PricewaterhouseCoopers LLP
500 Campus Dr.
Florham Park NJ 07932
Telephone (973) 236 7000
Facsimile (973) 236 7200

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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 (PCAOB Release No. 2003-017, October 7, 2003)

Dear Mr. Secretary:

PricewaterhouseCoopers LLP appreciates the opportunity to comment on the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* ("the proposed standard"), that has been prepared by the Public Company Accounting Oversight Board (the "Board").

We fully support the Board's efforts to further define and clarify management's and the auditor's respective responsibilities under Section 404 of the Sarbanes-Oxley Act (the "Act"). We believe the proposed standard strikes the proper balance between management's responsibility for the company's controls and their effectiveness, and the auditor's need to perform an independent audit while making appropriate use of the work performed by management and others to support management's assertion. It provides a logical framework and generally allows for the necessary exercise of the auditor's professional judgment. Specifically, we point to the following areas where we strongly support the proposed standard's conclusions:

- The proposed standard operationalizes the concept of one integrated audit process meeting two distinct objectives and resulting in two opinions—one on internal control over financial reporting and one on the financial statements. We believe this integration is key to meeting the public's expectations.

- The proposed standard properly recognizes that the auditor can make appropriate use of work done by management as part of its Section 404 assessment process. The standard's framework relating to the auditor's use of work performed by management and others generally provides a sound basis for auditors to make appropriate professional judgments, while still requiring that the auditor's own work must, at the end of the day, provide the "principal" basis for his or her opinion.

- We believe the Board's recognition of the importance of financial statement assertions as a key underpinning of an audit of internal control will significantly help auditors in performing effective audits of internal control. This will also emphasize the proper "linkage" between the audit of internal control and the additional procedures the auditor performs to complete the financial statement audit.

We have provided our answers to the Board's specific questions as well as more detailed comments in the attachment to this letter. However, we have several recommendations that we respectfully submit to the Board on how the goals of the proposed standard may be better achieved. These address the following:

- Reporting by the auditor
- Reasonable assurance
- Internal control deficiencies
- Evaluation of the audit committee's effectiveness
- Safeguarding of assets
- Multi-location testing considerations
- Walkthroughs
- Use of the work of others
- Extent of management's testing
- Evaluation of internal control for small and medium-sized companies
- Evaluation of management's assessment

<u>Reporting by the Auditor</u>

The proposed standard requires the auditor to issue an adverse opinion when one or more material weaknesses exist in the company's internal control over financial reporting. In our view, this requirement is too restrictive. We believe that the existence of one or more material weaknesses should not automatically result in an adverse opinion. In situations where a material weakness has an isolated impact on the overall effectiveness of internal control over financial reporting, we believe that the auditor should be allowed to apply professional judgment and issue a qualified or "except for" opinion. Examples of such situations might be a material weakness related to the preparation of timely account reconciliations at an individual business unit or location, or other instances where the impact is not so pervasive as to affect the overall integrity of the company's internal control. In these situations, a qualified or "except for" opinion provides more useful information to readers of the auditor's report as it allows the auditor to communicate a meaningful distinction between material weaknesses that have an isolated impact as opposed to a pervasive impact. This reporting alternative is particularly important considering the number of material weaknesses potentially being reported in the initial year. We believe auditors need flexibility to address situations where an adverse opinion resulting from an isolated material weakness could result in a disproportionately negative impression on users of a company's financial statements.

If the auditor is able to issue a qualified or "except for" opinion, management should also have that reporting alternative. The SEC's final rules implementing Section 404 state, "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." This does not appear to preclude management from making a qualified or "except for" assertion when there are one or more material weaknesses. Alternatively, if it is concluded that the existing 404 rules would not permit a qualified report by management, we believe the SEC should modify its Section 404 rules to allow management to make a qualified or "except for" assertion. This will provide the necessary symmetry between the rules governing management's assertion and those governing the auditor's opinion. We would be pleased to participate in discussions with staff of the PCAOB and the SEC to further explain our views in this regard.

