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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

Ladies and Gentlemen:

Citigroup Inc. appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (the "Board" or "PCAOB") Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. Citigroup is supportive of the Board's efforts to establish professional standards governing the independent auditor's attestation and reporting on management's assessment of the effectiveness of internal control.

We agree with the overall objective of the proposed standard, and believe that a new auditing standard will assist a company's independent auditors in reporting on management's assessment of the effectiveness of internal control. However, as explained more fully below, we believe that certain aspects of the proposed standard should be reconsidered. In general, we believe that the standard is too prescriptive and that independent auditors must have significantly more flexibility to determine the nature and scope of their testing, including the extent of their reliance on the work of others, in order to form an opinion on the effectiveness of a company's internal controls. We are particularly troubled that the proposed standard does not adequately recognize the benefits of a strong internal audit function.

The accounting abuses which led to the Sarbanes-Oxley Act and this proposed auditing standard resulted from the breakdown of key controls over high-risk areas of financial reporting. By prescribing limits on the extent to which the auditor can use the work of management and others, the proposed standard draws the auditor's attention and resources away from areas of high audit risk to areas that, for many companies with sophisticated systems, would otherwise be deemed to represent low audit risks (e.g., internal controls related to certain routine and recurring period-end financial reporting processes).

Using the Work of Management and Others

The proposed standard prescribes certain circumstances where the independent auditor would be precluded from using the results of testing performed by management and others. These prohibitions include:

(1) Controls that are part of the control environment, including controls specifically established to prevent and detect fraud that is reasonably likely to result in material misstatement of the financial statements;

(2) Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications);

(3) Controls that have a pervasive effect on the financial statements, such as certain information technology general controls on which the operating effectiveness of other controls depend; and,

(4) The proposed auditing standard would not allow the auditor to use the work performed by management or others to satisfy the requirement to perform walkthroughs.

Additionally, the proposed standard prescribes two areas where the independent auditor's use of the results of procedures performed by management and others should be limited:

(1) Controls over significant non-routine and nonsystematic transactions (such as accounts involving significant judgments and estimates); and,

(2) Controls over significant accounts, processes or disclosures where the auditor has assessed the risk of failure of the controls to operate effectively as high.

The specific internal controls in place, the inherent risks underlying those controls, and the competency of management, internal audit and others in reviewing and testing those controls, may vary greatly from company to company. The limitations and prohibitions the proposed standard places on the use of the work of management, internal audit and others, are unduly focused on specific types of controls without regard to the risks inherent in those controls. As a result, the proposed standard requires excessive independent testing by the auditor where the inherent audit risk might be deemed low. The standard should place more emphasis on the identification of those controls that represent the greatest audit risk and focus on the independent auditor's exercise of professional judgment in assessing those controls. The proposed standard should be amended to permit the independent auditor to use the work of management and others based on their assessment of the risks being reviewed, their understanding of the control environment, and the competency of the party performing the primary work. Furthermore, the auditor should be permitted to reduce the scope of their testing in favor of the work of others in recurring audits of those controls, especially where those controls are deemed to have low inherent risk. This will promote a more effective and efficient audit, particularly for large and complex organizations.

Limitations related to routine processes

We believe that the limitations related to the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements, are unduly restrictive. In paragraph 106, the proposed standard supports the independent auditor's use of the work of management and others to assess controls over the routine processing of significant accounts and disclosures, without specific limitation. For a company with sophisticated systems, the controls over the period-end financial reporting process are basic and routine and we believe that the limitations on the independent auditor's use of the work of management and others are contradictory to the guidance in paragraph 106. These controls are extensively reviewed, monitored and tested by management and internal audit. The blanket limitations related to the routine processes noted above will result in an excessive amount of work for the independent auditor in areas where it would be more sensible and efficient to use the work of others. We believe that the independent auditor should have full discretion in terms of their use of the work of others in these areas, particularly where the inherent audit risks are deemed low.

