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

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*

Dear Mr. Secretary:

KPMG appreciates this opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (Proposed Standard). KPMG also recognizes and acknowledges the significant efforts of the PCAOB staff as evidenced by the comprehensive nature of the Proposed Standard.

We agree with the Board that the existing Interim Standards pertaining to the conduct and reporting of an auditor's attestation on internal control over financial reporting (ICOFR) is not sufficient to effectively implement the requirements of the Securities and Exchange Commission's (SEC) rule implementing Section 404 of Sarbanes-Oxley. We believe that the Board's Proposed Standard represents a significant improvement over the relevant Interim Standards and hope that the comments and observations included in this letter will assist the Board in finalizing a standard on audits of internal control. KPMG fully supports the Board's efforts to improve financial reporting, corporate governance and audit quality with the objective of furthering the public interest and restoring confidence in our capital markets system.

This letter is organized by first providing a number of general observations and comments on the Proposed Standard followed by responses to the specific questions posed in PCAOB Release No. 2003-17 that includes the Proposed Standard as an appendix. Less significant and editorial comments and suggestions are included in Appendix A to this letter.

General Observations and Comments

Use of the term "all." Auditing standards historically have not included the term "all" as audit evidence generally is obtained on a test basis and test item selection and sample sizes are principally a matter of auditor judgment. In addition, it may not be possible for an auditor to evidence compliance with a standard that requires an evaluation or assessment of "all" of a particular item. We suggest that the Board reconsider the propriety of using the term "all" in its final standard, principally due to the belief that use of such term may establish an unachievable threshold. For example, we believe the Board should reconsider use of the term "all" in the following paragraphs:

- In paragraph 24, "The auditor should evaluate **all** controls specifically intended to address the risks of fraud…"
- In the monitoring section of paragraph 50, "The auditor's understanding of management's monitoring of controls extends to and includes its monitoring of **all** controls, including control activities..."
- In paragraph 79, in reference to walkthroughs, "…the auditor should trace **all** types of transactions and events, both recurring and unusual…"
- In paragraph 114, in reference to the auditor's evaluation of evidence, "…the auditor should review **all** reports issued during the year by internal audit…that address internal control over financial reporting and evaluate any deficiencies identified in those reports."
- In paragraph 191, "…the auditor should communicate to management, in writing, **all** deficiencies in internal control over financial reporting…" (Also see response to Question 20 below)

Changes to other standards. We note that, in several instances, provisions of the Proposed Standard modify existing Interim Standards adopted by the Board. For example:

- Paragraphs 139 and 140 of the Proposed Standard provide conditions that should be met and factors that should be evaluated before performing substantive analytical procedures. (Modifies AU Section 329)
- Paragraph 141 refers to a substantive procedure requiring reconciling the financial statements to the accounting records and examining material adjustments made during the course of preparing the financial statements. (Modifies AU Section 316)

- Paragraphs 190 to 193 refer to requirements for communication of internal control matters to audit committees. (Modifies AU Section 380)

We encourage the Board, in its final standard, to identify each instance in which the final standard modifies the Interim Standards to help ensure consistent application of the provisions of the modified Interim Standards by auditors.

Authoritative appendices. We note in the Board's Statement of Authority 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." We believe that appendices generally should be used for informational or illustrative purposes and should not carry the same authoritative weight as an auditing standard. In addition, we note that the Board's Interim Standards include a number of appendices that historically have not been viewed as carrying the same authoritative weight as the respective standards. In Appendix D to the Proposed Standard, we note that, while the information is intended to be illustrative, use of phrases such as "the auditor should determine" may be interpreted to establish imperatives in similar fact patterns.

Considerations for small and medium-sized issuers. The fundamental tenets of internal control apply equally to entities of all sizes and complexity. While the level of formality embedded in ICOFR may vary between entities of different size, paragraph 27 of the Proposed Standard indicates that, "…the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls related to all relevant financial statement assertions for all significant accounts and disclosures in the financial statements." We believe the information provided in Appendix E of the Proposed Standard may inadvertently serve to create a separate, and lower, standard of internal control for smaller issuers. We believe that the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) report, *Internal Control – Integrated Framework*, adequately addresses smaller entity considerations and recommend that Appendix E be eliminated from the final standard.

