BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

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

Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*

Dear Mr. Secretary:

BDO Seidman, LLP respectfully submits the following comments on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") proposed auditing standard ("the proposed standard") governing the independent auditor's attestation and reporting on management's assessment of the effectiveness of internal control over financial reporting referred to in Sections 103(a)(2)(A) and 404(b) of the Sarbanes-Oxley Act of 2002 ("the Act"). BDO Seidman, LLP is pleased to serve on the Task Force of the PCAOB considering implementation issues and the AICPA Task Forces that developed draft standards prior to the effective certification date of the PCAOB, and since that date has been discussing practical implementation issues.

We recognize the importance of establishing and enforcing standards that will restore confidence in our financial reporting environment and are anxious to participate further in the initiatives of the PCAOB and other regulatory bodies to advance the quality of our professional standards. We appreciate the dedicated effort necessary to develop quality standards.

In addition to the direct questions posed by the Exposure Draft, there are several overarching points related to the proposed standard we would like to communicate, as follows:

Lack of Preparer Guidance

We have previously communicated to the PCAOB (Letter dated August 6, 2003 to Douglas R. Carmichael, Chief Auditor) our concern that the preparer community lacks effective guidance relating to the extent of documentation and testing required to meet its responsibilities under Section 404 of the Act and the related SEC rules. In the absence of such guidance, the auditor must apply judgment on a case-by-case basis when assessing the adequacy of the documentation and testing performed by the preparer to support its assertion. We find it unreasonable to require the expression of an audit opinion covering a subject matter that is effectively "undefined."

Preparers are anxiously seeking guidance from their auditors as to their documentation and testing responsibilities under the Act and SEC rules. It is possible that auditors providing this guidance might be misconstrued as providing legal advice, or impairing the independence of the auditor. We understand that the PCAOB may not be able to mandate preparer responsibilities. We do acknowledge the criteria for auditor evaluation of preparer documentation in the proposed standard, which we believe are very helpful. However, we urge the PCAOB to work with the SEC to provide the necessary implementation standards and guidance to the preparer community.

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

Lack of Preparer Document Retention Guidance **-** The final standard should be expanded to include guidance relating to the retention of internal controls documentation and testing by the preparer. This is especially important in this standard, as auditors have not previously performed audits of internal controls as now envisioned.

An issue related to both audit documentation and the lack of current preparer guidance, is the lack of any specific documentation retention requirements for preparers. For example, some preparers are currently documenting and testing their internal controls using web-based tools. These systems may be set up so that documentation can be updated on a contemporaneous basis as elements of the systems change. In addition, preparers may use a proprietary software product to document their activities and software-licensing issues could make it difficult for the auditor to obtain or utilize the assessment. We believe that preparers should maintain an archived copy of the controls documentation that relate to each year's management assertion. We also believe that any software, licenses or tools needed for the auditor to review the documentation of the entity should be made available by the entity. In the absence of assurances that such documentation will be retained, the auditor may need to obtain copies of the preparer's documentation to include in the auditor workpapers and retain such documentation as evidence of the documents reviewed. In that regard, we believe it is inappropriate and inefficient for auditors to become the repository of corporate records.

This issue is broader than audits of internal controls, but has arisen as particularly troublesome in this context. Many preparers in our marketplace that have begun their 404 projects related to the internal controls documentation and testing had not initially considered this issue in their plans.

Some may believe that such an archived, indexed record may already be required under regulations requiring the retention of documentation supporting matters contained in SEC filings or under the existing "books and records" provision of the 1934 Exchange Act (13(b)). We do not think these provisions are currently worded broadly enough to clearly require the retention of management's support for its 404 assertion. Nevertheless, we have observed that the need to retain such documentation has not been universally recognized as a requirement by all preparers. Therefore, the final standard should include "the adequate retention of documentation of controls, evaluation of design effectiveness, and testing and monitoring of operating effectiveness" as an expected attribute that could, if absent, be a presumptive indicator of a material weakness.

Overall Efficiency of the Standard

While we believe the auditor's attestation regarding the effectiveness of internal control should contribute to better financial reporting, the underlying standard should recognize that there are a number of elements of existing auditing requirements and recent regulatory actions that already provide a significant measure of cost-effective public protection and risk reduction. Notably:

- The Implementation of Corporate Anti-Fraud Programs (recommended in Statement of Auditing Standards No. 99 "Consideration of Fraud in a Financial Statement Audit " and a component of an effective corporate control environment under the COSO framework)
- The implementation of the required auditing procedures and inquiries outlined in SAS 99, which are being applied for the first time this year.
- Improvements in the investigatory and legal processes wherein corporate executives will be investigated and prosecuted for fraud.
- Improvements in corporate governance to ensure independent and competent directors and effective audit committees

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

- A more effective industry-wide inspection program to ensure firm compliance with the form and substance of the standards, and to ensure the firms' focus on the proper "tone at the top" in their organizations.

