ERNST & YOUNG

■ **Ernst & Young LLP**
Suite 1300
925 Euclid Avenue
Cleveland, OH 44115-1476

■ Phone: (216) 861-5000
www.ey.com

November 21, 2003

Mr. J. Gordon Seymour
Acting Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006-2803

PCAOB Rulemaking Docket Matter No. 008
Proposed Auditing Standard—An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements

Dear Mr. Seymour:

We are pleased to comment on the PCAOB's proposed auditing standard (the "Proposed Standard") related to an audit of internal control over financial reporting in conjunction with an audit of financial statements (an "audit of internal control over financial reporting"). Overall, we support the Proposed Standard because we believe it would provide improved guidance for auditors in the execution of audits of internal control over financial reporting. The performance and reporting guidance in the Proposed Standard is consistent with the level of assurance an audit of internal control over financial reporting is expected to provide, and the PCAOB has appropriately recognized the responsibilities of management to assess and report on internal control over financial reporting, as described in the final rule issued by the Securities and Exchange Commission (the "SEC Final Rule").

While we commend the Board for its thorough Proposed Standard, we believe the Board should modify some aspects of the Proposed Standard to address a number of key matters, including the following:

Use of the Work of Management and Others (Paragraphs 103-110)
Provide the auditor more flexibility in using the work of internal auditors, especially where "the importance of the internal audit function results in a high degree of competence and objectivity." We believe paragraph 104 unnecessarily prohibits the use of the work of management and others, particularly internal audit, in three areas—walkthroughs, controls over the period-end financial reporting process, and controls that have a pervasive effect on the financial statements, such as certain information technology general controls. We believe the auditor should be permitted to use, on a "limited basis," the work of internal audit in these areas based on the auditor's assessment of the competence and objectivity of those performing the work.

Evaluating the Effectiveness of the Audit Committee's Oversight (Paragraphs 56-59)
Clarify that the auditor's responsibility to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is not a separate and distinct evaluation. Rather, it is

one element of the auditor's overall understanding and assessment of the company's control environment and monitoring components.

Evaluating the Results (Paragraphs 8 and 21 and Appendix D)
Reconsider whether "more than inconsequential" is the appropriate threshold for identifying significant deficiencies, and the effect of this threshold on other aspects of the Proposed Standard dealing with materiality and evaluating the results of the audit of internal control over financial reporting.

Auditor's Responsibility Relating to Management's Quarterly Certifications (Paragraphs 185-189)
We believe it is inappropriate to include additional responsibilities with regard to management's quarterly certifications in this Proposed Standard, which addresses "an audit of internal control over financial reporting performed in conjunction with an audit of financial statements." We do not believe the auditor's responsibility for management's quarterly certifications and related disclosures extends beyond the responsibility to inform the audit committee of matters coming to his or her attention.

Considerations for Small and Medium-Sized Companies (Appendix E)
Further clarify how an audit of internal control over financial reporting should be conducted for small and medium-sized issuers. We believe the COSO framework currently provides management and the auditor with sufficient guidance and flexibility with regard to small and medium-sized companies. We suggest the Board modify Appendix E to refer to the COSO guidance or provide more specific examples based on the COSO guidance.

Effect of Material Weaknesses on Reporting (Paragraphs 162-164)
Permit a qualified (e.g., "except for") management assessment and audit opinion in certain cases based on an evaluation of the significance of a material weakness. As further described in our response to question 25 in a later section, we believe this reporting alternative would more clearly communicate to users of the reports the effect of a material weakness and would be consistent with the SEC Final Rule.

We also urge the Board to clearly identify the changes being made to the Board's interim professional standards as a result of the Proposed Standard, including the substantive procedures with respect to audits of financial statements described in paragraphs 138-142.

We have organized our comment letter to first respond to the 31 questions on which the Board seeks public comment and then to provide additional comments that do not relate to a particular question. Our responses and additional comments include specific observations on those matters we have highlighted above.

We believe our comments and suggestions are in the spirit of the Board's broad objectives of promoting strong corporate governance and the communication of appropriate information on internal control over financial reporting.

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. The term "audit" appropriately denotes the level of assurance that the auditor's attestation report provides.

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?

For purposes of reporting on internal control over financial reporting under Section 404 as described in the Proposed Standard, we believe the accounting firm should be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the company's financial statements as of the same date. We recognize this requirement would mean (1) the same accounting firm would have to perform both audits, (2) the audit of internal control would necessarily coincide with the entity's fiscal year end, and (3) the auditor's report on the effectiveness of internal control over financial reporting, under these circumstances, would be as of a point in time. We agree with the Board's view that the audits are closely interrelated and the auditor needs to consider the potential significance of the information that might be obtained during the audit of the financial statements to his or her conclusions about the effectiveness of internal control over financial reporting.

However, we believe there may be other situations that require an audit of internal control over financial reporting of a public company, but do not also require an audit of financial statements. For example, a regulatory agency or a potential buyer might require an audit of internal control over financial reporting of a public company or one or more of its subsidiaries as of a point in time that does not coincide with the entity's fiscal year end. Under these circumstances, the audit of internal control over financial reporting need not be performed in conjunction with an audit of the financial statements. To address these circumstances, we suggest the Board not supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting" of Statement on Standards for Attestation Engagements No. 10 *Attestation Standards: Revision and Recodification* (AICPA, Professional Standards, Vol. 1, AT sec 501). We recommend this chapter be updated or otherwise amended as necessary for use in situations other than an audit of internal control over financial reporting in conjunction with an audit of financial statements.

