National State Auditors Association

November 21, 2003

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

Dear Board Members:

On behalf of the National State Auditors Association, we appreciate the opportunity to respond to the PCAOB's proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.*

Attached are our responses to the 31 questions for which the Board is seeking comments. Also attached are several additional comments on individual sections/paragraphs that we believe the Board should consider as it finalizes this standard.

We appreciate the efforts of the Board and the opportunity to provide our comments. Should you have any questions or need additional information regarding our response, please contact Sherri Rowland of NSAA at (859) 276-1147 or me at (217) 782-3536.

Sincerely,

William G. Holland
President, NSAA

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?*

We agree with referring 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. Although some auditors prefer not to use the terms attestation and audit interchangeably, the proposed standard makes clear the objectives of the internal control work to be done. Further, while some auditors may try to draw a distinction between these two terms, the Board, the auditees, and other users of these reports would understand this to be an 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?*

We believe that for purposes of the Sarbanes-Oxley requirements the two items should go hand in hand. However, the wording seems to preclude any additional internal control audits over financial reporting that a company might choose to have performed from occurring. It would seem that in some instances an auditor could audit internal control over financial reporting without also performing a complete audit of the financial statements. At times it seems it would be advantageous to shareholders if a company chose to have additional internal control audits performed. The audit concept should, however, continue to be differentiated from nonaudit services discussed in paragraph 33.

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?*

We do not see the purpose of requiring the auditor to perform work with regard to the financial statements comparable to that required to complete the financial statement audit as an alternative to requiring the auditor to also complete an audit of the financial statements. As noted in the proposed standard, the nature of the work to complete the audit of the financial statements and the audit of internal controls over financial reporting are highly integrated and portions of this standard expect the auditor to consider the results of financial statement audit tests in forming a conclusion about internal controls.

In addition, there are no standards for describing the level of financial statement auditing that is comparable to a financial statement audit, but does not result in a financial statement audit opinion. Lastly, we do not believe an auditor and auditee would want comparable work to be performed without issuing a product to represent that work.

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 the proposed standard provides for the appropriate level of testing given the size and complexity of the auditee and would not place small or medium size firms at a disadvantage. However, the proposed standard does not incorporate the Board's expectation that "the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control." (This quotation is from paragraph immediately preceding Question 4 in the lead-in to the proposed standard.) We believe this should be stated in the standard in the section, *Obtaining an Understanding of Internal Control Over Financial Reporting,* that begins on page A-22.

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 do not believe the Board should dictate the level of competency and training of audit personnel that is necessary to perform specific auditing procedures. Measuring competence and training is highly subjective and based on the individuals, their experience, the composition of the audit team and its assignments, and effective, timely training. If the Board decides to add more specific guidance in the standard about competency and training, we suggest the Board keep the discussion general, perhaps by briefly expanding paragraph 31.

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?*

In order to obtain the necessary level of assurance, the auditor should evaluate management's assessment and directly obtain evidence supporting their conclusions. Satisfying both requirements is necessary because it demonstrates management's responsibility for internal controls and the auditor's responsibility for auditing those internal controls. However, we believe the Board should revise the proposed standard to be clear about what the auditor would do in a situation in which management believes that because of budget constraints or other reasons, it is not cost effective to implement a control and the auditor disagrees or in a situation in which management has not assessed certain controls that they believe are not critical but the auditor believes are critical.

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

We believe it is appropriate for the Board to provide criteria that auditors should use to evaluate the adequacy of management's documentation. Part of the problem the audit industry faces at this point in time is the fact that too many auditors, even with good intent, use the flexible nature of the AICPA standards to justify the nature and extent of tests they perform in such audits. As a result, good auditors, trying to perform good audits, perform widely different levels of tests. More explicit descriptions of the standards' requirements help to improve consistency.

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 the auditor should be able to evaluate the level of severity of any such internal control deficiency. The auditor should be able to consider all of the relevant circumstances of inadequate documentation when evaluating to what level any such internal control deficiency rises. Because of the subjective nature of inadequate documentation, and to which internal controls it applies, the auditor will be in the best position to determine the appropriate level of deficiency he or she has found. To mandate this circumstance as significant or material may result in relatively insignificant documentation issues reported with more significant internal control deficiencies.

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

We believe the objectives to be achieved are sufficient to require the performance of walkthroughs. To ensure an understanding of how the system of internal control is designed and operates, the auditor should perform the walkthrough. Too often, auditors rely solely on what management tells them or shows them in written manuals. And just as often, the individuals who perform those procedures, or the procedures used in their place, can be different. In an automated environment, a traditional walkthrough may be difficult to perform so there should be the opportunity for the auditor to achieve the same objectives using alternative approaches if necessary.

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?

Generally, we believe it is appropriate for the auditor to perform the walkthrough to ensure an understanding of what is really happening in an internal control process. However, we believe that if the internal auditor is deemed to be competent and objective, the use of this internal audit documentation could be relied on, but only after verification. We do not believe it would be appropriate to rely on a walkthrough performed by management.

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?