Limitations related to non-routine and non-systematic transactions

We believe that the limitation related to significant non-routine and nonsystematic transactions (such as accounts involving significant judgments and estimates) is too restrictive. Such controls could encompass a broad spectrum of activities with varying levels of audit risk. Certainly, the audit risks inherent in many such controls require that the auditor perform the primary work, but the assessment of other controls with lower audit risk should be subject to the auditor's discretion. The proposed standard indicates that the reliance on the work of management and others in such circumstances should be "limited", but there is no explanation of what "limited" means. We believe that the independent auditor should evaluate each type of transaction and, using their professional judgment, determine the scope of their work and the extent of their testing based on their knowledge of related internal controls, documentation of processes, the competence of company personnel involved and the auditor's overall familiarity with these non-routine and non-systematic transactions.

Limitation related to walkthroughs

While Citigroup supports the notion that walkthroughs are important, their extent and timing should be left to the judgment of the auditor. The proposed standard does not allow the independent auditor to use the work performed by management or others to satisfy the requirement to perform walkthroughs. Walkthroughs are described as encompassing the entire process of initiating, recording, processing and reporting individual transactions, and controls for all five internal control components and fraud. We believe that this limitation is too broad in scope and that it will lead to the independent auditor's duplicating the work of internal audit in many cases. The limitation also fails to recognize that where certain processes are static it is not efficient or cost effective to prohibit using the work of management and others. In a large and complex organization, this limitation will place an overwhelming burden on the auditor that will draw their resources away from addressing more substantive issues where the audit risk is greater. We believe that the independent auditor should be permitted to use their professional judgment in determining where it is appropriate to use the work of internal audit and others to complete a walkthrough of controls. At the very least, the standard should permit the auditor to rotate its walkthrough testing, alternating with the internal auditor, so that the auditor can focus on areas of change and higher risk.

Limitations related to the work of internal audit

We are particularly troubled that the proposed standard does not adequately recognize the benefits of a strong internal audit function. The independent auditor should be able to place considerable reliance on the work of internal auditors if internal audit is sufficiently independent of management, has a strong reporting relationship directly with the audit committee and performs appropriate tests of controls. In a large and complex multi-national company such as Citigroup, the internal audit function performs a critical role in assessing the company's internal controls. At Citigroup, the internal audit group includes more than 700 professional audit staff who perform an independent and objective review of the Company's operations and procedures and report their findings to management and the audit committee. Their work includes a rigorous assessment of the Company's risk and control environment through the evaluation of financial, operational, and administrative controls; risk management practices; and adherence with laws, regulations and company policies. During 2003, Citigroup's internal audit group is expected to spend approximately 1,000,000 hours performing their work, including approximately 175,000 hours reviewing and testing technology operations with the majority covering information technology general controls. The internal audit function is independent of management and reports directly to the audit committee. Internal audit has no authority or responsibility for the activities it audits. Additionally, they neither develop nor install systems or procedures, prepare records, or engage in any other activity that would normally be audited.

As noted above, the independent auditors are limited from using the work of internal audit with respect to walkthroughs and in the assessment of certain important processes including the assessment of controls over the period-end financial reporting process, over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements. These functions are generally not where audit risk lies. The proposed standard also prohibits the use of the work of internal auditors in the testing of certain information technology general controls on which the operating effectiveness of other controls depends. However, in paragraph 108, the proposed standard acknowledges that, "Internal auditors would normally be expected to have greater competence with regard to internal control over financial reporting and objectivity than other company personnel. Therefore, the auditor may be able to use the results of their procedures to a greater extent than the results of procedures performed by others. This is particularly true in the case of internal auditors who follow the International Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors. At companies where the importance of the internal audit function results in a high degree of competence and objectivity and their work is extensive, the auditor could use their work to the greatest extent an auditor could use the work of others."

We are very concerned that the limitations imposed by the proposed standard do not recognize the competency and objectivity of the internal audit function and the significant amount of effort this group puts forth in performing their duties. It seems irrational that our internal audit group will perform approximately 175,000 hours auditing technology operations including IT general controls, and the proposed standard would preclude the independent auditor from using that work. These limitations will only serve to marginalize the efforts of the internal audit function to the detriment of the overall control environment. In determining the extent to which they will use the work of internal audit, the independent auditor should determine whether the internal audit function is independent of management, if they are qualified to do the work and whether the scope of their testing is adequate. Regardless of the work done by the independent auditor, management will continue to require internal audit's attention to these areas. This will result in a duplication of effort and significant additional cost with no real benefit. In order for management to complete its assessment of internal controls, management and internal audit are necessarily involved in the review and testing of critical areas, and we feel strongly that the independent auditors should have the flexibility to consider those efforts when determining the scope of their testing.