In that context, we are concerned that the current proposed standard requires redundant and excessive procedures to be performed by the auditor during an audit of internal controls. While we acknowledge the importance of significant auditor involvement in testing the work of management, in many places the auditor is required to go well beyond the traditional audit concept of testing and examining evidence. For example, the auditor is required in all significant processes to perform all the walkthrough procedures, and to perform all the procedures necessary to assess general controls and the control environment. We believe these requirements will not significantly contribute to more effective internal controls audits, and will unnecessarily raise the related auditing costs. We recommend the final standard better reflect the concept of testing by the auditor. Of course, this is subject to evaluating the objectivity and competence of internal auditors, contracted service providers, management or employees performing the documentation, testing and monitoring required of companies by the Act.

We have provided specific suggestions regarding this matter in our responses to questions 10, 14, 15 and 20.

The Proposed Auditing Standard Does Not Create a Cohesive and Comprehensive Body of Auditing Literature

In addition to addressing the issues related to the reporting and performance of audits of internal controls, the proposed standard modifies existing literature not directly related to the audit of internal controls.

For example, paragraph 138 states that "the auditor should perform substantive procedures for all relevant assertions for all significant accounts and disclosures" (emphasis added). Also, paragraph 141 states that "the auditor's substantive procedures must include reconciling the financial statements to the accounting records." These new audit requirements are not related to the audit of internal controls. While we believe these requirements are appropriate, and believe they are consistent with the "risk assessment" Exposure Draft of the AICPA, we are concerned about their subtle placement in this document.

These issues are neither highlighted in the text nor discussed in the briefing paper. Thus readers might not identify these changes in the literature. Additionally, if the existing AICPA standards adopted by the PCAOB as interim standards are not marked for conforming changes, the body of auditing literature applicable to audits of public companies may become confusing and contradictory. We strongly recommend the PCAOB clearly indicate any and all changes to its adopted interim standards as part of its exposure process.

It is our understanding that the body of AICPA standards applicable to private company audits conducted under AICPA standards will continue to grow and evolve. We assume the interim standards adopted by the PCAOB would not reflect changes in the AICPA standards after their adoption date as interim standards, and therefore that literature would be static for public company audits unless modified by the PCAOB. Therefore, it is likely that the two bodies of standards will diverge over time. Accordingly, to make the auditing literature relating to public companies clear and to maintain quality auditing in public company audits, we strongly recommend a "marked for changes" version of any paragraph or section edits of the adopted interim standards necessary as conforming changes be released with the new adopted standards of the PCAOB.

While we support the PCAOB's development of quality control standards, we recommend that they be presented in the appropriate section of the PCAOB Professional Literature. If there are very narrow implementation issues relating to a subject matter of a standard, we do not object to including that narrow guidance in a section of the auditing standard, but encourage such guidance to also be repeated in the PCAOB Quality Control Literature, where it otherwise would be expected to appear.

Effective Date

It is our understanding that after approval of a final standard by the PCAOB, an additional exposure period by the SEC is required. Therefore, a final "published" rule is unlikely until well into 2004. We believe this will not provide time for issuers to complete their documentation, evaluate and test controls, and correct any deficiencies identified, nor an opportunity for the auditing firms to ensure the requisite trained personnel are in place to perform the procedures required by the final standard. Most firms will find it impossible to provide timely training on the final standard during the "busy season," even though many auditors already have orientation and training in the subject matter.

Under these time constraints we see a risk that the implementation of the final standard for accelerated filers that must begin reporting on internal controls for years ending after June 15, 2004 will raise the potential for mistakes and misunderstandings that could undermine the intention of this requirement to restore investor confidence.

In that regard, we urge the PCAOB to make a recommendation to the SEC to delay the effective implementation of the final standard for accelerated filers. We believe it appropriate, assuming no further delays in issuing the standard, to require the audit of internal controls to accompany the financial statements of entities whose fiscal years end on or after October 15, 2004, but no earlier than six months after the final standard is published.

PCAOB Comment Letter – Draft Responses to Questions

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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

Yes. We believe the "audit" terminology clearly communicates the service being performed to users of financial statements and distinguishes the service from an attestation service performed under the standards of the AICPA which we believe should still be available to public entities for internal or other purposes.

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

Yes. We believe that the auditor performing an audit of internal controls under the PCAOB auditing and related standards must also audit the financial statements. This is a clear requirement of Rule

BDO

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

2-02 of Regulation S-X and is mandated by Section 404 of the Sarbanes-Oxley Act.