Reasonable Assurance

We believe the following sentences in paragraph 18 of the proposed standard may create confusion as to the responsibilities of management and of the auditor with respect to the effectiveness of internal control over financial reporting:

"Users of the reports from management and the auditor are entitled to receive the same level of assurance from both management and the auditor. This means that users should expect reasonable assurance that internal control over financial reporting is effective."

"The auditor provides the same level of assurance, though not the same assurance, as management."

The responsibilities of management and the auditor are very different. As noted in Section 404 of the Act and in the SEC's final Section 404 rules, management is responsible for establishing and maintaining adequate internal controls and procedures for financial reporting and for evaluating the effectiveness of the company's internal control over financial reporting. The auditor is responsible for performing an audit and expressing an opinion on management's assessment of effectiveness or directly on the effectiveness of internal control over financial reporting. The auditor is not responsible for the effectiveness of the company's internal control over financial reporting.

Reasonable assurance for the auditor relates to performing an audit to evaluate whether effective internal control over financial reporting was maintained in all material respects. Reasonable assurance for management relates to management's assessment of internal control over financial reporting, not to management's responsibility for the effectiveness of the company's internal control over financial reporting.

We believe these sentences should be deleted from paragraph 18. In addition, we believe the following should be added to paragraph 18:

"The subsequent discovery of a material weakness in internal control existing at the date of the auditor's report on internal control over financial reporting is not, in and of itself, evidence of (a) failure to obtain reasonable assurance; (b) inadequate planning, performance, or judgment; (c) the absence of due professional care; or (d) a failure to comply with PCAOB standards. Since the auditor's opinion on internal control is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee."

Internal Control Deficiencies

We believe the definitions of a significant deficiency and a material weakness included in the proposed standard provide greater clarity and permit more consistent application than the definitions in existing auditing literature. The new definitions better reflect a continuum from an internal control deficiency to a significant deficiency to a material weakness. However, we believe that by using the concept of “remote likelihood” in the standard’s definition of significant deficiency, the Board has significantly, and in our view inappropriately, increased the number of internal control deficiencies that will be classified as significant deficiencies. As a result, auditors, management, and audit committees may spend excessive time reviewing deficiencies that are unlikely to ever rise to the level of a material weakness, while perhaps not giving enough attention to more significant items presenting greater risk. Also, the requirement that unresolved significant deficiencies be regarded as strong indicators of a material weakness, when combined with the proposed definition, could result in companies adopting controls that are not justified from a cost–benefit perspective.

We recommend that the Board reconsider its definition of significant deficiency in light of these potential consequences. We acknowledge the significant efforts of the Board and others in developing a workable definition of significant deficiency. We suggest that the Board engage interested parties—including the SEC, the preparer community, and auditors—in a coordinated effort to resolve this issue.

The examples of significant deficiencies and material weaknesses in Appendix D are helpful. We believe management and auditors would benefit from additional guidance and examples at the lower part of the continuum (i.e., examples of internal control deficiencies that would not be deemed to be significant deficiencies). Additional guidance and examples on distinguishing between testing exceptions that do not rise to the level of an internal control deficiency versus those that do also would be helpful.

Evaluation of the Audit Committee’s Effectiveness

We agree that the auditor should evaluate the effectiveness of the audit committee’s oversight, recognizing its role within the critically important control environment and monitoring components of internal control over financial reporting. Consistent with the framework established by the Committee of Sponsoring Organizations of the Treadway Commission’s (COSO) report, *Internal Control – Integrated Framework*, the auditor has a responsibility to evaluate the “participation by those who govern,” including the audit committee, the board of directors, and management. However, we believe the evaluation of the audit committee’s effectiveness should be in the context of the auditor’s evaluation of the overall control environment. Singling out audit committee effectiveness for individual assessment overemphasizes one element of the control environment to the exclusion of others. As such, we believe that the auditor’s responsibility to evaluate the effectiveness of those who govern, including the audit committee, does not extend beyond the auditor’s evaluation of the company’s control environment in the context of internal control over financial reporting. We also believe that it is the board of directors’ role to determine the overall effectiveness of the audit committee.

