From: seetheforrestnotthetrees@rcn.com
Sent: Friday, November 21, 2003 4:54 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008

Distinguished Board Members,

When Chairman McDonough kicked-off the July 29th roundtable discussion on the reporting of internal control that preceded the proposed audit standard he said "In my view, good internal controls are cost effective, and once put in place more than justify the expense involved" – a statement with which I strongly concur.

However, I do not agree with the proposed standard since it requires the external auditor to perform significant audit work without adequate consideration of the additional costs and benefits involved. The roundtable discussion lacked sufficient debate on this point.

In fact there was even a suggestion to the board that "the cost benefit analysis really isn't the right way to look at things". Since I do not see an analysis of the relevant costs and benefits of the proposed audit standard (versus the cost and benefit of internal controls themselves which was discussed), the Board appears to have taken this suggestion to heart. In my opinion, the failure to acknowledge the basic fact that resources always have constraints has resulted in an unbalanced standard, despite the clear intention of the Board to contrary.

I respectively suggest that the Board analyze and give serious consideration to the expected costs and benefits of implementing any final standard. Without this type of analysis, there is a high risk that the standard could have unintended consequences.

For example, rather than being seen as an effective tool of management, internal control could be seen "as a necessary burden, imposed by regulators or by the dictates of overzealous bureaucrats" (COSO report page 14).

Another unintended consequence of setting the attestation bar too high could be the addition of controls based on the suggestion of conservative or inexperienced external auditors. A recent article describes how a big 4 accounting firm was looking to borrow twenty auditors from its sister operation in South Africa to deal with the increased workload. This is a natural response to a proposed standard that self proclaims that the audit of internal control over financial reporting "is an extensive process". The second Generally Accepted Auditing Standard related to field work already requires the auditor to obtain a sufficient understanding of internal controls. This standard clearly takes into account the cost benefit aspect and is used by the auditor to determine how much substantive work is to be performed. Were recent audit failures caused by deficient audit standards, or deficient audits?

A final unintended consequence to consider is a widening of the expectation gap. In your Release No. 2003-017 you state that “regardless of how well any system of internal control over financial reporting is designed and operating, it cannot provide absolute assurance of achieving financial reporting objectives because of inherent limitations. These inherent limitations exist because internal control over financial reporting is a process that involves human diligence and compliance and, consequently, can be intentionally circumvented.” Likewise, COSO points out that “internal control sometimes is looked upon as a cure-all for all real and potential business ills. This view is misguided. Internal Control is not a panacea."

In response to specific questions, I offer the following comments:

Question 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?

No. As discussed above, I believe you would be giving people a false sense of security and not properly acknowledging the significant inherent limitations of internal controls.

Question 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?

No. Not as the standard is written. I believe you have set the bar too high and that the demonstrated incremental benefits of the audit do not warrant the incremental costs. The result of the bar being set too high is that the auditor will need to redo significant work already required to be performed by management under Section 404(a) without demonstrating value of the redundancy.

When the concept of redundancies was discussed at the July 29th roundtable, an analogy was drawn between the extra audit work required and the fact that there are two engines on a plane.

To understand the failure of this analogy, one needs to consider the reason why the law was passed so quickly. The specific context included high profile cases like Enron, WorldCom and Tyco. In this context the correct analogy to use would be that four engines are now going to be required on every plane because it was discovered that in recent cases pilots (CEOs) were shutting off the engines (bypassing the internal controls) while they each wore a parachute (lack of personal responsibility). I believe the law passed the House and Senate on a combined vote of 523-3 because the lawmakers saw the need to hold corporate leaders personally responsible for their companies’ financial statements and their internal controls, and not to add punitive costs to a process without corresponding benefit. As President Bush mentioned when he signed the Act, the purpose was to “punish wrongdoers”. The audit standards should not punish everyone with overarching unjustified requirements.

In retrospect, if the allegations against Mr. Scrushy of HealthSouth are true, would the “internal control audit” as proposed been an effective deterrent to his alleged behavior? Or would a more effective deterrent to him been the fact that he is facing a possible maximum sentence of 650 years in prison and $315 million in forfeitures and fines?

While I am the program manager for a Fortune 500 company’s 404 effort, the views expressed above are my personal opinions.

Respectfully submitted,

Steven A. Forrest