Safeguarding of assets. Appendix C of the Proposed Standard provides examples of intentional and unintentional misstatements arising from deficiencies in controls over safeguarding of assets. We believe the information included in Appendix C and the provisions of the Proposed Standard addressing safeguarding of assets, while helpful, do not sufficiently address the question of which safeguarding controls should be considered within the scope of ICOFR. For instance, determination of an acceptable inventory shrinkage level due to theft is a management decision related to safeguarding of assets, but has financial reporting implications in the form of establishing an adequate reserve for such shrinkage. We suggest the final standard provide additional guidance on matters for the auditor to consider when identifying those safeguarding controls that directly affect ICOFR.

Inadequate documentation. Paragraphs 46 and 47 of the Proposed Standard indicate that inadequate documentation of the design of controls over relevant assertions related to significant accounts and disclosures represents a deficiency in ICOFR. We believe that inadequate documentation is an internal control deficiency, the severity of which should be evaluated by the auditor. The evaluation of inadequate documentation should be based on the individual facts and circumstances of the particular entity and such inadequacy should not automatically rise to the level of a significant deficiency or material weakness in internal control. This notion is consistent with our expectation that deficiencies in documentation may encompass a wide range of severity and are not necessarily subject to a predetermined assessment.

Information technology. Paragraph 70 of the Proposed Standard references paragraphs 16 through 20 of AU Section 319, *Consideration of Internal Control in a Financial Statement Audit*, regarding the nature and characteristics of the use of information technology in an entity's ICOFR. AU Section 319.19 indicates that one of the specific risks of information technology (IT) is, "Reliance on systems or programs that are inaccurately processing data..." This risk may arise when an entity relies on a program or system to perform a function (e.g., calculate, accumulate, etc.) that has no specific application controls (either within the program or manual controls) to ensure that it is appropriately processing information.

The lack of an application control may be mitigated by an IT general control, such as the review and testing of the system during development or implementation. However, to the extent that the application has been in place for a substantial period of time, the auditor may not be able to ascertain that the appropriate extent of testing was performed during system development. Further, many companies do not extensively test the processing accuracy when implementing a third party application.

The Board should consider further discussion in its final standard of the effect of IT on the auditor's consideration of internal control, and provide guidance in those situations where there is little, or no, direct control over the processing of information within an IT application.

Reporting. The reporting guidance provided in paragraph B16 of the Proposed Standard indicates that, should management and the audit committee not respond appropriately to auditor communications regarding certain consolidation matters, the auditor's report should include an explanatory paragraph describing the reasons why management's disclosure should be modified. In these instances, we believe that the auditor's report should disclose a scope limitation, rather than include an explanatory paragraph.

We note that the Proposed Standard contemplates a situation where the auditor reaches a conclusion that a material weakness has been identified; yet management has not disclosed the same matter in its report (paragraph 163). In this situation, it would appear that the Proposed Standard contemplates the auditor issuing an adverse opinion and management reaching a conclusion that its ICOFR is effective. We also note that the SEC does not accept auditor's reports on financial statements that are qualified as to scope or accounting principle (refer to Codification of Staff Accounting Bulletins, Topic 1E). We encourage the Board to coordinate efforts with the SEC staff to provide guidance to issuers and auditors on the SEC staff's willingness to accept the different forms of reporting and situations contemplated in the Proposed Standard.

Responses to Individual Questions

Our responses to the questions outlined in PCAOB Release No. 2003-17 that includes the Proposed Standard as an appendix follow:

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. We believe such reference reinforces the notion of an integrated financial statement and internal control audit.

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?**

   No. We believe that an auditor can perform an audit of ICOFR without also auditing the entity's financial statements as of that date. While not commonplace, an entity may request, pursuant to contractual or regulatory requirements, an audit of ICOFR as of a date other than its financial reporting year-end. We recommend that the final standard not limit an audit of an entity's ICOFR to those instances when the auditor also is conducting and reporting on an audit of the entity's financial statements. We do believe, however, that an audit of an entity's ICOFR as of a date other than its financial reporting year-end is appropriate only if the entity's most recent year-end financial statements have been audited.