3. Rather than requiring the auditor to also complete an audit of the financial statements, would an appropriate alternative be to require the auditor to perform work with regard to the financial statements comparable to that required to complete the financial statement audit?

No. For purposes of reporting on internal control over financial reporting under Section 404 as described in the Proposed Standard, we believe the audit of the financial statements necessarily must be completed at the same time as the audit of internal control over financial reporting. We agree with the Board's view that the audits are closely interrelated and that the two audit reports should be dated the same (paragraph 157).

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?

We believe the COSO framework currently provides management and the auditor with sufficient guidance and flexibility with regard to how the internal control components relate to small and medium-sized companies.

While we understand the Board is sensitive to the possible effects of the Proposed Standard on small and medium-sized companies, we believe Appendix E implies that, due to the involvement and interaction of senior management, there is a lower threshold for the design of effective internal control over financial reporting and a lower threshold for evidence of operating effectiveness for small and medium-sized companies. We agree the behavior and interaction of senior management is critical to an effective control environment. However, we do not agree that it is necessarily more so for smaller or medium-sized companies and, in any event, the owner-manager should not be viewed as a replacement for necessary controls that address the relevant assertions related to significant accounts and disclosures.

While it has been our experience with audits of smaller or medium-sized companies that systems and processes often are less complex and thus generally require fewer, less formal controls, the true measure of the overall effectiveness of internal control is the consistent execution of these controls and their sensitivity to identifying potential misstatements, whether caused by error or fraud.

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 interim professional standards adopted by the Board provide sufficient guidance regarding the level of competence, training and professional skepticism of audit personnel, and it is not necessary to reiterate the information from these standards as has been done in paragraphs 30-38 and paragraph 111 of the Proposed Standard. We believe it would be redundant to specify in the Proposed Standard the level of competence, training, and professional skepticism of audit personnel performing specific procedures for audits of internal control over financial reporting, while similar guidance on training, professional skepticism, and supervision relating to audits of financial statements is already included in the interim general and field work standards.

Evaluating Management's Assessment

6. Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?

Yes. We agree with the Board that “an auditing process restricted to evaluating what management has done would not provide the auditor with a sufficiently high level of assurance that management’s conclusion is correct.” To conclude that internal control over financial reporting is effective, the auditor necessarily will need to perform sufficient procedures to determine whether he or she agrees with management that internal control is effective.

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

Yes. We believe providing criteria auditors should use to evaluate the adequacy of management’s documentation will more clearly define the documentation requirements under management’s responsibilities, align the approaches used by management and the auditor to evaluate internal control over financial reporting, and drive consistency in practice. For example, requiring documentation about how significant transactions are initiated, recorded, processed, and reported helps to clarify that, as part of its assessment, management is expected to identify and evaluate controls over processes or activities at the transaction level. In the absence of this requirement, management might conclude that they need only identify higher-level management controls. Such higher-level controls might not be sufficiently sensitive to prevent or detect errors relating to one or more relevant assertions.

We also agree with the Board’s statement in paragraph 45 that “documentation . . . is evidence that controls related to management’s assessment . . . have been identified, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company.”

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?

If documentation is indeed inadequate, we agree it would be an internal control deficiency, the severity of which the auditor should evaluate. Documentation affects both the information and communication and monitoring components of internal control, providing the foundation for appropriate communication of responsibilities for performing controls and the entity’s evaluation and monitoring of the effective operation of controls. Because the auditor should consider the facts and circumstances of any documentation deficiency, we believe the effect of inadequate documentation should be evaluated similar to other deficiencies in internal control and not automatically rise to the level of a significant deficiency or material weakness.

Obtaining and 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. However, we believe the requirement to "trace all types of transactions and events, both recurring and unusual" is too broad.

We believe the word "all" would require the auditor to perform extensive procedures to search for, and walk through, an extensive number of transactions regardless of their risk. Additionally, notwithstanding that tracing "all types of transactions and events, both recurring and unusual" is not feasible, we do not believe the additional procedures will aid the auditor in further understanding how a process functions and the design of the related controls. We recommend the Board include qualifying language to denote that the auditor should walk through significant classes of transactions and related controls within significant processes, and possibly offer an example to clearly demonstrate the Board's intent with this requirement.

We also suggest the Board alter the second phrase in the first sentence of paragraph 80, i.e., "controls for all five internal control components and fraud." While we agree the auditor should perform procedures to confirm his or her understanding of the design of controls and that the controls have been placed in operation, we do not believe it feasible to "walk through" controls for all five internal control components or controls intended to address the risks of fraud.

We also suggest the Board revise paragraph 82 to make it clear that, for an audit of internal control over financial reporting as of the end of the year, the auditor should, when applicable, walk through transactions that were processed after there have been significant changes in the related processes and controls during the year.

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?

No. We believe there will be many situations where internal audit will perform walkthroughs as part of management's assessment process. The auditor should consider the nature and extent of those walkthroughs in determining his or her own walkthrough procedures. For example, the auditor should be able to use walkthrough procedures related to routine processes when internal auditors who possess a high degree of competence and objectivity perform those procedures.

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 it is appropriate to require the auditor to obtain such evidence every year, because each annual audit of internal control over financial reporting needs to stand on its own.

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?

We agree with the statement in paragraph 103, "The auditor should evaluate whether to use the work performed by management or others."

