



November 21, 2003

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Dear Mr. Secretary:

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

We respectfully submit our comments on the PCAOB's proposed standard on auditing internal control over financial reporting as part of an integrated audit. We have focused our comments on several, rather than all, of the PCAOB's questions below. We have numbered the questions according to the numbering scheme in the PCAOB's Release No. 2003-017 dated October 7, 2003.

10. Is it appropriate to require that the auditor perform a walkthrough himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?

No. The auditor should be allowed to rely on competent and objective internal auditors (or other similar parties, such as a separate process or risk control group which does not have the responsibility for executing processes) in the performance of walkthroughs that are effectively documented, provided the auditor is able to satisfy himself or herself about the adequacy of this work through appropriate procedures.

If the PCAOB (hereinafter sometimes referred to as the "Board") does not concur with this view, then at a minimum the Board should clarify that, for purposes of performing a walkthrough, the auditor may rely on documentation (process maps, process narratives, etc.) prepared by the audit client. As a practical matter, the Section 404 compliance teams for many companies, as well as their internal auditors, are documenting walkthroughs as a basis for understanding internal control over financial reporting, including the process flow of transactions, the completeness of the design of controls within the processes and whether and how the controls really operate – the same objective as that of the external auditor. The external auditor should be able to rely on this documentation and use it when reviewing documents that are used in, and that result from, the application of the controls, and comparing supporting documents to the accounting records.

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

Generally, if the intent is to prescribe the nature and extent of auditor reliance, the three categories of controls provide an effective framework for articulating the extent of reliance (however, please see our comment on Question 14 regarding the commingling of internal audit into the definition of “others”). Within the “no reliance” category, however, the proposed standard includes such pervasive controls as “certain information technology general controls on which the operating effectiveness of other controls depend.” We do not understand the rationale for this conclusion. We recommend that the Board clarify the nature of these “certain” controls and reconsider specifically which controls should be included in the “no reliance” category.

General IT processes are expansive in scope. They include, among other things: security administration, application change controls and data management and disaster recovery. We recommend the Board clarify the nature of the “certain information technology general controls” to which it refers in the proposed standard.

We suggest the Board also reconsider its position on general IT controls and include general IT controls in the second category of reliance, i.e., “controls for which there may be limited reliance.” IT general controls are not “soft controls” subject to a significant amount of judgment in evaluation. While the Board is correct that they are pervasive in scope and can impact the effectiveness of other controls, general IT controls are effected through processes that function just like revenue, purchasing and other routine processes, and are subject to similar kinds of testing. For example, general IT controls ordinarily address the critical IT processes within each entity or for each key location that supports significant financial applications. In certain circumstances, the same general controls area must be reviewed more than once. If there are multiple processes impacting each priority financial reporting area that are not subject to similar policies, process activities and control procedures, these multiple processes may need to be separately reviewed. Many of these control areas consist of controls that are subject to reperformance by the external auditor. Thus we recommend that general IT controls be included in the second category of reliance.

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 that the proposed standard gives sufficient recognition to or enough emphasis on the work of internal auditors in applying the Board’s proposed “three categories” construct. The Board should consider differentiating between the work of competent and objective internal auditors (or other similar parties) and the work of process or control owners who execute the processes and document management’s assertion in the internal control report. As companies experiment with ways to structure their organizations

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to accomplish the Sarbanes-Oxley certification objectives, the Board's standards should be flexible enough to recognize that internal audit or similar parties, such as a separate process or risk control group, may be capable of providing a reliable basis for conclusions.

We recommend that the Board separately evaluate the three categories of reliance against two groups – (i) management and others, excluding internal audit (or other similar parties), and (ii) internal audit (or other similar parties). We believe that there are some areas within the three categories that might be viewed differently between these two groups. For example, if competent and objective internal auditors (or other similar parties) test the general IT controls, as discussed above under Question 13, the auditor should be able to place at least limited reliance on that work.

16. Is the requirement for the auditor to obtain the principle evidence, on an overall basis, through his or her own work the appropriate benchmark for the amount of work that is required to be performed by the auditor?

No. This requirement has the potential to severely limit the extent of the auditor's reliance, regardless of the Board's guidance with respect to the "three categories", the effectiveness of the internal control structure and the nature, extent and timing of management's work and documentation supporting the conclusion expressed in the internal control report. Because the "three categories" already place a limit on the extent of reliance, the Board should evaluate whether this statement is really needed. If the PCAOB concludes the statement should be retained in the final standard, the Board should clarify how the statement is applied in view of the guidance it already provides with respect to the "three categories".