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?**

As stated in response to Question 2 above, we believe that an auditor can conduct and report on an audit of ICOFR without also performing an audit of the related financial statements, assuming that the entity's most recent year-end financial statements have been audited. We do not believe that it is necessary to perform procedures *comparable* to that required to complete a financial statement audit in order to conduct and report on ICOFR. In addition, the term "comparable" is subject to wide interpretation and does not adequately define the extent of procedures that might be necessary in such circumstances.

Question regarding the cost 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?

We believe that the underlying concepts regarding ICOFR do not discriminate based on the size of any particular entity. The application of auditing standards in general is subject to auditor judgment and is dependent on a number of factors, including the size and complexity of the particular entity. We believe that the Proposed Standard provides a framework for the audit of ICOFR for all entities, regardless of size. In addition, we believe that the guidance provided in Appendix E is incomplete and does not address a number of issues applicable to the audit of ICOFR for small and medium-sized entities. Accordingly we recommend the elimination of Appendix E in the final standard adopted by the Board. As an alternative, the Board may consider referring to existing guidance on internal control for small and medium-sized companies provided in the COSO report, *Internal Control – Integrated Framework*.

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.

No. Existing Interim Standards (AU Sections 210, *Training and Proficiency of the Independent Auditor*, and 311, *Planning and Supervision*) provide guidance for professional competence, training and supervision of audit staff. We do not believe it is appropriate for an individual auditing standard to prescribe the level of competency and training of personnel required to conduct auditing procedures. This is a matter of judgment by the auditor with final responsibility for the audit.

Any such prescribed requirements would be, by their very nature, arbitrary, not applicable in all circumstances, and incomplete.

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. We believe the scope of the audit of ICOFR articulated in the Proposed Standard is appropriate. In addition, we believe that the scope of the audit would be better understood by all interested parties if the auditor's report spoke directly the effectiveness of ICOFR, rather than management's assessment. Accordingly, we suggest that the Board consider requiring that the auditor report directly on the effectiveness of ICOFR in all situations.

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

   Yes. We believe that the guidance provided in the Proposed Standard would serve to enhance the consistency of documentation prepared and maintained by management in supporting its assessment of ICOFR. However, we believe that management should maintain sufficient documentation for locations and businesses that are not considered significant, either individually or in the aggregate, to evidence compliance with existing books and records requirements under the securities laws.

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?**

   We believe that inadequate documentation is an internal control deficiency, the severity of which should be evaluated by the auditor. The evaluation of inadequate documentation should be based on the individual facts and circumstances of the particular entity and such inadequacy should not automatically rise to the level of a significant deficiency or material weakness in internal control. This notion is consistent with our expectation that deficiencies in documentation may encompass a wide range of severity and are not necessarily subject to a predetermined assessment.

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?

We believe that walkthroughs represent an effective means of obtaining an understanding of an entity's ICOFR and an important component of an auditor's related evaluation. We support the requirement outlined in the Proposed Standard for the performance of walkthroughs for the entity's significant processes.

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?

While we agree that, in obtaining an understanding of an entity's ICOFR, walkthroughs should be performed, we do not believe that auditors should be prohibited from using the documented work of others in conducting walkthroughs. We suggest that the Board consider limiting the extent to which the auditor may use the work of others in the performance of walkthroughs, consistent with guidance outlined in paragraph 105 of the Proposed Standard.

Question regarding testing operating effectiveness:

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 the auditor should obtain evidence of effectiveness of controls for relevant assertions for significant accounts and disclosures each year. However, we also believe that the nature, timing and extent of test work directed toward relevant assertions can, and should, vary from year to year based on prior years' findings, changes in a company's internal control, or changes in management. We recommend that the Board consider including language in its final standard clearly stating that the auditor may not rely on specific audit evidence obtained from specific audit tests performed in prior years to support his or her current opinion on ICOFR.

Questions regarding using the work of management and others:

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

Auditors should not be required to use the work of management or others in evidencing compliance with the performance provisions of an auditing standard. An auditor's conclusions regarding using the work of management and others are based solely on the auditor's judgment. The factors outlined in paragraph 103 of the Proposed Standard represent appropriate matters for the auditor to consider when evaluating whether to use the work of management and others. However, we recommend that the Board consider emphasizing the level of competency and objectivity of management and others currently addressed in paragraph 107 of the Proposed Standard as a factor for the auditor to consider when evaluating whether to use the work performed by management or others.