The auditor is responsible, each year, for determining the effectiveness of controls. Since the Board has emphasized that only relevant assertions for significant accounts need testing, and that testing throughout the year is allowable, we believe it is appropriate to require evidence of the effectiveness of controls each year. Although management asserts policies, procedures, and computer controls have not changed, change is inherent. Manual procedures are subject to changes in personnel, changes in existing personnel's behaviors and motivations, and other circumstances. Computer controls are affected by not only changes in programs that directly relate to a process, but also other changes that may indirectly affect a process. Only careful analysis each year by the auditor can determine the effect of any changes to manual or computer controls.

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

We believe the auditor should be permitted, but not required to use the work of management and others. The auditor should have the flexibility to use auditor judgment in determining when to use the work of others. But, without some level of guidance, we believe auditors would vary widely on when they use the work of others and when they would not. We agree with the Board's proposal to describe the types of situations in which auditors cannot, can with limits, and can without specific limits use the work of others. In addition, the auditor should never be required to use the work of others as the sole source of evidence.

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

The proposed categories of controls clearly and consistently explain appropriate reliance on the work of others. It should also provide the auditee's management with areas in which it can determine where it might provide the auditor with opportunities to use others' work, thereby decreasing audit costs.

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 do not believe the standard can adequately address all of the possible levels of objectivity that different internal auditors achieve, and the resulting impact on the external auditor's work. Therefore, we agree with the Board's approach of explaining the nature of the internal auditor's potential for more or less objective work. This leaves the professional judgment with the auditor, rather than the internal auditor or the auditee's management, with respect to how much work the internal auditor can or should do to assist in this manner.

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 support the proposed standard's provision to allow the auditor flexibility in determining the extent of reperformance of the work of others. To the extent that the auditor can reasonably verify the competence and objectivity of others performing the work, it is not necessary to reperform or perform additional work as long as the results satisfy the auditor's objectives.

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?

We agree that it is appropriate for the auditor to obtain the principal evidence since it is the auditor that is required to opine on management's assertion. This would help prevent situations in which the auditor's work is primarily (or exclusively) based on the work of others.

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?

We believe the definitions in the proposed standard of significant deficiency and material weakness will provide for increased consistency in the evaluation of deficiencies. The criteria of likelihood and magnitude (paragraph 117), and the descriptions of them included in the proposed standard, provide a sound basis for determining the significance of the deficiency. Also, the additional circumstances listed in paragraph 126 that should be regarded as "at least a significant deficiency" are helpful. However, while the definitions may provide for increased consistency in evaluating deficiencies, the definitions are subjective and auditor judgment will always be a factor in evaluating those 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?

The examples in Appendix D are helpful and clearly demonstrate how to apply the criteria in evaluating the significance of internal control deficiencies. However, it would be helpful to add examples that address more subjective areas like the control environment and risk assessment.

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

We believe the auditor should evaluate the severity of all identified internal control deficiencies by applying the criteria in paragraph 117 to all deficiencies to determine the appropriate level of significance. Without evaluating all deficiencies, the auditor could not consider the aggregation of deficiencies and whether they rise to a significant level.

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 that written communication of all internal control deficiencies is appropriate. Given the requirements of management, the auditors, and the audit committees, written communication of all deficiencies ensures each party can fulfill their obligation in this matter.

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 examples of indicators of material weaknesses are appropriate. However, we believe that in practice, this will not be as clear-cut. There will be instances for which management and its auditors do not agree on the level of severity for certain deficiencies. In those cases, certain of these indicators will be more problematic for the auditor and management to address. For example, significant deficiencies that have not been corrected by management may be the result of management's initial belief that the deficiencies were not significant to begin with. A third party, perhaps the audit committee, will need to be strong in "refereeing" these situations.

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 agree that it is appropriate to require the auditor to evaluate the effectiveness of the audit committee's oversight on the company's external financial reporting and internal control over financial reporting. However, the Board should provide additional guidance on what is expected of the audit committee and how the auditor should evaluate the effectiveness of the audit committee's oversight.

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

We believe that with additional guidance provided by the Board, the auditor should be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight.

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

We believe that auditors should issue an adverse opinion rather than be allowed to withdraw from an engagement. Given the increased regulatory nature of the requirements and the overarching concept of providing shareholders information regarding potential problems, it would seem more effective to require the issuance of a report that includes all problems noted by an auditor. This would help preclude an audited entity from being able to shop around for opinions.

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?

Because the Securities and Exchange Commission has already established final rules requiring management to concede that internal control over financial reporting is not effective when a material weakness exists, we believe the auditor's conclusion should be the same (i.e., an adverse opinion). To allow the auditor to issue a qualified opinion, would introduce the potential for misinterpretation or confusion among users of the financial statements.

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

Given our response to question 25, a qualified opinion would not be appropriate.

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?

We agree that when the auditor issues a nonstandard opinion the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting. The proposed standard clearly explains the confusion that might occur if the auditor's report that management's assertion is fairly stated, when management has stated that they do not have effective internal controls. In these circumstances, it may appear that the auditors disagree with management's assessment of inadequate internal controls. Reporting directly on the effectiveness of the internal controls provides for clear reporting of the circumstances in the auditor's report.