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

In the list of circumstances that should be regarded as at least a significant deficiency and as a strong indicator of a material weakness, the proposed standard included a reference to "an ineffective regulatory compliance function" in highly regulated industries. We agree that this type of deficiency can be troublesome. However, does the reference to this type of deficiency suggest that documentary evidence is required to support an assertion that such a deficiency does not exist? We cannot find any guidance in the proposed standard where this question is addressed. Because this is a potentially broad audit area, we recommend that the Board clarify the nature, extent and timing of work needed to address it.

If the standard is intended to require additional work, the question arises as to whether such a requirement extends beyond the coverage intended by the SEC's final rule on Section 404. Note that in its final rule, the SEC states "our definition [of internal control over financial reporting] does not encompass the elements of the COSO Report definition that relate to effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations, with the exception of

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compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements.”

We suggest that the Board clarify its intentions on this point.

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 board of directors is ultimately responsible for evaluating audit committee effectiveness using the criteria set forth in the proposed standard. The external auditor, who is hired by the audit committee, is not in the best position to make the call as to the committee’s effectiveness and would have a difficult (if not impossible) challenge to do so while retaining a position of independence both in fact and appearance. We agree that an ineffective audit committee adversely affects an evaluation of internal control over financial reporting. However, under Section 301 of The Sarbanes-Oxley Act, an audit committee has direct responsibility to hire, fire, compensate and evaluate the auditors. In addition, the auditor is not always present during committee meetings and deliberations.

If the PCAOB decides to retain this requirement, the question arises as to how auditors are required to satisfy themselves that a company’s audit committee is providing effective oversight of external financial reporting and internal control over financial reporting? Are the criteria provided by the proposed standard of certain legal and regulatory requirements and certain qualitative factors adequate? What procedures will the auditor need to perform? What are the implications of those procedures in terms of requiring auditor access to audit committee deliberations and interfaces with management and others in situations in which the auditor is not always present? What is an appropriate level of involvement and interaction by the Committee? How does the auditor determine whether audit committee members “act independently from management?” Clarity is needed for these questions not only for auditors but also for audit committees and management so they will better understand what to expect from the audit process.

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

Yes. We recommend that the Board provide specific guidance on independence in the context of this proposed standard. In our experience, there continues to be divergent views between public companies and between and within the accounting firms themselves as to the nature and scope of internal control-related services a company's external auditors can provide. For example, we see different approaches being taken in similar circumstances where, on the one hand, companies hire their external auditors to document their internal controls and, on the other hand, companies decide not to engage their auditors to do this work on the basis that such action could present independence in appearance issues. We also see instances where some external audit

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firms have taken similar public positions to not engage in this work for the same reasons. It is therefore an issue where reasonable men and women can differ. While specificity exists regarding the prohibited services associated with financial statement audits, no such list has been addressed with respect to reporting on internal controls since the issuance of the new Section 404 reporting requirement. Some degree of granularity, similar to the list of ten prohibited non-audit services in conjunction with the audit of financial statements, would enable boards and audit committees to better comply and avoid public misconceptions regarding auditor independence.

We have attached to this letter an excerpt from our frequently asked questions publication, released in August, which includes a question on the internal controls documentation matter. We also point out to the Board that there are other issues besides documentation that the Board should provide guidance on with respect to independence and internal control-related non-audit services in the context of the proposed standard.

We appreciate the opportunity to submit our comments. We hope they are helpful to the staff. If the staff would like to discuss any of the points made in this letter, please contact Jim DeLoach at (713) 314-4981.

Very truly yours,
PROTIVITI INC.



By: James W. DeLoach, Jr.
Managing Director

ATTACHMENT

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Excerpt from *Guide to the Sarbanes-Oxley Act: Internal Control Reporting Requirements* -- QUESTION 150

Can the company engage the independent public accountant to create original documentation of its internal control over financial reporting without impairing independence?

The safe answer in today's environment is probably not. According to Rule 2.01 of Regulation S-X of the SEC, the external auditor must be independent both in fact and in appearance. While the standards have not been promulgated by which the external auditor will be required to attest, significant involvement in the documentation of a company's internal control structure, followed by an attestation process in which the same documentation is reviewed, would be tantamount to keeping the books and auditing the books. The SEC's position is that the auditor cannot perform in the role of management or audit his or her own work.

During its open meeting in May 2003, the SEC made statements to the effect that the documentation of controls and the evaluation of their effectiveness is indeed a management function. Therefore, if the auditor has been asked to perform that role instead of or on behalf of management that would involve the auditor taking on a management role. Thus the SEC staff pointed out that companies and their auditors need to be mindful of the independence requirements and determine how involved the auditor needs to be to understand adequately the controls and what management has done without having to actually "step into a management role."