We believe the auditor’s evaluation of the effectiveness of those who govern—as part of the control environment—should be a qualitative assessment. We believe the list of factors in paragraph 57 for evaluating the effectiveness of the audit committee in the context of the overall control environment should be revised as they are not necessarily the most relevant for this purpose. For example, the amount of time that the audit committee devotes to control issues, and that audit committee members devote to committee activity, may not be directly relevant to the effectiveness of the audit committee. In addition, including the audit committee's compliance with the applicable listing standards adopted pursuant to Section 301 of the Act may be viewed as inappropriately extending the auditor's evaluation outside the scope of internal control over financial reporting and into areas of regulatory compliance, which are matters for legal determination and are outside the scope of the auditor's responsibility.

We recommend that the Board consider adding factors outlined on pages 26 and 27 of the COSO report as factors relevant to evaluating the effectiveness of those who govern, including the audit committee. Specifically, we believe factors such as the following should be considered for inclusion:

- Courage, willingness and ability to raise, scrutinize, and pursue difficult questions with both management and the auditor;
- Focus on areas of higher business or corporate governance risk;
- Understanding of critical accounting policies and highly subjective and judgmental accounting estimates; and
- Direct and independent interaction with key members of financial management, including the chief financial officer and the chief accounting officer.

However, by suggesting these factors, our intent is not to create a "checklist" approach for evaluating the effectiveness of those who govern. In this regard, we recommend that the standard clearly indicate that the auditor, while required to consider these factors, is not required to separately conclude on the audit committee's effectiveness with regard to each and every factor.

<u>Safeguarding of Assets</u>

We appreciate the Board's efforts in Appendix C of the proposed standard to clarify which controls are covered by the definition of safeguarding of assets. However, we do not believe the guidance in Appendix C is sufficient to answer the many questions that we see in practice regarding which controls relate to safeguarding of assets in a financial reporting context. For example, it is not clear what the Board's views are with respect to whether controls related to disaster recovery procedures, or controls designed to prevent unauthorized use of intellectual property (software, music, etc.), would be considered safeguarding of assets in a financial reporting context and therefore would require management and the auditor to evaluate their design and operating effectiveness. Such controls typically would have no direct impact on whether the historical financial statements are fairly stated. Accordingly, we do not believe that such controls should be included in the definition of safeguarding of assets for purposes of the proposed standard.

We believe Appendix C should be expanded to address these and other situations in order to avoid confusion as to what is intended by the definition of safeguarding of assets. This is particularly important because the effort to test many of the controls that might possibly be considered as relating to safeguarding of assets would be significant. Furthermore, depending on the final definition of safeguarding, such testing might require skill sets different from those normally encompassed by auditors' professional training and experience.

We also believe the existing definitions of internal control deficiencies, significant deficiencies, and material weaknesses may need to be revisited, once the scope of safeguarding of assets is better defined. These definitions are currently in the context of a potential "misstatement" in the financial statements. Deficiencies in areas such as those mentioned above, however, would not typically result in the risk of "misstatement" of the financial statements.

Multi-location Testing Considerations

We believe the guidance in Appendix B on multi-location testing considerations provides the auditor with a useful framework for exercising the considerable judgment needed to effectively plan an audit of internal control involving multiple locations or business units. We believe that auditors will require implementation guidance for situations where a company has many locations or business units (e.g., hundreds of retail stores or hotels) that are of approximately the same size, no one of which is relatively more financially significant than another. For example, guidance permitting the auditor to use some form of sampling in this type of situation may be appropriate.

Walkthroughs

We believe independent walkthroughs are an important part of the auditor's evaluation of the design effectiveness of controls and we support the PCAOB's requirement that the auditor perform walkthroughs of significant processes. We also believe that the objectives of walkthroughs set forth in paragraph 79 of the proposed standard are sufficient to make walkthroughs required procedures. Further, we believe the auditor should perform walkthroughs himself or herself rather than using walkthrough procedures performed by management, internal auditors, or others. To conclude on design effectiveness, it is essential for the auditor to develop his or her own point of view about risks and controls within significant processes. This is effectively accomplished by performing walkthroughs.