It is our understanding that the final standard will replace the current AICPA AT Section 501 guidance in the PCAOB standards literature. In that circumstance, there would be no public company auditing literature guiding an attest service relating to internal controls unless performed in conjunction with an audit of the financial statements. However, we can envision a circumstance where such an attest service might be requested without requiring a full financial statement audit, such as a pre-merger attestation to evaluate to the effectiveness of controls of that entity as of a specific date or an attestation engagement for an interim financial period. In our view, an attestation service can be performed under AICPA AT 501 standards in such circumstances.

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?

With respect to the required audit of internal controls accompanying the annual audit of the financial statements, we believe the rules are clear that a division of auditor responsibility is not permitted, and thus the concept of "comparable" work is not relevant in that context.

Questions regarding the costs and benefits of internal control:

4. Does the Board's proposed standard give appropriate consideration to how internal control is implemented in, and how the audit of internal control over financial reporting should be conducted at, small and medium-sized issuers?

No. We believe the proposed standard does not give adequate guidance on how internal control audits differ when conducted for small and medium size businesses. While we do not believe there should be a lower standard for evaluating or reporting on the effectiveness of internal controls in smaller enterprises, we acknowledge the techniques of auditing the internal controls of such smaller issuers will likely differ.

We believe the example in the Appendix, suggesting that management oversight might compensate for a missing or ineffective control, improperly implies that management supervision is an acceptable alternative to controls. We believe such an implication may be used by many entities to excuse missing or ineffective controls. However, recent history is replete with examples where management <u>is</u> the problem, and not the control.

We also think it inappropriate that the responsibility for defining the different small company environment and the associated audit responsibilities in these environments rests with the auditor. We are not aware of any guidance that would aid in achieving a consistent approach across companies and among firms on this issue. Absent guidance tailored to the small and medium sized issuers or changes in the reporting options, the proposed standard will likely result in a large proportion of smaller issuers receiving adverse opinions.

We do not feel a remedy for this is to weaken the value of an unqualified opinion on internal controls for smaller entities. The public will be unable to identify when an unqualified audit report may mean something different because the entity's controls were evaluated according to a small entity standard. We would rather see a deferral of the implementation date for smaller entities (perhaps using a non-accelerated filer definition) pending further research and experimentation in providing and reporting on this service.

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

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, we believe this level of guidance in the public company auditing standards is unnecessary and not a response to an identified issue. We believe the interim AICPA standards adopted by the PCAOB adequately address this issue in the existing general and field work standards for auditing and attestation engagements.

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, both management's assessment and the underlying effectiveness of internal controls are important for the auditor to consider when rendering an opinion on internal controls. Management's assessment is a public communication that has great flexibility permitted in its form and content. That document should not be misleading by commission or significant omission or a presentation that obscures important information from the reader. To render an audit report on internal controls, the auditor must accumulate sufficient evidence of controls effectiveness.

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 providing examples of such criteria are appropriate. As we stated earlier, we suggest the final standard also list the preparer's failure to plan for and retain (archive) its documentation of its controls and its evaluation, testing and monitoring to support its assessment as a potential material weakness.

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?

Yes, we believe it appropriate to require the auditor to assess the significance of the deficiency on a case-by-case basis. At this time, as commented previously, law or regulation does not specify the level and format of documentation required of preparers. In the absence of such guidance or a benchmark, we do not believe that an imposition of an automatic categorization of an undefined condition as a significant deficiency or material weakness will have any value in user reporting. We do encourage a re-visitation of this point if either by practical experience in applying the requirements or legislation, a more objective definition of what constitutes "inadequate documentation" can be developed.

Paragraph 46 says: "In evaluating the deficiency as to its significance, the auditor should determine whether management can demonstrate the monitoring component of internal control over financial

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

reporting in the absence of documentation." We do not understand how, if an objective and clear definition of a documentation deficiency can be agreed, obvious documentation deficiencies can be overcome in such cases, and in the absence of any such rationale, recommend this guidance be changed to state affirmatively that documentation deficiencies ordinarily cannot be overcome.

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?

Yes. Walkthroughs to confirm the auditor's understanding of the design and implementation of controls are well established in auditing practice, and we believe would be performed in many circumstances, even if not required. We concur that such procedures are important to perform, but also caution that they do not provide sufficient evidence of manual control operations. They are simply a "sample of one."

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?