The final rules released on June 6, 2003, do not reconcile clearly to the discussion during the open meeting in May. Specifically, in the open meeting, an absolute restriction was articulated as a "red light" to prohibit the independent accountant from documenting internal control over financial reporting for audit clients. The final rules, however, do not prohibit this practice but instead place limits around this activity and remind issuers and their auditors to adhere to the independence restrictions.

This development is not a surprise. The SEC has a long-standing practice of allowing issuers to formulate their own policies with respect to compliance matters. Subsequent to the open meeting, the SEC staff pointed out to us that nothing said in the open meeting or included in the final release on Section 404 is intended to change the independence release or rules, or the appropriate interpretation of those rules. When formulating company policies in this regard, management and audit committees must take into account the SEC's oral comments in the open meeting as well as its written rules. Thus the burden is on management and the audit committee to evaluate the desirability of engaging the independent accountant in documenting internal control over financial reporting on behalf of management. In effect, the final rules constitute a "yellow light" of caution signaling to companies that it would be wise to monitor further SEC and

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PCAOB developments for additional clarification in what could very well be an evolving area.

In the final rules, the SEC states it understands the need for management and the company's independent auditors to coordinate their respective activities relating to documenting and testing internal control over financial reporting. In stating that understanding, the SEC also issued two reminders to companies and their auditors:

- First, the Commission's rules on auditor independence prohibit an auditor from providing certain nonaudit services to an audit client.
- Second, management cannot delegate its responsibility to assess its internal control over financial reporting to the auditor.

The SEC also made two other points on independence:

- If the auditor is engaged to assist management in documenting internal controls, management must be actively involved in the process.
- Management's acceptance of responsibility for the documentation and testing performed by the auditor does not satisfy the auditor independence rules.

The above views expressed by the SEC raises several points.

- First, documentation of internal control over financial reporting by the independent accountant is implied to constitute a nonaudit service.
- Second, if the auditor performs documentation and testing of internal controls, management cannot simply accept responsibility for that work. This would be tantamount to management accepting responsibility for the results of bookkeeping or other services provided by the auditor related to the company's significant accounting records or financial reporting areas. Management must be actively involved in the documentation process.
- Third, the auditor must exercise care to ensure that he or she does not end up auditing his or her own work or provide a service acting in a management capacity.
- Finally, while there is some ambiguity in the final rules that didn't exist during the SEC's open meeting in May 2003, it appears the overriding message is for management, and the audit committee, to proceed with care when engaging independent accountants to document internal control over financial reporting.

One practical approach to addressing the ambiguity of this issue is to focus on the magnitude of the documentation required to bring a company into compliance. This approach, which has been embraced by one major accounting firm, would prescribe that any situation in which "significant" documentation was necessary should avoid engagement of the external auditor other than in an advisory role. On the other hand, those environments in which minimal additional documentation was necessary might

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utilize the external auditor to help management identify and finalize the Section 404 documentation.

Sarbanes-Oxley requires management to establish and maintain controls and procedures to ensure all material information is presented to the public in accordance with the SEC's rules and forms, i.e., management is required to design the internal control structure. The documentation issue represents a minefield for boards and management teams because it will forever remain difficult to delineate the difference between documenting the internal control structure and designing the internal control structure. Documenting an internal control structure is similar to "blazing a trail." It requires a decision-tree type approach in which someone must decide each path to achieve an appropriate control structure. The selection of the primary path is a function of the risks that management perceives the company faces. Subsequent decision points will revolve around questions such as:

- What is the proper combination of preventive controls or detective controls?
- Do transaction volume and velocity permit manual controls or must computerized system controls be utilized?
- Within a process, how much segregation of duties is required?
- Are there pervasive controls affecting multiple processes and, if so, what is their impact?
- What is the impact of a centralized versus decentralized organization?

Each of these and other decisions require significant professional judgment. They represent trail markers about which management must make the ultimate determination. If the independent public accountant is asked to blaze and mark the trail and subsequently also determine if the markings are correct, then management, the board and the auditor could be exposed to allegations that independence was impaired. While independence in fact may have been preserved, the appearance of independence would be difficult if not impossible to explain in the public arena. If explanations are subsequently required, the accounting firm could be placed in the position of an advocate for management, a position the SEC rules do not permit. Given today's hypersensitive environment, this issue does not appear to be one in which it is in anyone's interest to test.