been corrected, or is inquiry and observation sufficient? Furthermore, what are the auditor's (and management's) responsibilities with respect to deficiencies that both arise and are corrected in the same period?

Additionally, some practical issues should be addressed including (1) some controls may not be observable either due to timing or because the controls are automated; it is not clear how the auditor should proceed with respect to those that can not be observed, and (2) it is not clear whether such procedures must be performed within the quarter as opposed to after the quarter-end when reviews of quarterly financial information typically occur.

We appreciate the opportunity to comment, and would be pleased to discuss these issues with you further. If you have any questions or would like to discuss these issues further, please contact Robert J. Kueppers at (203) 761-3579.

Very truly yours,

/s/ Deloitte & Touche LLP

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