We believe it important that auditors perform many of the critical walkthroughs for significant systems and accounts. However, we believe that walkthroughs performed by others (assessed as competent and objective) on all controls and to a greater extent on less critical control operations, could be tested by the auditor to still achieve a high degree of audit assurance, in lieu of requiring that they be redundantly performed 100% by the auditor. Following this approach would represent a significant cost saving to businesses over the proposed approach. We believe a properly implemented testing approach would accomplish the desired protection for the pubic at a lower cost.

Additionally, we believe that the current wording of the standard would require that, say, if revenue were identified as a significant account, then walkthroughs of <u>all</u> revenue processes, regardless of their significance or materiality are required. Paragraph 79 of the draft states the requirement that the auditor "should trace <u>all</u> types of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports." The extent of work required by setting the scope to <u>"all"</u> could be extraordinary for a large, distributed enterprise, and is inefficient.

We believe the concept of a "significant process" in this proposed standard when used as a basis for assessing which controls require walkthroughs, for example, has a profound impact on how management and the auditor view the controls for an entity. We believe it worthwhile to provide examples of what the proposed standard intended by the use of this term. This is fundamental to a common understanding between the auditor and preparer.

A remedy that should be considered is the requirement to consider measures of significance or materiality when identifying the necessity of performing walkthroughs, and whether the auditor in all circumstances must perform such walkthroughs.

Currently, we believe the guidance in paragraph 79 of the proposed standard requiring auditor walkthroughs is in conflict with the guidance in Appendix B 13. Under B13, "locations or business units that are not important, even when aggregated with others" do not require any auditor action. Yet, the provisions of paragraph 79 might require a walkthough of a transaction type at these

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

locations. Furthermore, if the location was not previously documented and tested by management, then the walkthrough of a transaction to "confirm" the documented control makes no sense. We therefore support the documentation, assessment and selective testing of all locations by management if the auditor might have some responsibility to perform procedures at those locations

We support the broad performance of walkthroughs by management in more instances than required of the auditor as an element of their procedures to support their assertion.

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 evidence needs to be accumulated annually that controls are effective in order to issue an audit report on internal controls. In our view, management needs to fully test these important elements to the extent necessary to provide a high degree of assurance annually as part of their monitoring function. However, from an audit perspective, once it is established that a control is effective, and a system as well as the environment in which it operates has not changed, the passing of a calendar date alone should not change that basic conclusion.

With respect to the most critical controls over all relevant assertions for all significant accounts, we believe that at a minimum the auditor devote some attention each year to each of those controls. However, we believe it would be more efficient, with no loss of effectiveness, to encourage the rotation of testing <u>emphasis</u> on controls (not the rotation of controls testing). While some controls might, based on a risk assessment and entity testing findings, warrant extensive testing annually by the auditor, we believe a more effective audit could be performed when the auditor would be encouraged to focus on certain controls on a periodic basis, extending the analysis and testing of some of these controls As reflected in SAS 99, varying the nature and extent of procedures performed from year to year is an effective strategy to achieve a high degree of assurance on the subject matter and prevent/detect fraud. On balance, the increased depth of testing in some areas should compensate for the lesser level of testing in others.

We believe this concept is already reflected in paragraph 101 of the proposed standard. However, if this was not intended, then the proposed standard should be clarified.

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?

The auditor should be permitted to use the work of management and others within or engaged by the company to the extent supported by the auditor's assessment of their objectivity and competence. Generally, management would not be considered to be as objective as those outside the entity or of internal auditors, and their work might not be relied on, or relied on significantly less than if an outsourced competent service provider or objective internal audit function performed the same work.

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

We cannot identify any circumstances where the auditor should be required to use the work of management or others within or engaged by the company. Since the independent auditor has the professional responsibility for his or her opinion, such a requirement would be inappropriate.

However, we acknowledge that the engagement of specialists by auditors may be more frequently encountered than before under this standard due to the specialized nature of many topics in, for example, information technology based controls. Where an engagement team does not possess the requisite skills and knowledge to evaluate the design of or perform tests of a complex, technology based control, for example, a resource should be engaged to assist the auditor. In these cases we would expect that the auditor would continue to follow the provisions of SAS 73.

We also ask the Board to clarify whether its guidance in the proposed standard (Appendix B) on the use of service organizations is intended to modify the exiting SAS 70 literature, and if so, how. One area of likely significant implementation questions will include the role of service organizations and SAS 70 reports as they relate to the required audit of internal controls.

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

We believe the categories are appropriate and helpful as a conceptual aid for auditors to understand the requirements of the proposed standard. However, as noted in several of the following responses, we have concerns that the proposed auditor requirements related to these three categories require adjustment in the final 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 to the first question. Appropriate recognition is given to the value internal audit can bring to the organization and the overall audit process.

But the answer to the second question is more complicated, as we feel the mix of procedures required in the proposed standard is inefficient and ineffective.