We believe the auditor should be permitted, but never required, to use the work of management or others based on the auditor's assessment of the competence and objectivity of those performing the work, and the relative importance of that work to the overall audit of internal control over financial reporting. However, as further discussed in our responses to questions 13 through 15 and elsewhere in this letter, when the auditor's evaluation indicates that the individuals performing the work have a high degree of competence and objectivity (e.g., internal audit), we believe the auditor should be permitted to use this work more extensively. Similarly, the auditor should be permitted to use the work of "others" more extensively, but only when such individuals perform roles similar to internal auditors and have a high degree of competence and objectivity (e.g., a loan review function in a financial institution). This also is conditioned on the auditor re-performing a sufficient amount of the work to be satisfied as to the sufficiency of the procedures performed and accuracy of the results.

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

No. In the first category of controls, we believe paragraph 104 unnecessarily prohibits the use of the work of management and others in three areas—walkthroughs, controls over the period-end financial reporting process, and controls that have a pervasive effect on the financial statements, such as certain information technology general controls. We believe these three areas should be moved to paragraph 105, which describes procedures performed by management and others where the auditor's use of such work "should be limited." Our rationale for walkthroughs is described in our response to question 10 in this section.

We agree that certain IT general controls have a pervasive effect on other controls, and further agree that controls over the period-end financial reporting process are important to the auditor's assessment of the effectiveness of internal control over financial reporting and the detection of fraud. However, we are not convinced that the criteria in paragraph 103 should preclude the auditor from using the work of competent and objective internal auditors in these areas. The internal audit departments of public companies often include professionals with specialized skills (e.g., information technology), and who appropriately follow established professional standards in the conduct of their work. We believe the auditor's inability to use the work of these professionals potentially would detract from, rather than enhance, the quality of audits of internal control over financial reporting and, at a minimum, would unnecessarily add to the cost borne by public companies.

In the second category of controls, where the use of the results of procedures performed by management and others should be "limited," we suggest the Board clarify the extent of the use of the work of management and others it considers acceptable in these situations. In our view, it is inconsistent to conclude that internal audit is competent and objective, but then discount their training and experience when planning to use their work. While we agree that certain accounts involve significant judgments and estimates that affect the account balance or disclosure as noted in the fifth bullet in paragraph 103, it does not necessarily follow that the evaluation of all of the related processes and controls also is subjective.

In the third category of controls, the description in paragraph 106 ("other areas, such as controls over routine processing of significant accounts and disclosures") indicates the auditor might decide to use the work of "management and others *within the company*" (emphasis added). This differs from the reference to "management and others" used elsewhere in the Proposed Standard. The term "others" is defined in paragraph 42 to "include internal audit and third parties working under the direction of management, including other auditors and accounting professionals engaged to perform procedures as a basis for management's assessment." We recommend the words "within the company" be deleted.

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?

Paragraph 108 appears to give appropriate recognition to the work of internal auditors. However, we do not believe this recognition has been reflected in paragraphs 103-107. Where the auditor's evaluation indicates that the internal audit function has a high degree of competence and objectivity, we suggest the auditor be permitted to use the work of internal audit more extensively, including some areas of the audit of internal control over financial reporting where the auditor is otherwise prohibited from using the work of management (see response to question 13 above). Similarly, the auditor should be permitted to use the work of "others" more extensively, but only when such individuals perform roles similar to internal auditors and have a high degree of competence and objectivity (e.g., a loan review function in a financial institution).

15. Is the flexibility in determining the extent of re-performance of the work of others appropriate, or should the auditor be specifically required to re-perform a certain level of work (for example, re-perform tests of all significant accounts or re-perform every test performed by others that the auditor intends to use)?

We believe the flexibility in determining the extent of re-performance of the work of others is appropriate. The auditor should use professional judgment in determining the extent of re-performance based on the type of control and the assessment of the competence and objectivity of those performing the tests.

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 a benchmark is appropriate; however, we suggest the Proposed Standard be revised to explicitly state that meeting the "principal evidence" requirement is based on qualitative, not just quantitative, factors.

Evaluating the 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?

We acknowledge the Board's effort to improve the definition of a significant deficiency and material weakness. We believe the focus in the definitions on the magnitude of the potential misstatement and the likelihood of their occurrence, along with the examples provided in Appendix D, have the potential for increasing consistency in the evaluation of internal control deficiencies. While we believe the auditor's consideration of the likelihood of occurrence is clear, we believe the auditor's consideration of magnitude requires further clarification.

We believe the examples in Appendix D generally are consistent with the definition of a significant deficiency in paragraph 8—that is, "a misstatement of the annual or interim financial statements that is more than inconsequential." However, the definition in paragraph 8 appears to conflict with the materiality discussion in paragraph 21, which indicates that materiality at the individual account-balance level is relevant to deciding whether a deficiency represents a significant deficiency. While the term "inconsequential" in paragraph 8 is not defined, we believe it implies a lower threshold than individual account-balance materiality. We suggest the Board define the term "inconsequential" in paragraph 8 and otherwise provide clarification on the interrelationship of these two materiality concepts. We believe auditors will continue to need to use significant professional judgment in determining whether a deficiency represents a significant deficiency and suggest that the Proposed Standard acknowledge this.

We believe the inclusion of the phrase "annual or interim" in paragraphs 8 and 9 causes confusion as to the intended scope of an audit of internal control over financial reporting. The phrase is not defined elsewhere in the Proposed Standard, and it is unclear how the phrase "period-end financial reporting process" as used in paragraphs 41 and 43 relates to "annual or interim financial statements" in paragraphs 8 and 9.