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

In general, we agree with the three-category approach outlined in the Proposed Standard for determining the extent to which the auditor may use the work of others. However, we have several comments regarding specific control types and control activities identified in the individual categories:

- The second bullet point in paragraph 104 of the Proposed Standard requires auditors to independently test controls over the period-end financial reporting process. We believe the nature of these controls are more appropriately categorized as a control over a significant process identified in paragraph 105 of the Proposed Standard and, as such, should allow for limited use of the work of others.

- Under the third bullet point in paragraph 104, "Controls that have a pervasive effect on the financial statements, such as certain information technology general controls," are required to be tested by the auditor. Internal audit personnel in many entities possess the skills and objectivity to effectively perform tests of information technology general controls. We believe that these controls should be considered in the same light as controls over significant non-routine and nonsystematic transactions and, accordingly, are more appropriately categorized as controls for which the auditor's use of the work of others should be limited as discussed in paragraph 105 of the Proposed Standard.

- Paragraph 106 of the Proposed Standard indicates that the auditor has the ability to use the testing results of management and others "without specific limitation" for controls over routine processing of significant accounts and disclosures. One could interpret "without specific limitation" to indicate that the auditor may rely solely on the work of others in certain instances. We recommend that the Board provide additional guidance in its final standard regarding the meaning of "without specific limitation." In that regard, we believe that the auditor should not rely solely on the work of others in the areas identified in paragraph 106 of the Proposed Standard.

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?

Yes. We believe the Proposed Standard, in paragraph 108, provides appropriate recognition to the work of internal auditors.

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 flexibility in determining the extent of reperformance of the work of others is appropriate as auditor judgment is required in assessing the level of auditor reperformance. For example, the auditor's evaluation of the competency and objectivity of an entity's internal audit function may influence the extent of auditor reperformance of internal audit's work.

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. We believe that the auditor should obtain, through his or her own work, the principal evidence for conducting an audit of and reporting on ICOFR. We believe that this notion is necessarily based on a number of subjective determinations and is not susceptible to objective measurement. Accordingly, we believe that the final standard should specifically make reference to the fact that, because controls over certain areas are not always susceptible to mathematical measurement, the auditor will need to apply judgment to determine whether he or she has obtained the principal evidence in support of the auditor's opinion.

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?

Evaluating the severity of an internal control deficiency requires a high degree of judgment and, accordingly, is not conducive to a high degree of consistency in application. The Proposed Standard identifies several instances of internal control deficiencies that ordinarily would be considered significant deficiencies or, potentially, material weaknesses, thereby enhancing the level of consistency in practice relative to those particular matters.

We believe the definition of the term "significant deficiency" in the Proposed Standard is too broad and represents a significant departure from the current definition of a reportable condition in AU Section 325. Included in the definition of a significant deficiency in the Proposed Standard is "…a single deficiency, or a combination of deficiencies, that results in more than a remote likelihood that a misstatement of the annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected." In reference to this definition, we believe there will be few internal control deficiencies identified where the likelihood of a potential misstatement is "remote" and the magnitude of such a potential misstatement is "inconsequential." In fact, this definition could lead to literally every misstatement identified during the course of a financial statement audit resulting in at least a significant deficiency.

The varying magnitude of potential financial statement misstatements between those considered inconsequential and those considered material represents a wide range of possibilities. We believe that the Board should consider revising the definition of a significant deficiency to more clearly reflect those matters coming to the auditor's attention that adversely affect the entity's ability to initiate, record, process and report reliable external financial data (consistent with the definition of a significant deficiency in report examples A-2 and A-3 in Appendix A of the Proposed Standard). To that end, we suggest that the following replace the second sentence of paragraph 8 of the Proposed Standard: "A significant deficiency is an internal control deficiency or an aggregation of such deficiencies that could result in a misstatement of the financial statements that is more than inconsequential." We believe that the definition of a significant deficiency in the Proposed Standard will ultimately and inadvertently dilute the importance of significant deficiencies and the related responses by management, the audit committee, the board of directors, and others to such deficiencies.