Requirement for the Auditor's Work to Provide the Principal Evidence for the Audit Opinion

In addition to the limitations described above, the proposed standard requires that, on an overall basis, the auditor's own work must provide the principal evidence for the audit opinion (paragraph 109). It is unclear what is meant by "principal evidence". Since internal controls may affect many individual account balances and related financial statement disclosures, it is difficult to relate the testing of a particular internal control to the either the size of an individual account balance, a particular disclosure or the financial statements taken as a whole. Moreover, when any level of reliance is placed on the work of others it may be impossible to assert that the independent auditor has met the "principal evidence" threshold. Should "principal evidence" be measured in terms of hours worked, the number of individual transactions tested, or the size of individual items tested? Should it be measured in terms of individual account balances at a point in time affected by a particular control or is it somehow measured by the risk inherent in a particular control?

We believe that it will not be possible to measure in a meaningful way the testing performed by the independent auditor against the work performed by management and others to determine whether the independent auditor's own work has provided the principal evidence for the audit opinion. This is particularly true since the independent auditor, management, internal audit and others will be assessing internal controls with varying levels of inherent risk that affect the same individual account balances. For a large, complex company such as Citigroup, we believe that achieving the level of "principal evidence" that is required by the proposed standard (regardless of how that is measured), will necessitate that the independent auditor perform an unreasonable amount of testing in light of the extensive work performed by the internal audit group and management. At a high level, the concept of "principal evidence" may be relevant to the question of whether to base the opinion in part on the report of another auditor, but is not operable in respect of the interrelated controls that may be tested by both the auditor and others. We believe that the requirement that the independent auditor's own work provide the principal evidence for the audit opinion should be removed from the standard as it is inoperable and is likely to cause considerable confusion. The primary consideration should be whether the overall scope and nature of the work performed supports the audit opinion, and we believe the standard provides sufficient guidance for the independent auditor to plan and perform the audit to obtain reasonable assurance about the effectiveness of internal control without the "principal evidence" requirement.

Use of a Service Auditor's Report

The proposed standard directs an auditor to determine whether management has evaluated the operating effectiveness of controls based on procedures sufficient to assess their operating effectiveness. Such procedures include the use of a service auditor's report. However, the proposed standard does not provide adequate guidance with respect to which service auditor reports are required and how often the reports should be obtained. With respect to financial statement audit reports, SAS 70 provides guidance as to the level of review and the types of service organizations that should be reviewed during an audit of financial statements. SAS 70 states that the significance of the controls of the service organization to those of the user organization depends on the nature of the services provided by the service organization, the nature and materiality of the transactions it processes for the user organization and the degree of interaction between the service organization's activities and those of the user organization. We encourage the Board to adopt similar guidance, as we believe that concepts of materiality of the controls related to service organizations and "facts and circumstances" determinations are appropriate to promote efficient and effective audits of internal control. We believe that an auditor should be permitted to limit his or her review to those service organizations providing services likely to have a material impact on the financial statements.

Furthermore, in the case of service organizations located where U.S. auditing standards are not applied, SAS 70 reports may not be available. We believe the Board should permit the use of comparable reports under non-U.S. generally accepted auditing standards.

Definitions of "Significant Deficiency" and "Material Weakness"

The Board is likely to receive many comments on the proposed standard's definitions of "significant deficiency" and "material weakness" because these definitions represent a lower threshold for reporting internal control deficiencies than the current definitions established in AU §325. These definitions are critical not only because of the reporting requirements they carry, but also because of the resources a company must employ to implement corrective action. As discussed in more detail below, we believe the proposed thresholds for identifying a significant deficiency and a material weakness are too low and this will cause management and the audit committee to focus limited company resources on issues that represent lower risks to financial reporting and may otherwise be sufficiently mitigated by compensating controls.