If it is the Board's intention that the scope of management's assessment process and the auditor's audit procedures address controls over both the preparation of interim financial statements and year-end financial statements, we suggest that it be made clear in paragraph 41 describing the scope of controls that are to be evaluated. We also recommend the Board clarify the relationship of the auditor's responsibilities for evaluating internal control over interim financial statements with the auditor's responsibilities with respect to interim financial statements described in SAS No. 100, *Interim Financial Statements*.

Further, we believe the Proposed Standard is not clear regarding whether the phrase "annual or interim" is intended to change the concept of materiality, because this phrase suggests that materiality needs to be determined based on quarterly as well as annual financial results. Materiality in an annual audit of financial statements generally is based upon the annual financial results. In an integrated audit, we believe it is both inappropriate and inconsistent to require materiality at a much lower level (i.e., interim financial results) for purposes of the audit of internal control.

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?

Yes. The examples demonstrate a consistent thought process the auditor should employ in determining whether control deficiencies are either a significant deficiency or material weakness.

We suggest the Board consider also providing one or more examples where the likelihood of material misstatement is remote, resulting in the conclusion that a significant deficiency does not represent a material weakness even when the magnitude of potential misstatement is material. We believe these additional examples would help auditors better understand how to apply the concepts of likelihood and magnitude together when evaluating deficiencies in internal control.

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

Yes.

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 do not believe the auditor should be required to communicate all internal control deficiencies to management in writing, and therefore suggest this requirement be eliminated.

We believe it is appropriate that all internal control deficiencies that are identified by the auditor and of which management is unaware should be communicated to management. In our view, however, requiring the auditor to communicate deficiencies regardless of who first identified them would create confusion when the deficiencies already have been reported to management internally (e.g., by internal audit). Management has the primary responsibility for implementing an effective system of internal control over financial reporting and for assessing its effectiveness at the end of the most recent year. Accordingly, we believe the auditor should first determine whether the company has implemented a process that provides for the communication of internal control deficiencies to appropriate levels of management on a timely basis.

Under the COSO framework, internal control should be self-monitoring and self-correcting. There should be an expectation that internal control deficiencies identified through ongoing monitoring activities (as well as the annual assessment of internal control over financial reporting required by the Act) are raised to appropriate levels of management. We believe it would be more appropriate for the auditor, as part of his or her evaluation of internal control over financial reporting, to determine that internal control deficiencies identified by the company through its monitoring activities and annual assessment are reported to appropriate levels of management in a timely manner. We also suggest the Board acknowledge that the lack of an internal process to report deficiencies in internal control to management on a timely basis represents an internal control deficiency that should be evaluated for severity by the auditor.

Requiring the auditor to report all deficiencies to management in an environment where control deficiencies are already routinely raised to management potentially detracts from the relevance of the auditor's work and management's monitoring activities and undermines the Board's promotion of strong corporate governance through effective systems of internal control.

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 do not agree that all the matters listed are necessarily strong indicators that a material weakness in internal control exists. We believe the auditor needs to first gain an understanding of the facts and circumstances of the matter. In this regard, we suggest that the Board clarify whether the evaluation would be different if the matters discussed in paragraph 126 were detected by the company's system of internal control or by the auditors in the performance of their procedures. For example, the identification of fraud on the part of senior management by the company's system of internal control might indicate that internal control is operating effectively rather than indicating a significant deficiency or material weakness. Moreover, a presumption that the identification of fraud of any magnitude on the part of senior management is at least a significant deficiency fails to adequately consider the inherent limitations of internal control.

We suggest the Board clarify or provide examples of the instances when restatement of previously issued financial statements to reflect the correction of a misstatement should be regarded as at least a significant deficiency in internal control over financial reporting. For example, we believe a restatement to reflect the SEC's subsequent view of an accounting matter when the auditor concluded that management has reasonable support for its original position would not necessarily be a significant deficiency in internal control over financial reporting. Also, we believe a restatement relating to a nonrecurring transaction in a prior year would not necessarily reflect a material weakness in internal control over financial reporting in the current year.

We also suggest the Board clarify that identification by an auditor of a material misstatement in the current period before all of management's controls had an opportunity to function would not necessarily result in a conclusion that a significant deficiency exists in internal control over financial reporting. For example, it is normal for the auditor to perform his or her review and other procedures relating to year-end financial statement information at about the same time that management performs its review and other procedures. In this situation, the auditor might identify a material misstatement in draft financial statements while the corporate controller, chief financial officer, and other members of executive management are still completing their respective reviews and other procedures. Therefore, we believe the second bullet in paragraph 126 is impractical as stated, in that it would require the auditor to consider whether the reviews and other procedures performed by the company's executives (i.e., a higher-level detect control) would have identified the material misstatement. In effect this would require the auditor to predict the future functioning of the company's controls.

While some controls that focus primarily on compliance with laws and regulations also might have a material effect on the reliability of financial reporting, we do not believe assessing the effectiveness of a company's regulatory compliance function is within the scope of an audit of internal control over financial reporting. As noted in the SEC Final Rule, the definition of internal control "does not encompass the elements of the COSO Report definition that relate to . . . a company's compliance with applicable laws and regulations, with the exception of 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 the auditor's consideration of the effectiveness of the internal audit function for larger, more complex entities also consider the focus of the internal audit function. We observe that some internal audit functions, while effective, primarily focus on internal control objectives other than financial reporting and thus do not necessarily contribute as much to effective internal control over financial reporting.

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 the audit committee plays a critical role. Like the independent auditor, the audit committee is independent of management. However, the audit committee is not a separate component of the company's system internal control. The system of internal control should function without the direct involvement of the audit committee. The audit committee's role, like the independent auditor's, is an evaluative one.