We do not agree with the proposed standard's requirement that all the assurance the auditor receives with respect to general controls and IT controls need come solely from the auditor's procedures. In circumstances where the objectivity and competence of the internal auditor or others is assessed as high, we believe it appropriate and cost effective to permit some assurance be taken for work performed by others in these areas. We concur with the assessment of the importance of these areas overall, but believe the objectives can be achieved by requiring that most, but not necessarily all, assurance come from the independent auditor's procedures.

We also do not agree with the proposed standard's requirement that the auditor can rely "without limitation" on the work of others with regards to controls over routine processing. This can be interpreted as permitting the auditor to rely solely on others for this work. We believe it inappropriate to permit such limited involvement in controls over transactions that constitute a large portion of the transactions processed by most entities. We support the requirement in paragraph 107 that the auditor reperform some procedures as a basis for reliance and conduct some independent tests of the controls over routine processing. We believe that most of the assurance in this area could come from work performed by others who are assessed as objective and competent. However, we are mindful that many of the unfortunate incidents leading to corporate failures took place in

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

organizations that had internal audit staffs that were assessed as objective and competent. Thus, we believe in all circumstances the auditor should perform some procedures in each category of classification of controls.

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 it is appropriate in this standard to provide flexibility in the extent of reperformance required in a particular circumstance. Paragraph 107 states that if the auditor intends to use the work of others, "the auditor should reperform some of the tests of controls originally performed by others." This level of guidance seems appropriate.

We believe it would be inefficient, and without an associated reduction in risk, to require the reperformance of each test performed by others on which the auditor intends to place some reliance. When work is performed by individuals or separate organizations (whose objectivity and competence is separately assessed) we believe it would be appropriate in the application of reperformance guidance to confirm the assessment of the competence of the work of that person by reperforming a sufficient level of that work to corroborate the competence with which the work was performed. Thus, a strong Firm-wide organization of internal auditors could require fewer reperformance tests to achieve the auditor's objectives than a loose organization of independent contractors performing the same procedures at different locations. In general, we believe the objectives embodied in the word "all" can in many instances be achieved at a lower cost and without a loss in quality if careful consideration is given to the principles of testing.

16. Is the requirement for the auditor to obtain the principle (sic. 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. However, it needs to be explicitly recognized in the standard that this is an auditor judgment, and not subject to an exact mathematical measurement.

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?

In our view the use of the concept "remote likelihood" in the definition of a significant deficiency will needlessly and inappropriately sweep many issues into this category. We would favor a tolerance threshold that is considerably higher than remote (e.g., reasonably possible).

We urge the PCAOB to continue to gather practical examples and further develop this guidance as professional experience grows in this area.

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?

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

Yes. We encourage the PCAOB to consider an outlet such as a "Q&A" publication that can help create more consistent applications. The examples seem rather clear cut, but the more difficult decisions will be in the gray areas.

Our comments in other sections of this letter extend to the examples provided.

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

Yes. It is necessary to make judgments of the significance and severity of all identified deficiencies We do not believe the profession yet has the requisite experience in these areas to set narrow guidelines requiring a specific treatment for specific identified deficiencies that are less than significant.

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?

No. Paragraph 191 refers to deficiencies from all sources such as regulators, internal auditor reports, etc. We believe that for a large and complex organization this is an unreasonable requirement that will be very costly. We believe that isolated and insignificant deficiencies may need only be communicated to local management. Deficiencies identified by internal audit or regulatory auditors or others that have already been communicated to management should not have to be repeated by the auditor. The requirement to prepare a written report should be limited to deficiencies that, in combination with other deficiencies, raise the risk of a potential significant deficiency in an account, assertion or location, plus all significant deficiencies and material weaknesses found. We note that an audit committee may request a written report of all deficiencies of any nature and significance. However we do not feel such a report should be mandated.

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

Yes. However, see our response to question 22 with respect to the proposed separate evaluation of the audit committee. We believe that the indicators listed in paragraph 126 should also include "the absence of sufficient evidence to support the responsible party's evaluation of the operating effectiveness of internal control constitutes a material weakness," as suggested in the AICPA draft standard forwarded to the PCAOB.

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? <u>And</u>

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

Corporate governance is a critical component of the control environment. The audit committee, as that role has been strengthened recently by the rules of the stock exchanges, is an increasingly important element of the governance process. However, we disagree with the requirement in the proposed standard for the auditor to assess the effectiveness of the audit committee as a separate element of the internal control environment in order to determine whether a weak audit committee might be indicative of a material weakness in internal controls. COSO acknowledges the importance of the audit committee function, but does not single out this function. Rather, it considers it within the context of the board of directors and other Control Environment elements.