In our view, the requirement that 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" is excessive and inappropriately constrains the auditor's use of professional judgment. For example, a literal reading of this sentence could result in an auditor of a large multinational company performing hundreds of walkthroughs encompassing immaterial transactions and events at business units or locations that are immaterial individually and in the aggregate. We believe such a requirement is also inconsistent with the proposed standard's thrust—which we strongly support—of driving the auditor's efforts to those areas that the auditor judges to be important (e.g., significant accounts and disclosures, significant processes, important locations, etc.).

We do not believe the concept of significant processes that appears in paragraph 79 is consistent with that in paragraph 69. Paragraph 69 states that "the auditor should identify each significant process over each major class of transactions affecting significant accounts or groups of accounts." We recommend that this important point be incorporated in paragraph 79 to emphasize that the auditor's consideration of significant processes is solely in the context of major classes of transactions affecting significant accounts or groups of accounts and disclosures.

Use of the Work of Others

We believe that it is appropriate to consider the work of others in certain circumstances. We agree that the auditor's use of others' work must be subject to the auditor's overall conclusion, using professional judgment, that his or her own work provides the "principal" evidence for the auditor's opinion. We believe the proposed standard should clearly state that the auditor's judgment with regard to "principal evidence" is qualitative and not subject to quantitative measurements. For example, the auditor's determination of principal evidence might appropriately give greater weight to some areas of work performed by the auditor (e.g., the control environment) than to other areas (e.g., controls over routine processing of significant accounts and disclosures).

We agree generally with the three categories that the Board has outlined. However, we believe that the auditor should not be automatically precluded from using the results of testing performed by management and others of information technology general computer controls. Companies generally recognize the importance of information technology general computer controls and many (particularly in the financial services industry) have large and sophisticated internal audit functions that perform extensive testing of such controls. We believe the auditor's ability to obtain the principal evidence to support the opinion on internal control will not be adversely affected by permitting the auditor to use some of the testing performed by management. Accordingly, we recommend these controls be regarded as an area where auditors may make limited use of work performed by management and others, where appropriate.

We believe it would be highly unusual for the auditor's own work to provide the principal evidence required for the auditor's opinion without the auditor performing at least some independent testing of controls over routine processing of significant accounts and disclosures included in the third category.

Extent of Management's Testing

We believe the proposed standard provides useful guidance to the auditor in determining the nature, timing, and extent of testing to perform in evaluating design and operating effectiveness. However, similar guidance does not exist with respect to the required testing by management. As a result, many registrants do not have a consistent view of the extent of testing that is required for management to have sufficient evidence to provide a basis for its assertion. As a general rule, we believe that management's testing should be at a level that is at least equivalent to the level of testing generally expected of the auditor. We recommend that the PCAOB work with the SEC to provide management with appropriate guidance to ensure that management's testing is adequate and at least at a level reasonably consistent with that performed by the auditor.

We also believe that paragraph 126 of the proposed standard should be revised to add the following to the list of circumstances that are considered significant deficiencies and strong indicators of a material weakness: "The lack of sufficient evidence to support the management assertion regarding the operating effectiveness of internal control."

Evaluation of Internal Control for Small and Medium-Sized Companies

We believe that there should be no significant difference in the standard's requirements for small companies, other than to acknowledge the potential for a less formal internal control structure. While we agree that a small company will likely have less complex processes and, therefore, less complex controls, the same basic internal control tenets apply equally to all companies. The standard can provide only general guidance that auditors must then apply—using their professional judgment—to the facts and circumstances of a specific audit, only one of which is the company's size. While such facts and circumstances differ from company to company and affect the auditor's approach to gaining evidence, the auditor's need to obtain sufficient evidence to support his or her opinion is unchanged. Accordingly, we believe it is inappropriate for auditing standards to set forth different expectations for auditor performance based on the entity's size. Rather, standards should be written so that auditors can apply them in a flexible manner that appropriately recognizes each entity as unique.