We agree that the auditor's assessment of the control environment and monitoring components should consider the effectiveness of the audit committee's oversight role, but only as it relates to the audit committee's assessment of *management's* approach to designing, implementing and monitoring internal control over financial reporting. For example, as part of the assessment of the control environment, the auditor generally would consider whether the audit committee appropriately reacts when management fails to respond appropriately to control deficiencies or other matters.

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

We believe the auditor can evaluate aspects of the audit committee's oversight role as part of the company's control environment and monitoring components of the system of internal control over financial reporting. However, the Proposed Standard would require the auditor to evaluate certain aspects of the audit committee's oversight for which objective and measurable criteria are not provided in the Proposed Standard (e.g., clarity with which the audit committee's responsibilities are articulated and how well the audit committee and management understand those responsibilities). In addition, when assessing the effectiveness of the audit committee's oversight, the quality of the time and effort put forth by the committee members, and the way they react to and interact with management and the independent auditors in dealing with critical issues, is arguably more important than the amount of time spent on various activities. Finally, there are other aspects of the audit committee's oversight that involve legal determination (e.g., independence of audit committee members from management, compliance with applicable listing standards).

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. While the auditor always has the option to withdraw from an engagement, we do not believe it would be appropriate for the standard to require the auditor to withdraw in this situation. Requiring the auditor to withdraw without first providing the company's board of directors the opportunity to react to the matter could cause irreparable harm to the company and its shareholders.

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?

We believe it would be consistent with the SEC Final Rule for management and the auditor, in certain circumstances, to issue a qualified assessment and opinion about the effectiveness of the company's internal control over financial reporting (i.e., internal control is effective "except for" an identified material weakness).

Section II.B.3.c of the SEC Final Rule and related footnote no. 72 states,

> "The final rules therefore preclude management from determining that a company's internal control over financial reporting is effective if it identifies one or more material weaknesses in the company's internal control over financial reporting. This is consistent with interim attestation standards. See AT sec. 501."

We believe this reference to the interim attestation standard in the SEC Final Rule is referring to AT sec. 501, par. 37, which states in part,

> "Therefore, the presence of a material weakness will preclude the practitioner from concluding that the entity has effective internal control. However, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the practitioner may qualify his or her opinion (that is, express an opinion that internal control is effective "except for" the material weakness noted) or may express an adverse opinion."

Our reading of the SEC Final Rule and the interim attestation standard leads us to conclude that it would be appropriate for the auditor to express either an adverse opinion or a qualified "except for" opinion about the effectiveness of the company's internal control over financial reporting depending on the circumstances. See our response to question 26 for an example of where a qualified opinion might be appropriate.

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

Yes. We believe that management and auditors might encounter situations in practice where a qualified "except for" conclusion would be appropriate, as it would provide more meaningful information to investors. For example, a company may have adopted a new accounting principle in the current year, which required a material audit adjustment. The auditor concluded that this adjustment resulted from a material weakness, but the material weakness was confined to one significant account. The company otherwise has effective internal control over financial reporting. We believe an auditor's report with a qualification explaining the material weakness, rather than an adverse opinion on the effectiveness of internal control over financial reporting as a whole, would provide more meaningful information to investors.

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?

Yes. We also suggest the Board require in all cases that the auditor's opinion speak directly to the effectiveness of the internal control over financial reporting. We believe such a requirement would help to address potential misconceptions as to the scope and objective of an audit of internal control over financial reporting.

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?

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

No. We do not believe it is appropriate to include specific independence guidance in the Proposed Standard. We believe all independence guidance should be located in a discrete section of the professional standards and it would be helpful to refer to this guidance where appropriate in the Proposed Standard. We also believe current SEC independence rules and related SEC interpretations (e.g., Frequently Asked Questions) are sufficient in the context of this Proposed Standard, and potential changes to or further interpretation of such rules and interpretations should be subject to separate notice and comment rulemaking.

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?

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

We believe it is inappropriate to include additional responsibilities with regard to management's quarterly certifications in this Proposed Standard, which addresses "an audit of internal control over financial reporting performed in conjunction with an audit of financial statements." Additional requirements relating to the auditor's quarterly review responsibilities should be separately proposed and exposed for public comment.

We do not believe the auditor's responsibility for management's quarterly certifications and related disclosures extends beyond the responsibility to inform the audit committee of matters coming to his or her attention. We believe a requirement for the auditor to describe in his or her report the reasons the auditor believes management's certification should be modified would create an inappropriate dual-reporting responsibility and imply the auditor's responsibility extends beyond the scope of his or her audit report on internal control over financial reporting.

Additional Comments

Our additional comments are organized by corresponding paragraph number of the Proposed Standard.

Par. 10—The definitions of preventive and detective controls state these controls have the objective of either preventing or detecting a misstatement. We suggest that preventive and detective controls have the objective of preventing or detecting errors or fraud that could result in a misstatement of the financial statements. We believe there are many types of controls that are relevant to the overall effectiveness of internal control over financial reporting for which it may be difficult to identify a direct relationship to potential misstatements in the financial statements. For example, edit or range checks over the input of transaction data that help assure that transaction files are accurate are fundamental controls in an effective system of internal control over financial reporting, but do not have a direct bearing on preventing misstatements in the financial statements. The definitions of preventive and detective controls in the Proposed Standard may cause management or the auditor to exclude controls important to assessing the overall effectiveness of internal control over financial reporting.