The proposed standard states that an internal control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A "significant deficiency" is defined as an internal control deficiency (or a combination of internal control deficiencies) that, by itself or in combination with other internal control deficiencies, results in **more than a remote likelihood** that a misstatement of the company's annual or interim financial statements that is **more than inconsequential in amount** will not be prevented or detected. We believe that the threshold for identifying a significant deficiency is too low. Clearly the Board did not intend that every internal control deficiency should be considered a significant deficiency, however, we see very little space between the two. In practical terms, it will be very difficult to assert that any internal control deficiency does not meet the "more than a remote likelihood" and "more than inconsequential in amount" thresholds.

We would agree that management should address all internal control deficiencies. However, we are concerned the definitions as proposed present such a low threshold that management and the auditor may report items to the audit committee that are not indicators of "significant deficiencies", but are more recommendations of best practices or deficiencies that are otherwise sufficiently mitigated by compensating controls. In a large and complex organization with worldwide operations and multiple product offerings, certain internal control deficiencies that in the opinion of management and the auditors do not present a significant risk to the consolidated company will nonetheless be reported as "significant deficiencies". We believe that it will be more effective to provide a greater distinction between internal control deficiencies and significant deficiencies so that senior management and the audit committee can focus resources on those issues that warrant more attention. With this in mind, we suggest the Board consider adopting a threshold for identifying significant deficiencies that is at least "reasonably possible" as described in FAS 5.

The PCAOB has introduced the term "more than inconsequential" in the definition of a significant deficiency. We believe this is a new term in accounting literature and, as such, the proposed standard should provide guidance on how to determine if an amount is "more than inconsequential". In order to ensure that the audit committee's attention and company resources are focused on the most important internal control issues, we suggest that the Board adopt a definition such as "significant, but less than material".

We are also concerned that the definition of a "material weakness" is inconsistent with the definition of that term under the SEC's final rules relating to management's assessment of the effectiveness of internal control over financial reporting. The SEC's Section 404 Release refers to SAS 60 when defining a "material weakness". The SEC's Release states, "a "material weakness" is defined in Statement on Auditing Standards No. 60 (codified in Codification of Statements on Auditing Standards AU §325) as a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a **relatively low level** the risk that misstatements caused by errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions." In contrast, the proposed standard defines a "material weakness" as "a significant deficiency that, by itself, or in combination with other significant deficiencies, results in a more than a **remote likelihood** that a material misstatement of the annual or interim financial statements will not be prevented or detected." The difference between a "remote likelihood" and a "relatively low level" creates the possibility that there could be a difference in the application of the final auditing standard and the SEC's Release. We believe that the definition in the proposed standard will be difficult to reconcile with the definition in the SEC's Release. Accordingly, we believe that the proposed standard should adopt the existing AU §325 definitions of a material weakness and a significant deficiency (reportable weakness).

Identifying Significant Deficiencies

The proposed standard provides a list of certain circumstances that should be regarded as at least a significant deficiency in internal control and strong indicators that a material weakness in internal control exists. As indicated in paragraph 126 of the proposed standard, such circumstances include:

- Restatement of previously issued financial statements to reflect the correction of a misstatement.
- Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting. (This is still a strong indicator of a material weakness even if management subsequently corrects the misstatement.)
- Oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective. (Paragraphs 56 through 59 present factors to evaluate when determining whether the audit committee is ineffective.)
- For larger, more complex entities, the internal audit function or the risk assessment function is ineffective.

- For complex entities in highly regulated industries, an ineffective regulatory compliance function.
- Identification of fraud of any magnitude on the part of senior management.
- Significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time.

We believe that it is not appropriate to include such a list in the final standard. This list may be intended to create a bright-line standard for identifying significant deficiencies, but, in practice, we believe it will force the reporting of certain issues that do not rise to the level of a significant deficiency in the opinion of management and the independent auditor. Certain items on the list are vague and could be subject to a broad interpretation. For example, several of the items use the term "ineffective" which is not adequately defined in the proposed standard. We agree that the items on this list could easily rise to the level of a significant deficiency and even a material weakness. However, since the circumstances surrounding any of the items on this list and the potential impact on the internal control environment will vary for every company, we believe it is not appropriate to create such a bright-line for reporting significant deficiencies. We feel that the final standard should not include any specific list of deficiencies, significant deficiencies or material weaknesses.