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?

Use of examples to demonstrate the application of concepts in the Proposed Standard to an individual fact pattern may be useful to auditors. However, we note the following in the Board's Statement of Authority: "Additionally, 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." We do not believe it is appropriate to include examples such as those evidenced in Appendix D in an auditing standard, but rather believe such examples are more appropriately included in non-authoritative implementation guidance. The possibility exists that practitioners may draw analogies to alternative fact patterns, resulting in inappropriate conclusions. In addition, examples have a tendency to take on definitional status over time and, accordingly, result in a dilution of judgment influencing an auditor's ultimate evaluation.

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

Upon becoming aware of internal control deficiencies, we believe that the auditor should evaluate the severity of such deficiencies, in much the same manner as the auditor evaluates identified misstatements to the entity's financial statements.

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?

We believe it is appropriate for the auditor to communicate to management in writing all internal control deficiencies identified by the auditor during the audit. We recommend that paragraph 191 of the Proposed Standard be revised to clarify that the auditor is responsible for communication to management only those internal control deficiencies *identified* by the auditor.

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 have a number of comments on this subject:

- With regard to the first bullet point in paragraph 126 of the Proposed Standard, we agree that a restatement of previously issued financial statements is a strong indicator of a material weakness, but suggest the Board provide guidance regarding how to treat a material weakness identified in a subsequent period yet pertaining to a prior period. For example, it appears that if a financial statement restatement occurs, there is a strong indicator of a material weakness in the period that is restated, but not necessarily as of the latest balance sheet date.

- With regard to the fourth bullet point in paragraph 126, we believe that an ineffective internal audit function has implications for all entities that support such a function. In addition, this bullet point infers that all larger, more complex entities should support an internal audit function, effectively mandating the same for such entities. We recommend the Board clarify its intentions with regard to the application of this provision to larger entities that do not support an internal audit function and smaller entities that support an internal audit function that is found to be ineffective.

- With regard to the fifth bullet point in paragraph 126, we believe further clarification of the auditor's responsibility with regard to the entity's regulatory compliance function is necessary in order to effectively interpret the scope of this provision. In other words, is the auditor responsible for evaluating the effectiveness of the entity's controls that do not have a direct impact on the entity's financial statements and disclosures? Many entities operating in highly regulated industries maintain extensive regulatory compliance functions addressing, for example, product development, environmental matters, workplace safety, and employment opportunities. Many of the activities of these compliance functions do not directly impact the entity's financial statements and disclosures.

  We note that paragraph 14 of the Proposed Standard refers to "…operations and compliance with laws and regulations directly related to the presentation of and required disclosures in financial statements" as being encompassed in ICOFR. We recommend the Board clarify in the final standard that the reference to an entity's regulatory compliance function in paragraph 126 is consistent with the notion of compliance activities directly related to the presentation of and required disclosures in financial statements addressed in paragraph 14 of the Proposed Standard.

- With regard to the sixth bullet point in paragraph 126, it appears that the Proposed Standard establishes an obligation on the part of the auditor to determine whether senior management has been party to any fraud. AU Section 317.08 indicates that, "Normally, an audit in accordance with generally accepted auditing standards does not include audit procedures specifically designed to detect illegal acts". However, instances of management fraud that come to the auditor's attention may require some action on the part of the auditor.

We believe that the auditor should consider compliance with laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. In addition, the auditor should be aware of compliance matters that may have a material, but indirect, effect on the entity's financial statements. If the auditor becomes aware of compliance matters that could have a material, indirect effect on financial statements, action on the part of the auditor should be required. We recommend that the Board consider revising the sixth bullet point in paragraph 126 to clarify that the auditor is responsible for considering those illegal acts that may be significant to the entity's financial reporting process.

- We believe that instances of an ineffective control environment should be considered at least a significant deficiency, and a strong indicator of a material weakness, in ICOFR.

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?

We believe that the auditor's consideration of the effectiveness of the audit committee's oversight of the entity's external reporting and ICOFR is contemplated in his or her responsibility to obtain an understanding of and test the design and operating effectiveness of controls related to the control environment in its entirety. In addition, we believe that an effective audit committee plays a significant role in setting a positive "tone at the top." However, we do not believe that the auditor should be required to separately conclude on the effectiveness of the audit committee's oversight.