Evaluation of Management's Assessment

We recognize that one of the issues faced by the Board in developing the proposed standard was whether the auditor's conclusion should relate to the effectiveness of a company's internal control over financial reporting or, alternatively, relate solely to the company's assessment process under Section 404. Both in the United States and globally, many organizations, companies, and auditors (including one of our territorial firms) have differing views on this subject. Some believe that Congress' intent in Section 404 was to have the auditor report on the effectiveness of internal control rather than on management's assessment process. Others believe—for various environmental, legal, and commercial reasons—that the auditor should report only on management's assessment process. While recognizing this honest divergence of opinions, we nevertheless strongly support the proposed standard's conclusion that, to best serve the public interest, the auditor's opinion must run directly to the effectiveness of internal control over financial reporting. We believe the auditor's independent audit of internal control effectiveness meets the intent of the Act.

To ensure clarity around this point and to eliminate confusion on the part of users, we believe the auditor should report in all cases directly on the effectiveness of the company's internal control over financial reporting rather than on management's assertion. Accordingly, the auditor's unqualified opinions in Report Examples A-1 and A-6 should run directly to the effectiveness of internal control. Consistent with these views, we agree with the proposed standard's requirement that the auditor report directly on effectiveness rather than on management's assertion when the auditor issues other than an unqualified opinion.

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We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions the staff may have. Please do not hesitate to contact Ray Bromark (973-236-7781), Gary Stauffer (973-236-5419), or Jim Lee (973-236-4478) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

<u>Attachment</u>

This attachment includes:

- Comments on the impact of the proposed standard on other auditing standards,
- Responses to the specific questions presented in the proposed standard, and
- Other comments related to specific paragraphs in the proposed standard.

Comments on the Impact of the Proposed Standard on Other Auditing Standards

The proposed standard modifies guidance in the PCAOB's interim standards in several areas beyond AT Section 501. For example, paragraph 141 states that "the auditor's substantive procedures must include reconciling the financial statements to the accounting records." While we support this requirement, it and others, particularly in the section, "Effect of Tests of Controls on Substantive Procedures," would appear to go beyond existing auditing standards.

In such cases, we believe the PCAOB should identify and communicate how requirements in a proposed standard diverge from existing requirements and how issuance of the standard would affect existing standards.

As the PCAOB issues new standards or modifies its interim standards, we believe a formal process should be put in place to communicate in a clear and direct manner any changes to existing standards.

We also note the "Statement of Authority" preceding the proposed standard as it relates to the Board's proposed Rule 3101 regarding the use of certain terms in the Board's standards. We interpret the discussion as requiring adherence to the Board's proposed rule on use of certain terms, including its additional documentation requirements, in connection with the audit of internal control under this proposed standard. We believe this is inappropriate and suggest that its application to this standard await issuance of the final standard on use of terms.

Responses to Specific Questions Presented in the Proposed Standard

<u>Questions regarding an integrated audit of the financial statements and internal control over financial reporting:</u>

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, we believe it is appropriate to refer to the auditor's attestation of management's assertion on 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, the auditor should be prohibited from performing an audit of internal control over financial reporting, as required by Section 404 of the Act, without also performing an audit of the financial statements. In our view, only an integrated audit performed by the company's independent auditor can achieve the desired improvement in financial reporting effectively and efficiently.

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. Requiring the auditor to perform work with regard to the financial statements comparable to that required to complete the financial statement audit is not an appropriate alternative to performing a 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 issuers?

See our separate comments on the evaluation of internal control for small and medium-sized companies in our comment letter.

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.

We agree that competence and proper training of audit personnel are essential for the performance of effective audits. However, we believe the existing auditing standards (*PCAOB Interim Professional Standards*, AU Section 150) provide sufficient general guidance and the Board should not in this standard attempt to specify the level of competence and training of the audit personnel necessary to perform specific auditing procedures effectively. Any general consideration of auditor competence and training should be done as part of the Board's review of its interim standards. While such review could encompass this issue, we believe that auditors—at an engagement level—require flexibility in determining the appropriate staff to perform different aspects of the audit work.

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?

See our separate comments on evaluation of management's assessment in our comment letter.

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

Yes, it is appropriate for the Board to provide criteria that auditors should use to evaluate the adequacy of management's documentation. Comparable to the auditor's documentation, management's documentation is the principal record of the assessment procedures applied, evidence obtained, and conclusions reached by management as to the effectiveness of the company's internal control. Criteria for evaluating the adequacy of management's documentation provide a useful frame of reference, benefiting both auditors and management.