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

We believe it is not possible for the auditor to provide implicit assurance on the effectiveness of the audit committee. In our view, the auditor is not in a position to observe all the meetings, communications and actions of the audit committee as a basis for making such an assessment. We have difficulty envisioning the evidence and procedures that would support this assessment. While an auditor may be able to distinguish some weaker from stronger audit committees, and may observe an act or condition calling into question the effectiveness of the committee, an overall assessment of effectiveness is still a very subjective assessment.

Moreover, since the auditor is hired and retained by the audit committee, the requirement that the auditor conclude separately on the effectiveness of the audit committee creates a clear conflict. The imposition of such a requirement will likely hinder effective and open communication between the audit committee and the auditor at a time when better communication should be encouraged.

We also ask that regulators and the PCAOB understand that smaller entities have been responding to the requirements that audit committees improve in quality, but this is an ongoing process. The imposition of a requirement at this time to separately assess the audit committee may not have the desired effects on communication and continued improvement.

We urge that the final standard not require a specific assessment of the audit committee, but acknowledge its place within the governance structure and control environment.

If the final standard continues to require a separate assessment of the audit committee, we suggest the standard also make clear that management must also make a separate assessment of the audit committee as a basis for management's assertion

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

See response to question 22 above.

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 see no basis for requiring the auditor's withdrawal from the engagement nor any benefit to the investing public or the business community from leaving the entity without an auditor based solely on this one issue. We believe that communicating this weakness provides better information for investors than the lack of an auditor's report resulting from the auditor's withdrawal. We believe that regulatory action would be more effective than auditing standards as a way to correct such deficiencies.

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?

No. We believe there are circumstances where the issuance of an "except for" opinion by the auditor is appropriate. While Item 308 of Regulation S-K precludes an unqualified opinion where

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

there are material weaknesses, we believe that a qualified opinion is not precluded. Furthermore, the adopted interim standard AT 501, which the SEC specifically cites in its conclusions, precludes an unqualified opinion in the presence of a material weakness, but permits a qualified opinion.

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

Yes. For example, if a merger occurs at or near year-end, it may not be practicable to identify or correct any material weaknesses in internal controls of such entity in the short time between acquisition date and the year-end. In those circumstances, it seems unnecessarily harsh to require an adverse opinion unless the acquired business is highly significant to the consolidated entity. This may be common in the acquisition of a private entity where an opinion on internal control has not previously been rendered. To require an adverse opinion would present the issuer in an inappropriately bad light and could even chill the market for acquisitions made late in the year. In those cases, it would be appear more informative for the user to issue a qualified opinion.

In many smaller entities it will be impossible to create an effective segregation of duties over some functions to avoid a material weakness. Similarly a qualified opinion is more useful to readers than an adverse opinion when other compensating controls have been established and are operating effectively.

We are also concerned that the excessive use of the adverse opinion resulting from the guidance in the proposed standard will lessen the potential message to readers when such a conclusion is truly warranted. We believe that adverse opinions should provide a signal of the magnitude of a pervasive weakness such as when there is severely inadequate documentation or testing or an inattention to internal controls in general.

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?

We believe the auditor's report should be clear that it covers the effectiveness of internal controls in all cases. We do not believe the extent of work required to attest to management's assertion rather than to issue an audit opinion on internal controls should differ.

It is our view that the issue of the auditor's attesting to management's assessment has already led to significant confusion in the business community as to the auditor's role and extent of procedures that auditors are required to perform to issue such a report. We believe the user community will better understand the nature and extent of auditor involvement when an auditor issues an opinion on internal control.

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?

If the PCAOB intends to include narrow, subject focused guidance on the subjects in this standard, that guidance should also be repeated in the Independence and Quality Control sections of the PCAOB literature. We think that the SEC independence guidance and the guidance in this standard are sufficient at this time.

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

We acknowledge the PCAOB's authority to write the auditing standards for public companies in whatever format it wishes, but think that to the extent that its proposed structure for its literature will be organized somewhat along the lines of the existing literature will be more useful. Accordingly we believe it should not commingle general independence, attest and general quality control standards guidance with auditing performance and reporting standards.

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

Yes. We believe the SEC has provided significant guidance in this area, and those examples need not be repeated here.

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?

Yes, we believe that differing levels are appropriate, but urge the Board to not expand the Section 404 requirement to cover or appear to cover quarterly procedures regarding internal controls. See our response to question 31.

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

Paragraph 186, in referring to quarterly procedures states "Determine, through a combination of observation and inquiry, whether significant changes in internal control over financial reporting may introduce significant deficiencies or material weaknesses in the design of internal control over financial reporting". We believe that in using the terms "observation" and "Determine," this requirement goes beyond the nature of procedures required for reviewing financial reporting information required under SAS 100, and is an expansion of scope we do not support.