Ultimately, we believe that an entity's board of directors, not its independent auditor, is responsible to evaluate the effectiveness of the audit committee's oversight of the entity's external financial reporting process and ICOFR.

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

We believe that an auditor's ability to effectively evaluate the effectiveness of the audit committee's oversight is negatively affected by a number of factors. Auditors generally do not have unfettered access to audit committee members, may not attend all audit committee meetings, and do not have access to all information considered by audit committee members in the performance of their stated duties.

In addition, it is not clear to us how the auditor determines how well the audit committee understands its responsibilities, the amount of time that the audit committee devotes to control issues or the amount of time audit committee members are able to devote to committee activity. Further, the determination of whether the audit committee complies with the applicable listing standards adopted pursuant to Section 301 of Sarbanes-Oxley and includes one or more financial experts as described in the SEC's rule implementing Section 407 of Sarbanes-Oxley appear to be matters of legal interpretation and regulatory compliance that generally fall outside the scope of reliable financial reporting.

If this requirement is retained in the final standard, we recommend that:

- The criteria referenced in the auditor's evaluation be clarified to facilitate consistent application;
- Management be required to evidence its evaluation of the audit committee as part of its assessment of ICOFR; and
- The auditor be required to obtain written representation from the audit committee as evidence in performing his or her evaluation.

Refusal by an audit committee to furnish the aforementioned written representation should constitute a scope limitation.

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?

No. We do not believe that resignation by the auditor necessarily serves the public interest. In addition, we do not believe that an auditing standard should dictate client retention conclusions to the auditor. While an auditor may decide to withdraw from an audit engagement in these instances, such decision is a professional matter for the auditor to consider based on available facts and circumstances.

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?

Yes. We believe that, by definition, identification of a material weakness in ICOFR should result in the auditor expressing an adverse opinion. The SEC final rule implementing the provisions of Section 404 of Sarbanes-Oxley states that, "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." We believe that the SEC's rule implementing the provisions of Section 404 requires management, upon determining the existence of a material weakness, to conclude and report that the entity's ICOFR is not operating effectively. Accordingly, we believe that the auditor's reporting should be consistent with the required reporting model for management.

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

As illustrated in example A-3 in the Proposed Statement, we believe that examples of scope limitations beyond management's control may exist where the auditor's issuance of a qualified "except for" conclusion is an appropriate alternative. However, as noted in the response to question 25 above, we do not believe that a qualified "except for" conclusion is appropriate in those instances where a material weakness exists.

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

Yes. Further, in order to definitively conclude on the engagement scope contemplated by the Proposed Standard and eliminate potential confusion regarding the meaning of "management's assessment" as referred to in the auditors' report, we recommend that the Board consider requiring that the auditors' report speak directly to the effectiveness of internal control over financial reporting. We believe that, despite the clarifications as to scope included in the Proposed Standard, continued use of the "management's assessment" terminology in the auditors' report serves to detract from a consistent understanding of the scope of an audit of ICOFR.

Questions regarding auditor independence:

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

No. We believe that the SEC rules on independence are sufficiently comprehensive. Additionally, we do not believe that the Proposed Standard is the appropriate forum for providing guidance on independence and internal control related non-audit services.

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

We believe that the independence matters relating to the provision of non-audit services by an entity's independent auditor are sufficiently addressed in the aforementioned SEC rules. We do not believe that additional guidance in this area is necessary at this time.

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 do not believe the auditor has, or should have, a different level of responsibility in reference to management's disclosures responsive to the requirements of the quarterly and annual certifications, other than as outlined in the Interim Standards. We believe that existing guidance outlined in the Interim Standards addressing the auditor's responsibility for other information in documents containing audited financial statements (AU Section 550) or interim financial information (AU Section 722), and illegal acts by clients (AU Section 317), is sufficiently comprehensive and well understood in practice.

Clearly, an auditor's responsibility in the conduct of a review of interim financial information is different from that in an audit of financial statements or ICOFR. AU Section 550, the provisions of which also apply to reviews of interim financial information pursuant to AU Section 722, states that, "The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation appearing in the financial statements."