We believe the Board needs to clarify paragraph B-3 of the proposed standard with regard to documentation of controls where the company has multiple locations or business units. For example, does the guidance in paragraph B-3 mean that management would not be required to have controls documented at locations or business units that are not able to create, either individually or in the aggregate, a material misstatement? We believe management should have at least a minimum level of documentation of controls at these locations consistent with the requirement that registrants must maintain adequate books and records.

We believe more guidance is needed also in the area of documentation of locations or business units that individually are insignificant but when aggregated could result in a material misstatement. For these locations, we believe management should be required to document controls over relevant assertions relating to significant accounts at the consolidated financial statement level. Without appropriate documentation, we do not believe management could demonstrate adequate company-level controls since documentation of controls is a foundation of company-level controls.

Further, as part of providing criteria that auditors should use to evaluate the adequacy of management's documentation, we believe that the Board and the SEC should provide guidance on management's retention of documentation as well as the auditor's retention of management's documentation of the entity's systems and controls.

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?

It is appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate. We do not believe that inadequate documentation would automatically rise to the level of a significant deficiency or material weakness in internal control.

We believe the severity of the inadequate documentation should be evaluated by the auditor and, based on his or her professional judgment, appropriately categorized as an internal control deficiency, a significant deficiency, or a material weakness. Every situation will be different and will require its own evaluation and conclusion.

We recommend that the last sentence in paragraph 46 be revised to more clearly communicate what we believe to be the intended meaning—that the monitoring component of internal control cannot be demonstrated in the absence of sufficient evidence to support management's assertion. Alternatively, if the Board believes that there are ways in which management can demonstrate the monitoring component in the absence of documentation of controls, we believe there needs to be clarification around this statement and examples of how management would do this.

<u>Questions regarding obtaining an understanding of internal control over financial reporting:</u>

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

See separate discussion of walkthroughs in our comment letter.

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?

See separate discussion of walkthroughs in our comment letter.

<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?

We believe that it is appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for significant accounts and disclosures every year. Reliance on prior year work is inappropriate. However, we believe the source of the evidence (direct or indirect) and the nature, timing, and extent can vary from year to year.

In the case of automated application controls, where the auditor believes that controls are unchanged, evidence of the lack of change and the continued operating effectiveness can come from annual walkthroughs of major transactions within significant processes, along with testing of IT general computer controls annually.

We believe that paragraph 101 of the proposed standard should be revised to clarify that each year's audit of internal control must stand on its own and encompass not just all internal control components but all relevant assertions for all significant accounts and disclosures.

<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?

The auditor should be permitted—but not required—to use the work of management and others. The auditor should evaluate the competence and objectivity of those performing the work and apply professional judgment to determine how the work of management and others affects the nature, timing, and extent of the auditor's own procedures, underpinned by the requirement that the auditor's opinion be based principally on evidence that the auditor has independently obtained.

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

See separate discussion on use of the work of others in our comment letter.

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?

We believe the proposed standard gives appropriate recognition to the work of internal auditors. As outlined in the proposed standard, the auditor should assess internal audit's objectivity and competence using the same criteria as for the objectivity and competence of management and others when determining the level of use of their work.

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)?

We believe that the judgment contemplated in the proposed standard with regard to the level of reperformance when using the work of others is appropriate.

16. Is the requirement for the auditor to obtain the principal 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?

Yes. Recognizing that this determination must necessarily be based on the auditor's qualitative judgments and not quantitative measures, we believe that the standard of principal evidence is the appropriate benchmark for the amount of work required to be performed by the auditor.

<u>Questions regarding evaluating results:</u>

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?

See our separate comments on internal control deficiencies in our comment letter.

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?

See our separate comments on internal control deficiencies in our comment letter.

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

Yes. We believe that it is necessary for the auditor to evaluate the significance of all identified internal control deficiencies. Without performing an evaluation, auditors would have no basis for determining whether an item was of "inconsequential" magnitude or "remote likelihood," or alternatively rose to the level of a significant deficiency or material weakness. We also believe that it is essential for management to develop a similar process to evaluate all identified internal control deficiencies. In our view, management and auditors would benefit from additional guidance and examples, as discussed in our comment letter.