Par. 14—We suggest clarifying the wording of this paragraph to state: (1) the COSO framework identifies three primary objectives of internal control (i.e., efficiency and effectiveness of operations, financial reporting, and compliance with laws and regulations) and an audit of internal control over financial reporting is concerned with only the financial reporting objective, and (2) the controls that management designs and implements may achieve more than one objective.

Par. 16—We suggest practitioners and other parties might find the correlation of reasonable assurance to "a high level of assurance" confusing and it may be appropriate to further clarify this concept in the Proposed Standard. We suggest the Board analogize the audit of internal control to the audit of financial statements where traditionally an "audit" of financial statements provides a high level of assurance while a "review" of financial statements provides a moderate level of assurance.

Par. 24—This paragraph states "the auditor should review all controls specifically intended to address the risks of fraud that are reasonably likely to have a material effect on the company's financial statements." We believe the word "all" is too broad and potentially would require the auditor to review controls that are not relevant to the audit of internal control over financial reporting. Further, the requirement to review "all" controls potentially conflicts with the requirement to place "special emphasis on the evaluation of such controls in the control environment," which implies that some of the controls management may have implemented to specifically address the risks of fraud are more relevant than other controls.

We suggest the Board remove the second bullet, "Company's risk assessment processes," as it is not part of the control environment. We also suggest changing the wording in the fourth bullet point to change the focus from functional reporting, which is not defined, to a focus on direct reporting to the audit committee and the audit committee's involvement and interaction with internal audit. We believe the wording in this bullet point should be consistent with the description in the fourth bullet point in paragraph 57 relating to audit committee oversight of the internal audit function. Finally, we suggest the Board clarify the terminology in the first bullet point, "controls restraining the inappropriate use of company assets."

Par. 41—We believe the examples of procedures management may use to evaluate the operating effectiveness of controls in the fifth bullet point of this paragraph do not reflect the full range of procedures management may employ. For example, the COSO framework indicates management might be able to determine that controls operate effectively through direct and ongoing monitoring of the functioning of controls. This might be accomplished through regular management and supervisory activities, monitoring adherence to policies and procedures, and other routine actions. While we agree with the Board's statement in paragraph 18 that "users of the reports from management and the auditor are entitled to receive the same level of assurance from management and the auditor," we believe management's daily interaction with the system of internal control provides it with a broader array of procedures to achieve that level of assurance.

Par. 50—The word "should" in the last sentence of the bullet point discussing the control environment creates a presumptively mandatory obligation (based on the terminology in the Board's Proposed Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*) on the part of the auditor to alter the nature, timing, or extent of tests of operating effectiveness without first considering the effects, if any, of the weakness noted in the control environment on the effectiveness of other controls. This presumptively mandatory obligation to alter the nature, timing, and extent of tests of controls also may be inappropriate if the auditor already had designed tests sufficient to detect such effects, if any.

Par. 51-52—We agree that the objective of an audit of internal control over financial reporting is to evaluate the overall effectiveness of internal control over financial reporting and not to evaluate individual controls in isolation. Accordingly, the auditor also has to consider that certain internal controls (e.g., higher-level monitoring controls) often are dependent on the functioning of other controls or work in combination to achieve the objectives of effective internal control. However, it is not clear how the concepts discussed in paragraphs 51 and 52 are consistent with the requirement stated in paragraph 27, and other places throughout the Proposed Standard, that the auditor "must obtain sufficient competent evidence about the design and operating effectiveness of controls related to all relevant financial statement assertions for all significant accounts and disclosures in the financial statements."

We suggest the Board clarify how the auditor should apply the concepts in paragraphs 51 and 52 in light of the focus on assertions in paragraph 27.

Par. 53-54—We suggest the Board reverse the order of these paragraphs to better set up the discussion of company-level controls.

Par. 62-63—We suggest the Board clarify the use of the term "component" in these two paragraphs. Paragraph 62 refers to a component as a portion of an account balance (for example, the allowance for doubtful accounts and trade receivables are components of the net trade receivables account balance). Paragraph 63 refers to a component as the corresponding account balance of a business unit. We suggest the Board not refer to corresponding account balances of individual business units as significant accounts as this implies that the determination of significant accounts should be based on individual locations or business units, rather than at the financial-statement level.

Par. 72—We suggest the Board clarify in the last bullet point under this paragraph, or elsewhere in the Proposed Standard, the contemplated nature and extent of involvement of the audit committee in the period-end financial reporting process. Is the Board suggesting that the audit committee's involvement extend beyond its oversight role for the external financial reporting process to include some level of involvement or oversight in the aspects of the financial reporting process discussed in paragraph 51 of AU319?

Par. 91—We recommend the Board provide additional examples of information that inquiries might provide, including 1) the skill and competency of those performing the control, 2) the relative sensitivity of the control to prevent or detect errors, and 3) the frequency with which the control operates to prevent and detect errors.

Par. 92—We suggest the Board incorporate a similar discussion in paragraph 41 to indicate that in performing its assessment, management also should not rely solely on inquiry and should obtain sufficient evidence through other procedures, including inspection and re-performance.

Par. 97—We do not find this paragraph helpful and suggest the Board consider combining it with another paragraph.

Par. 102—See comment on paragraph 16 in this section. We suggest the phrase "high level of assurance" may be confusing to practitioners in that the concept is being used in a different context in this paragraph than used elsewhere in the Proposed Standard. The phrase "high level of assurance" applies to the auditor's overall opinion on internal control in paragraph 16 and we do not believe the concept is relevant to the individual tests of operating effectiveness of controls.