In that regard, we believe the auditor's procedures regarding controls at the interim period should be limited to inquiries, and in the case of inconclusive or contradictory information, the auditor should apply whatever procedures considered necessary to resolve the issue.

In addition, review procedures are not determinative, but rather are a basis for creating an awareness of any material modifications necessary in the circumstances.

We also have not been able to conclude whether quarterly closing and related controls are intended to be swept-in under the Section 404 audit standard. However, we find no legislative, regulatory or other support to expand the 404 requirements to cover controls over interim reporting. We encourage the PCAOB to clarify its intention. We do not support including such procedures at this time.

If quarterly internal control procedures are required by the PCAOB, it would be most logical that they be required to be performed contemporaneously with the quarterly filing and the nature and extent of procedures be defined to promote consistency in application. While a retrospective evaluation of the quarterly closing and reporting controls may be possible, the risk of a weakness being identified in a subsequent procedure, after management has certified to the period, is an

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

undesirable result. We note the quarterly reporting timeframe is currently significantly constrained due to shortened filing times for accelerated filers, and increased involvement by the auditors in the review of financial information under SAS 100.

Any requirement that Section 404 engagements include interim controls tests should also be communicated to preparers, as some preparers are not currently including quarterly procedures in the scope of their Section 404 projects.

If quarterly responsibilities related to internal controls (beyond inquiries) are imposed, we believe that they should only become effective for the first quarter following the first annual reporting period for which a Section 404 audit opinion is rendered. Prior to this date, management's documentation, testing and monitoring over these quarterly controls may not be in place, and the auditor might not have an adequate basis for making an assessment. Moreover, such timing would be consistent with the SEC's transition approach for Exchange Act Rules 13a-15(d) and 15d-15(d), which require issuers to begin evaluating changes in internal control over financial reporting on a quarterly basis. Issuers are not required to comply with these rules until the first periodic report due after the first annual report that must include a management report on internal control over financial reporting.

Other Matters

Sampling

We believe the first sentence in the second bullet in paragraph 102 is incorrect as stated. In general, sample sizes for tests of controls do not increase as the number of control procedures increase. The exception to the rule is that for very small populations (say, less than a couple of hundred items), fewer items need to be examined. The example given is a small population of controls operating infrequently, and small populations such as this do require fewer items to test. However, the general statement in the first sentence is not supported by sampling theory or the guidance in the Audit Sampling Guide. Since attribute samples are seeking comfort that exceptions do not exceed some tolerable rate, increasing population size (once a threshold population size is reached) does not increase the required sample size.

The sentence referred to is generally true in all cases where substantive tests based on dollar values is performed. In a substantive test, the precision of the substantive test is linked to materiality (which is a specific amount), so, as the population grows, the sample size necessary to test for misstatement grows. We do not believe that the proposed standard intended that tests of controls be designed as substantive tests, using materiality thresholds to drive the sample size. Therefore, we believe the sentence should be corrected or clarified.

The Relationship Between Preparer and Auditor Test Levels

A common question asked by preparers is how much testing are they required to perform. As we mentioned earlier in this comment letter, this is a result of the lack of guidance for preparers. This often brings into question the relationship between the extent of testing of auditors and that of preparers. It is our view that the final standard should reflect that when auditors have assessed the documentation and testing by management and concluded that management has achieved a high level of assurance that their assertion concerning internal control is supported, that auditor test levels can often be expected to be less than those used by management. This is because the auditors have a significant and important piece of evidence the preparer did not have prior to their testing – management's analysis and test results. Thus, the levels of tests by management to

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

achieve a high assurance of effective operation should be greater than the levels required of auditors in their tests of internal control.

The Use of the "All" Requirement in the Proposed Standard

When the term "all" is used it provides no room for judgment for application of procedures that are effective and efficient. We believe the term "all" applies more appropriately to management's need to be very thorough in identifying, documenting and testing controls. It has been a long-standing practice that the auditor could practically and economically limit his or her procedures by testing. While we can envision circumstances where "all" might be the right scope, in many cases it will cause the performance of unproductive and expensive procedures. Examples from the proposed standard include:

> 114 As part of this evaluation, the auditor should review ***all*** reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address controls related to internal control over financial reporting and evaluate any internal control deficiencies identified in those reports.
>
> 191 In addition, the auditor should communicate to management, in writing, ***all*** deficiencies in internal control over financial reporting (that is, those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the audit and inform the audit committee when such a communication has been made.