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 for the auditor to communicate to management all internal control deficiencies he or she has identified. Documentation and communication of this identification and evaluation process are necessary and will contribute to consistency on engagements and also provide a formal mechanism for management to address and respond to identified deficiencies. However, we believe the requirement in paragraph 191 of the proposed standard for the auditor's communication to also include or refer to deficiencies identified by internal audit and others is inappropriate. We believe it is management's responsibility to ensure they receive such 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?

We believe the guidance in paragraph 126 regarding circumstances that are strong indicators of a material weakness in internal control over financial reporting is useful to both management and the auditor. We do, however, have several points on the specific circumstances cited:

- We believe that the absence of sufficient evidence to support the responsible party's evaluation of the operating effectiveness of internal control is a strong indicator of a material weakness and should be added to the list in paragraph 126 and deleted from paragraph 125.

- Consistent with our views expressed in our comment letter, we believe that an ineffective control environment should be added to paragraph 126.

- As stated in the Board's interim standard, AU Section 317, auditors are responsible to consider laws and regulations that have a *direct and material* effect on the determination of financial statement amounts. While we agree an ineffective regulatory compliance function may result in a direct and material misstatement in the financial statements (e.g., noncompliance with tax laws affecting the determination of financial statement amounts) and therefore be encompassed within internal control over financial reporting, there are many aspects of regulatory compliance that by themselves may be ineffective but would not affect the financial statements, or would affect them only indirectly (e.g., contingent liabilities for violations of environmental laws and regulations). Accordingly, we believe it is inappropriate to specify the entire regulatory compliance function. This gives the erroneous impression that regulatory compliance (encompassing laws and regulations related to areas such as securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, price fixing, and antitrust) is entirely within the definition of internal control over financial reporting and within the auditor's expertise to evaluate. We believe the fifth bullet in paragraph 126 should be deleted or, at a minimum, modified to make it clear that it is limited to situations where the ineffective regulatory function relates solely to those aspects where related violations of laws and regulations could have a direct and material effect on the financial statements.

- While we agree fraud on the part of senior management is a serious issue, we do not believe it is the responsibility of the auditor to identify fraud of any magnitude. We also do not believe that fraud of any magnitude would necessarily constitute a significant deficiency or a material weakness, particularly in situations where the company's controls uncovered the issue. Further, we do not believe that the auditor should be required to identify issues that occur outside the company's environment, such as an individual's filing a false tax return.

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?

See our separate comments on the evaluation of the effectiveness of the audit committee in our comment letter.

We note that the proposed standard would require the auditor to evaluate factors related to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting, including, among other factors, the independence of the audit committee members from management. Paragraph 58 of the proposed standard states that as part of evaluating the independence of audit committee members, the auditor should evaluate how audit committee members are nominated and selected and whether they act independently from management. The SEC release implementing Section 301 of the Act contains certain exemptions with respect to independence requirements for foreign private issuers. Accordingly, to be consistent with the provisions of the SEC rules implementing Section 301 of the Act, we believe that the exemptions granted to foreign private issuers should be considered in the auditor's evaluation of the independence of committee members.

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

See our separate comments on the evaluation of the effectiveness of the audit committee in our comment letter.

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?

We believe the existence of a specific material weakness should not automatically result in the auditor's resignation. The existence of an ineffective audit committee, coupled with a mandate for auditor resignation, clearly would not be in the public's interest. Rather, auditors should be able to make this decision, as they do now, based on all the facts and circumstances of the engagement.

<u>Questions regarding forming an opinion and reporting:</u>

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?

See our separate comments on reporting by the auditor in our comment letter.

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

See our separate comments on reporting by the auditor in our comment letter.

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?

See our separate comments on reporting by the auditor in our comment letter.

<u>Questions regarding auditor independence:</u>

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

We believe that adequate guidance is contained within the independence rules issued by the SEC.

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

We believe the existing independence requirements that were adopted by the SEC in February 2003 are appropriate and should be given sufficient time to operate.

<u>Questions regarding auditor's responsibilities with regard to management's certifications:</u>

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 it is appropriate to have a differing level of responsibility as it relates to the fourth quarter certification.