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

We do not believe that the Board should provide specific guidance on independence in the proposed standard. Rather, we believe the standard should reference to the independence requirements established by the SEC and the Act. When the auditor independence provisions of the Act are fully implemented and evaluated, the Board could then address any weaknesses noted in implementing the Act.

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

Rather than describe, in this standard, specific internal control-related non-audit services the auditor is prohibited from performing, the standard should reference to the standards established by the SEC and the Act. See comments to question 28.

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

The provisions of the proposed standard regarding the auditor's differing level of responsibility by reporting period are appropriate. By the fourth quarter, if an auditor has otherwise completed the audit, withdrawal from the engagement would seem to be inappropriate if management refuses to make accurate fourth quarter disclosures. Therefore, an explanatory paragraph would allow the auditor to bring the matter to the attention of the SEC and investors.

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

The provisions of the proposed standard regarding the auditor's responsibility for quarterly disclosures are appropriate. To add additional burdens for "auditing" interim disclosures seems unnecessary.

Additional comments	
Paragraph	**Comment**
102, first bullet	We are concerned that the first two sentences give the auditors a basis for under-testing automated controls. Because of the complexity of certain transactions and activities, and the resulting variations that can occur in those transactions or activities, the extent of tests of automated controls must be sufficient to determine the controls' effectiveness for each of the possible variations. In those cases, testing only one item for that automated control is not sufficient. Our concern stems from the standard highlighting testing a single item, which we believe auditors will liberally apply to circumstances for which testing only one item is not sufficient.
174-175	Paragraph 174 explains examples of information management might add to its report. However, paragraph 175 provides specific wording that the auditor should use for only one of the examples. If the Board is going to establish that the auditor "should" use this language, then examples should be provided for the language the Board wants the auditor to use in the other examples in paragraph 174. If that is not the intent, the Board should either a) remove paragraph 175's example, b) revise the wording in paragraph 175's second sentence to replace the word "should" with a less prescriptive term, such as "could", or c) generalize the sample wording to say: We do not express an opinion or any other form of assurance on management's statement referring to *(describe the additional information management included).*
176	This paragraph explains what actions the auditor should take to convince the company to remove materially misstated additional information from management's report. However, the Board does not say whether the auditor should say anything in his or her auditor's report about this matter, if the material misstatement remains in management's report. Since the auditor is required to issue an audit report, including an opinion on internal controls, it seems appropriate that he or she also includes a discussion of material misstatements in additional information in an explanatory paragraph. Accordingly, the Board should indicate how the auditor should report such material misstatements, when not corrected by management. If the Board does not believe such auditor disclosure is necessary, it should explicitly state that the auditor has no responsibility to do so, and why.
179	We agree with the guidance provided in paragraph 178, and the auditor's need to report that information. And we agree with the reason set forth in paragraph 179 that users need to understand why the financial statement opinion was unaffected. However, the language provided by the proposed standard does not explain the reason why the auditor issued an unqualified opinion, only that an unqualified opinion was issued. If users need to understand the reasons why, as stated in paragraph 179, the Board should revise the example, or add to its advisory comments in italics, that the auditor should explain why the opinion was unaffected. If this is not the Board's intent, paragraph 179 should be revised to remove the word "why" and replace it with the word "that."
Paragraph 88-110; Appendix B	The discussion in the proposed standard and the Examples of Extent of Testing Decisions do a good job of giving perspective and examples that should help an auditor understand the nature and timing of tests to be performed when evaluating the effectiveness of internal controls. However, the discussion in the proposed standard regarding the extent of tests is brief and does little to give proper perspective about how much is enough to test. Then, the examples use certain sample sizes that create confusion as to the necessary level of the extent of tests. We have been informed all along that performing an audit of internal controls sufficient to opine on the effectiveness of those controls is a higher level of assurance than the extent of tests performed on internal controls in a financial statement audit. However, the discussion in the proposed standard does not reflect that perspective. While it provides some factors to consider, it falls well short of providing auditors with a sound basis for knowing how much is enough. Further, the examples give quite a different impression by suggesting that walkthroughs, testing of one item here, or five periods there, or 25 vouchers, is sufficient to evaluate the effectiveness of certain internal controls. In fact, compared to financial statement audits we perform and the sample sizes we use in our audits' tests of controls, these sample sizes are the same in some cases, and in other cases, less. Even the AICPA's audit sampling guide for financial statement audits provide sample size guidance that suggests sample sizes much larger than the examples provided in the proposed

Additional comments	
Paragraph	**Comment**
	standard. To justify a sample of 25, the AIPCA sampling guide considered an acceptable tolerable error rate in excess of 10 percent, yet the Board's example expected a high level of assurance from testing only 25 items. We believe the major reason for the expectation gap between auditors and the users of audit reports is the extent of work performed. The users always expect the auditors to test more than the auditors do. If the Board expects internal control audits to meet the expectations of SEC intent, investors, and other users, the examples will have to be reconsidered and the guidance in the proposed standard will need to be improved. We certainly do not advocate mandated sample sizes. However, we also believe the current proposed guidance and examples will not close the expectation gap.