We recommend that the final standard reconsider the use or concept of "all" throughout the document. In our view, if the preparer has done a good job in documentation, testing and monitoring, and has demonstrated an adequate basis for its assessment, "all" will rarely be the correct requirement for the independent auditor.

Safeguarding of Assets

We believe that there will be a considerable number of implementation questions on the auditor's responsibility for identifying and testing controls related to the safeguarding of assets. We believe a mechanism, such as a PCAOB staff Q&A document, can help provide consistent and timely answers to questions about which controls should be included in the controls assessment and how they should be tested.

For example, in a retail operation, is the failure to use security cameras or merchandise theft tags a weakness? Does the auditor need to test or have a security expert test such controls if they are represented to be in use? Are poor pricing policies a control weakness? Is inefficiency a control weakness? Should controls be established to prevent the loss of customer lists and intellectual property and to what degree of security must these controls operate to be considered effective?

We believe this subject area can quickly mushroom into something unintended such that every business problem might be articulated in terms of it being evidence of an absence or failure of controls.

Additional Specific Comments

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

1. Paragraph 2 should be modified to directly address benefit plans that file Form 11-K. The SEC staff has recently informally stated that such issuers are not subject to the reporting requirements of Section 404.

2. Paragraph 33 introduces a level of audit committee pre-approval for "internal control-related services" that appears to exceed the pre-approval requirements in the SEC rule, since they must be "specifically" pre-approved.

   The SEC set the requirements for the pre-approval of services after due process. In our view, if modifications of those requirements are considered necessary, we would expect those modifications to come from the SEC.

3. Paragraph 34 says internal control auditing requires more than ordinary attention to maintaining independence. This implies that auditors can give only "ordinary" attention in "ordinary" engagements, which presumably include audits of financial statements. We don't understand the rationale for this statement or what extraordinary measures the auditor needs to take. We also do not agree that this requires any more diligence regarding independence than other attest engagements.

4. Paragraph 57 – The fifth bullet refers to complying with listing standards. We do not understand the reason for this. First, not all issuers are subject to the listing standards (because not all are listed). Second, the listing standards deal with the composition and activities of the audit committee and thus only deal indirectly with reliable financial reporting.

5. Paragraph 94 focuses on timing from the standpoint of work at an interim date vs. work at the "as of" date. The final standard should also provide guidance on what to do when the auditor is hired after the "as of" date.

6. Paragraph 126 – The first sentence should say that the following "should *usually* be regarded …" There are often cases where a restatement of financial statements is not due to any weakness in internal control (e.g., cases where accounting or disclosure is responsibly reviewed at all levels of the company and at the highest levels of the auditing firm, but a restatement is still required due to the insistence of the SEC staff based upon differing judgment).

7. Paragraph 134 states: "the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements." We believe the term "sufficient" in this case is unclear. We assume the Board means that they must operate for a long enough time to allow for testing of their effectiveness (e.g., a few weeks or a month for frequent controls), and not over an extended time during the year.

8. Paragraph 156 says that when separate reports are issued on the audits of the internal control over financial reporting and the financial statements, an auditor needs to add to the report on the financial statements audit a reference to the audit of the internal control over financial reporting. Shouldn't the auditor also add a comment to the report on the internal control audit referring to the financial statements audit?

.

BDO Seidman, LLP

330 Madison
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

9. Paragraph 173 seems to presume that management would disclose in its report on internal control over financial reporting a subsequent event that materially affects the effectiveness of the controls. We do not believe there is currently any specific SEC requirement for management to make such disclosure until the subsequent quarter, in which the change occurred. Therefore, we believe the PCAOB should clarify its view on management's disclosure requirement in the final standard. If the PCAOB believes that disclosure is implicitly required, the PCAOB should add a footnote or use some other means to fully explain the rationale for this conclusion. This will ensure that auditors and issuers focus on this point

10. Paragraph 181 presumes that reports on internal control are "part" of a registration statement and subject to Securities Act liability. We question whether this is the case, as such reports are required in Securities Act filings only when the issuer *elects* to use a short-form registration statement that requires the issuer to incorporate the most recent annual report by reference.

11. B15 states: "the evaluation ordinarily would not extend to controls at the equity method investee…" We cannot envision a circumstance where it should, and unless one can be identified we suggest the word "ordinarily" be struck.

*   *   *   *   *

We appreciate your consideration of our comments and suggestions, and would be pleased to communicate or meet with the PCAOB and its staff to clarify any of our comments.

Please direct comments to Wayne Kolins National Director of Assurance at 212-885-8595 Wkolins@bdo.com or Lynford Graham, National Director of Auditing at 212-885-8551 Lgraham@bdo.com.

Sincerely,

BDO Seidman, LLP

BDO Seidman, LLP