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

We agree that inquiry coupled with observation are the appropriate procedures to perform for internal control over financial reporting for quarterly disclosures. We also believe that the Board should clarify that these procedures are not an adequate basis for reporting and that it was not envisioned that the auditor would be permitted to report on internal control over financial reporting on a quarterly basis.

We are concerned that paragraphs 8 and 9 of the proposed standard may imply that the auditor is required to identify deficiencies that could result in a misstatement in interim financial statements. We do not believe that the auditor should be required to plan his or her audit of internal control at a materiality level of the interim financial statements.
To conform the wording to that relating to management in the SEC's final 404 rule, we recommend that the existing language in the second bullet of paragraph 186 be changed to: "Determine, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting."

We believe the auditor evaluation responsibilities described in paragraphs 185 through 189 should not be required until the first quarter after the company's issuance of its first annual 404 report.

Other Comments Relating to Specific Paragraphs in the Proposed Standard

Paragraph 21 – In our view, this paragraph intermingles—and is likely to cause confusion with regard to—several important concepts: planning materiality vs. materiality in evaluating internal control deficiencies; materiality at a financial statement level vs. materiality at an account-balance level; and significant deficiencies vs. material weaknesses. Specifically:

- We believe the concept of materiality at an account-balance level is more relevant to planning materiality than to an evaluation of deficiencies, as the paragraph seems to imply. The auditor must plan the audit to obtain reasonable assurance that deficiencies that, individually or in the aggregate, would represent material weaknesses are identified. In doing so, the auditor must appropriately plan his or her other work at an account-balance level.

- The auditor evaluates deficiencies at the overall financial statement level, not at the account-balance level, as the paragraph seems to imply. Deficiencies at an overall financial statement level, e.g., deficiencies in a particular facet of the control environment, may be significant deficiencies or rise to the level of material weaknesses. Similarly, an internal control deficiency present at an account-balance level may be a significant deficiency or rise to a material weakness, again when evaluated at the financial statement level, not at the account-balance level, as the proposed standard presently implies.

We recommend that the Board re-examine and clarify the important concepts in this paragraph.

Paragraph 24 – We recommend that the first bullet be changed from "controls restraining the inappropriate use of company assets" to "controls restraining misappropriation of assets that could result in a material misstatement." This would tie the statement to the definitions and guidance in the existing standard on fraud as well as eliminate overly subjective judgments as to what might be considered "inappropriate."

Paragraph 41 – We believe the second bullet should address magnitude as well as likelihood.

Paragraph 78 – We recommend including additional guidance on the extent to which redundant controls need to be tested, along with specific examples of those controls that the auditor would be expected to test because "redundancy is itself a control objective, as in the case of certain computer controls."

Paragraph 112 – The last sentence states, "A conclusion that an identified exception does not represent an internal control deficiency is appropriate only if evidence beyond what the auditor had initially planned and beyond inquiry supports that conclusion." We believe that auditors would benefit from additional guidance. We agree that the auditor should obtain evidence regarding the underlying reason for and implications of any exception. However, we do not believe that the existence of one or more exceptions would necessarily require the auditor to increase the number of items tested if the number of exceptions was within an acceptable range that would allow the auditor to conclude that the control was operating effectively.

Paragraph 114 – In our view, this paragraph is also overly prescriptive in requiring that the auditor review all reports issued during the year by internal audit. This inappropriately restricts the auditor's use of professional judgment and will potentially lead to inefficiencies. For example, in a multilocation audit this would require auditors to review internal audit reports for numerous locations that—even when aggregated—could not be material. Also, companies should have controls in place to assess all deficiencies identified by internal auditors, and the auditor should be allowed to make appropriate use of such work, without being required to directly review all reports.

Paragraph 128 – As presently written, item d. requires management in its representation letter to state only that it has disclosed to the auditor "all significant deficiencies … that it believes to be material weaknesses." We believe management's communication responsibilities to the auditor should be comparable to those of the auditor to management. Accordingly, in addition to material weaknesses, management's required communications should encompass inconsequential deficiencies as well as significant deficiencies that, in management's judgment, do not rise to the level of material weaknesses.