Par. 103, 107-108—We suggest the Board move the discussion of the competence and objectivity of "individuals performing tests of controls" in paragraph 107 and "internal auditors who follow the *International Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors" in paragraph 108 so that it follows the general discussion of evaluating whether to use the work of management and others in paragraph 103, and precedes the discussion of the three categories for using the work of management and others discussed in paragraphs 104-106. We believe this positioning will better demonstrate that the auditor should consider, regardless of the category of controls, both the subject matter of the work of management and others and the competence and objectivity of those performing the work in evaluating whether to use the results of procedures performed by others.

Please see our other comments related to these paragraphs in our responses to questions 12-14 in the previous section.

Par. 113—We suggest the Board change the second bullet point to denote that only negative results derived from substantive procedures (for example, recorded and unrecorded adjustments resulting from performing these procedures) provides evidence relevant to the audit of internal control over financial reporting. This change would be consistent with paragraph 144 that states, "The absence of misstatements detected by substantive procedures does not provide evidence that controls related to the assertion being tested are effective."

Par. 124—We believe the requirement that auditors, when evaluating the significance of a deficiency in internal control over financial reporting, "also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs," applies a different definition of a significant deficiency than provided in paragraph 8. Paragraph 8 sets the threshold as a matter "that adversely affects the company's ability to initiate, record, process, or report external financial data." We believe the difference in the definitions in paragraphs 8 and 124 is more than subtle and recommend the Board address this difference in the final standard.

Par. 136-137—We do not believe it is likely that the auditor would perform further tests of controls in the audit of the financial statements in response to identified control deficiencies as a result of tests performed in the audit of internal control. Additionally, we question the necessity of these two paragraphs.

Par. 138-142—We believe the discussion in these paragraphs regarding substantive procedures performed in the conduct of an audit of financial statements is not relevant to an audit of internal control over financial reporting. We also believe certain elements of the discussion in these paragraphs suggest requirements for the audit of financial statements that exceed current requirements under interim auditing standards, and should not be introduced in a standard devoted to auditing internal control over financial reporting. For example, in paragraph 138, the Board states, "the auditor should perform substantive procedures for all relevant assertions for all significant accounts and disclosures." Under existing interim auditing standards (AU 319.107), the auditor should perform substantive procedures for "significant account balances and transaction classes" (but not necessarily for all relevant assertions).

We suggest the Board revise paragraph 141 to indicate that the auditor's substantive procedures should include testing management's process for reconciling the financial statements to the accounting records. In addition, paragraph 139 refers to the term "significant risks" but does not define it.

We urge the Board to clearly identify all the changes being made to the Board's interim professional standards as a result of the Proposed Standard. Inclusion in the Proposed Standard of important performance requirements for auditors that relate to, or differ from, interim professional standards without clearly identifying such changes and their applicability increases the risk that such changes might not be fully understood. We also urge the Board to consider whether certain of these matters should be exposed for public comment separately rather than making "conforming" changes to interim professional standards that have not been previously identified in the Proposed Standard.

Par. 145—We suggest the Board include a discussion in the Proposed Standard as to the types of documentation of the entity's systems and controls the auditor should retain in the working papers to support his or her assessment of the design and operating effectiveness of internal control over financial reporting. We believe this is particularly important in light of the extensive documentation that management will prepare to support its assessment of the design and operating effectiveness of internal control over financial reporting. For example, will it be appropriate for the auditor to refer to management's documentation or should the auditor include copies of all items of management documentation relevant to his or her evaluation of internal control over financial reporting? If the auditor can refer in his or her working papers to management's documentation, should the auditor obtain management's agreement that it will retain such documentation in its current form for a period of no less than seven years? If the auditor intends to use the results of testing performed by management and others, does he or she need to retain copies of the original working papers documenting the performance of and conclusions from these tests?

Par. 168—We believe the premise for this paragraph is incorrect, because an audit of internal control over financial reporting performed under this Proposed Standard will be in conjunction with an audit of the financial statements. The decision as to principal auditor would be made based on an analysis of the facts and circumstances relating to the audit of the financial statements.

We also suggest this paragraph discuss the situation where the decision whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment, but the report on internal control over financial reporting would not make a similar reference because management's evaluation ordinarily would not extend to controls at the equity method investee.

Par. 181-182—We suggest the Board provide additional guidance on the specific procedures to perform when the auditor is consenting to the inclusion of his or her report on internal control over financial reporting in a securities filing.

Par. 186—We suggest the Board state in paragraph 186 that foreign private issuers filing Forms 20-F and 40-F are not subject to quarterly reporting requirements and therefore the auditor's responsibilities would only extend to the certifications in the annual report.

Par. 194—The discussion of the effective date of the Proposed Standard does not make clear when the responsibilities for evaluating management's certification disclosures described in paragraphs 183-189 are first applicable. For instance, for a calendar-year issuer that is required to include its first report on internal control in its annual report for the year ended December 31, 2004, would these responsibilities commence in the first quarter of fiscal 2004 or the first quarter of fiscal 2005?

Appendix B—We suggest the Board clarify that the performance requirements and guidance in Appendix B only apply to an audit of internal control over financial reporting and do not apply to an audit of financial statements.

Appendix B, Par. B11—We understand this paragraph is meant to require that the auditor first identify, evaluate, and test controls at individually important locations and business units, including those business units or locations where there are specific risks. However, the paragraph states if this approach does not result in the auditor testing a *large portion* of the company's operations and financial position, he or she should expand the number of business units and locations evaluated in this manner. We suggest the Board clarify the term "a large portion" in this paragraph to better define what is considered an appropriate threshold.