AU Section 317, also referenced in AU Section 722, addresses the auditor's consideration of the possibility of illegal acts and the auditor's response to detected illegal acts. Accordingly, we believe that those instances where an auditor encounters inaccurate or omitted disclosures by management are clearly and sufficiently addressed in the Board's Interim Standards, and further analysis is unnecessarily duplicative in a final standard on auditing ICOFR.

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

We do not believe the auditor's responsibilities relative to management's quarterly disclosures regarding ICOFR should go beyond those outlined in AU Sections 722, 550 and 317 (including Section 10A of the Securities Exchange Act of 1934). In fulfilling this responsibility, we believe that it is appropriate for the auditor to perform, on a quarterly basis, the procedures outlined in paragraph 186 of the Proposed Standard. See response to Question 30 above.

* * * * * *

If you have questions regarding the information included in this letter, please contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com or Craig W. Crawford, (212) 909-5536, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP

The following editorial and other comments and suggestions are presented for your consideration:

1. Paragraph 8 – the definition of significant deficiency includes "interim financial statements." As the Proposed Standard provides for an "as of" date audit, which is generally assumed to be the audited balance sheet date, clarification should be provided regarding the inclusion of the term "interim financial statements" and the related implications for test work and reporting.

2. In paragraph 33, the auditor can provide certain permissible internal control-related services if *specifically* pre-approved by the audit committee. On the surface, this requirement appears to be a modification of the SEC's rules relative to pre-approval of auditor services included in the SEC's final rules on independence (Release No. 33-8183). In order for audit committees to understand their obligations regarding pre-approval of auditor services, we believe that the SEC should provide similar guidance in the securities laws governing audit committee pre-approval requirements.

3. Paragraph 61 - the definition of a significant account appears too broad. Literally, all accounts, when aggregated with other accounts, could contain more than a remote likelihood of a significant misstatement. We encourage the Board to clarify the intent of this paragraph in the final standard.

4. Paragraph 82 infers that walkthroughs of transactions both before and after a significant change in the process flow of transactions may be necessary in some circumstances. We believe that this concept is confusing in light of the auditor's requirement to report on ICOFR as of the audited balance sheet date. We suggest that this paragraph be deleted from the final standard.

5. In paragraph 102, the term "high level of assurance" is used (this term also is used elsewhere in the document). The use of different terms to refer to the concept of "reasonable assurance" is confusing. We believe that the term "reasonable assurance" should be used in those instances where the auditor's level of assurance is referenced.

6. In paragraph 126, the existence of significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after some reasonable period of time is considered a strong indicator of a material weakness. We believe the Board should consider defining a "reasonable period" in the final standard as no later than the entity's next "as of" reporting date.

7. Paragraph 145 states that, "the auditor should document the identification of where misstatements related to relevant financial statement assertions could occur within significant accounts, assertions, and processes." The term "where" generally refers to a location. We recommend that the term "how" be used in place of the term "where" in the final standard.

8. Paragraphs 146 and 147 appear to be out of place in the Proposed Standard. We suggest that information included in these two paragraphs be reflected in a section addressing the interaction of the audit of ICOFR and the financial statement audit.

9. In paragraph 179, we believe that the term "how" should be used in place of the term "why" in the final standard.

10. Paragraph 189 refers to an auditor's reporting obligation in instances when the "…auditor believes management's certifications should be modified." The term "certification" should be replaced with the term "disclosure" to appropriately describe the auditor's responsibility in these instances. Refer to responses to Questions 30 and 31.

11. Paragraph 194 should be revised to clarify that the final standard also will apply to audits of financial statements of entities other than accelerated filers for years ending on or after April 15, 2005. This paragraph currently appears to refer only to the auditor's obligation for audits of ICOFR for accelerated filers.

12. The footnote to example A-3 should note that, in the event the auditor identifies a material weakness that is not included in management's assessment, the auditor expresses an adverse opinion on the entity's ICOFR.

13. All example reports in Appendix A should be revised to include reference to City and State above the date line. In addition, these example reports should indicate by footnote that the ICOFR audit report date should be the same as the financial statement audit report date.

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