Appendix B, Par. B13—We recommend the Board clarify whether "company-level" controls in the table refer to the same controls described in paragraph 53, or a narrower subset of those controls. If they are a subset, we recommend changing the terminology in the table to reflect the difference.

Appendix B, Par. B14-16—We suggest the Board provide guidance indicating that certain entities that are not service organizations as defined in AU324 but which provide information affecting the financial statements of the issuer (e.g., amounts covered by reinsurance contracts, information provided by actuaries) are not within the scope of the company's assessment of internal control over financial reporting.

Appendix B, Par. B15—We suggest the Board clarify in the last sentence of this paragraph those situations where management's evaluation of internal control over financial reporting would extend to controls at an equity method investee. Otherwise, we suggest the Board delete the word "ordinarily."

Appendix B, Par. B18—We believe the example is inappropriate. If an account is material to the financial statements, the account should be significant to both the audit of the financial statements and the audit of internal control over financial reporting.

Appendix B, Par. B24-39—We have the following observations and recommendations regarding the section titled *Use of Service Auditor's Report*.

The title of this section should be changed from *Use of Service Auditor's Report* to something such as *Use of Service Organizations*. The use of a service auditor's report is only one way of obtaining the required information when the company uses a service organization. This section should address (1) when a service organization is important to the audit of internal control over financial reporting and (2) what management and the auditor should do for purposes of the audit of internal control over financial reporting when a service organization is used.

It is not clear how this section relates to the existing guidance in AU324. For example, these paragraphs summarize certain (but not all) material in AU324 and, in doing so they alter the current content of AU324. For example, paragraph B27 states:

"Paragraph .07 of AU324, Service Organizations, describes the procedures that management and the auditor should perform with respect to the activities performed by the service organization, which include:

- Obtaining an understanding of the controls at the service organization that are relevant to the company's internal control over financial reporting, and
- Obtaining evidence that the controls that are relevant to management's assessment and the auditor's opinion are operating effectively."

However, AU324.07 does not contain this guidance, but instead includes guidance on how a service organization affects the understanding needed by the auditor in planning the audit. In the context of AU324, this clearly means the procedures to obtain evidence to support the opinion on the financial statements, not to express an opinion on internal control, because AU324 was never intended to address the "audit of internal control." Further, there are several references to the "audit" in this section (e.g., paragraphs B29, B31, B32, B33), without clarifying whether this guidance replaces or merely changes the existing (and more complete) guidance in AU324 regarding the procedures to obtain evidence to support the opinion on the financial statements. Finally, this section appears to modify the opening paragraphs of AU324 that define when a service organization is part of the company's information system (e.g., B26 and AU324.03).

We believe the proposed rules should (1) refer to AU324 for definitions of terms and guidance on the procedures the auditor should perform in obtaining evidence to support the opinion on the financial statements, and (2) include only additional considerations and additional (or changed) procedures required to support an opinion on internal control.

Additional specific comments on this section are:

1. Paragraph B26—Should the word "reported" in the second bullet be "recorded?"

2. Paragraph B27—In addition to misstating the material in AU324.07 as described above, the phrase "nature, timing and extent of evidence" is unclear. We believe this should be changed to something such as "nature, timing and extent of procedures to obtain evidence."

3. Paragraph B28—This paragraph does not recognize the fact that the service organization has a relationship with the "user organization," not the "user auditor" (which are defined terms in AU324.02.) We believe one of the fundamental changes in the relationship between the service organization, its users, and auditors resulting from Section 404 reporting is that the user organization—that is, the company making the assessment on internal control—now has a vital interest and need to obtain information about the controls at a service organization to support its assessment. We believe this paragraph misses this point. The service organization may do things to assist both its user—the company—and the auditor.

4. Paragraph B30—The summary of the SAS 70 opinion is incomplete. It omits the very important portion of the opinion that the controls described have been placed in operation.

5. Paragraph B31—The statement, "this report does not provide any evidence of the operating effectiveness of controls," changes the guidance in AU324.12 that states, "Such a report is not intended to provide any evidence of the operating effectiveness of the relevant controls." This is an example of the difficulty of paraphrasing or summarizing the material in existing standards. We believe it would be better to simply refer to existing AU324 than to restate it in different words that will inevitably have different meanings. However, if this standard does summarize or restate existing guidance in the interim standards, we believe it is imperative that those standards be amended to reflect the conforming changes being made through the new standard being adopted by the Board.

6. Paragraph B32—The first half of this paragraph summarizes the existing guidance in AU324.18-19; however, it does not contain all of the guidance. Again, we believe the Proposed Standard should clearly indicate how existing guidance is being changed. Further, this paragraph does not refer to management. As noted above, we believe one of the fundamental changes resulting from Section 404 reporting is that management also has a need for information about the service organization's controls to support its assessment. The last half of B32 is flawed in that it refers only to the auditor's needs.

7. Appendix B, Paragraph B33—We suggest the list of sources of information for the auditor described in this paragraph include the documentation and evaluation of controls at the service organization that management obtains as part of its required assessment of internal control over financial reporting as described in paragraph B25.

Appendix C—We believe the material in Appendix C raises many questions as to the scope of controls over the safeguarding of assets that are to be included in the assessment of internal control over financial reporting. We recommend the Board clarify that material weaknesses relating to controls over the safeguarding of assets would exist only when the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

****

We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Very truly yours,

Ernst + Young LLP