Consideration of Regulatory Compliance in the Assessment of Internal Control

The proposed standard states that the operations and compliance with laws and regulations directly related to the presentation of and required disclosures in financial statements are encompassed in internal control over financial reporting. Where a company operates in highly regulated industries as Citigroup does, the consideration of compliance includes many areas that are directly related to financial reporting and many areas that are not. For example, sales practices, privacy standards, staff licensing requirements, and trade supervision are important areas of regulatory compliance, but they are not directly related to financial reporting. While such areas may be subject to review under other laws and regulations, we believe that these areas of regulatory compliance that are not directly related to financial reporting should be outside the scope of the proposed standard. Paragraph 126 of the proposed standard is written very broadly, indicating that for complex entities in highly regulated industries, an ineffective regulatory compliance function would be regarded as at least a significant internal control deficiency. We are concerned that this paragraph does not distinguish those areas of regulatory compliance that relate to financial reporting from the areas that do not. As written, this paragraph seems to imply that the independent auditor is required to perform an assessment of controls that are not directly related to financial reporting. There is no such requirement under the SEC's Release or this proposed standard and the auditor might not be in a position to determine if controls unrelated to financial reporting are effective. Notwithstanding our comment above regarding the list of significant deficiencies in paragraph 126, we recommend that the standard be amended to clarify that only regulatory compliance directly related to financial reporting is within the scope of the standard.

Reporting of "Except For" Conclusions

The Board has asked whether there are circumstances where a qualified "except for" conclusion would be appropriate. As the Board noted, the SEC's final rules implementing Section 404 state, "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." We do not believe this precludes an "except for" conclusion.

There are certain circumstances where management and the independent auditor will not have an opportunity to assess the internal controls of a part of a company, particularly with respect to acquisitions that take place close to the reporting date. This will be a particular issue in acquisitions of certain non-public US companies and foreign companies that have not been subject to the requirements of Section 404. We believe that the inability to assess the internal control environment of a recently acquired business is not, by itself, indicative of a significant deficiency or a material weakness in internal control. In such circumstances, management should be permitted a reasonable amount of time, given the size and complexity of the acquired business, to assess the internal controls of the acquired company and the independent auditor should be permitted to issue an opinion that is "except for" the acquired business.

Audit Committee Pre-Approval of Internal Control-Related Services

The proposed standard expands the SEC's auditor independence rules related to pre-approval of non-audit services by requiring that any non-audit service related to internal control be specifically pre-approved by the audit committee, rather than being pre-approved as part of a category of non-audit services related to internal control.

The audits of internal control, in many cases, are required by regulators in the U.S. and overseas. In a large complex organization, there can be hundreds of such reviews required each year. The audits are normally part of the financial statement audit, or a separate engagement specifically for the purpose of issuing an opinion on the effectiveness of the internal control environment (FDICIA or SAS 70 reviews are two examples). To require the pre-approval of the audit committee for each and every internal control review would place undue burden on the audit committee. A specifically pre-approved limit for these type of reviews delegated to senior management would be more appropriate.

Documentation Standards

The proposed standard in paragraph 43 defines the standards for the external auditor to determine whether management's documentation provides reasonable support for its assessment of internal control effectiveness. The standard would dictate the exact items that the auditor would look for including:

- Design of controls over relevant assertions related to all significant accounts and disclosures in the financial statements, including all five components in paragraph 50.
- Information about how significant transactions are initiated, recorded, processed, and reported.
- Enough information about the flow of transactions to identify where material misstatements due to error or fraud could occur.
- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties.
- Controls over the safeguarding of assets.
- The results of management's testing and evaluation.

We believe that the requirement to include all five components of internal control as part of the individual documentation related to "all significant accounts and disclosures" is unduly prescriptive and will add tremendous burden to management's assessment. While we support the need to document the five components of internal control as stated in paragraph 50, this can be done at a business level, or company level, and should not be required at an individual control level. We believe that paragraph 44, which allows for many forms of documentation and requires no one specific form of documentation, is the right standard that the PCAOB should adopt. Any list in paragraph 43 should include language stating that the items on the list are examples, and are not required at the individual control level. Alternatively, the list should be deleted and included as an appendix of examples. We are also concerned with the use of language such as "enough information" leaves this open to interpretation and should be deleted.

Overall, the level of documentation should be a matter of judgment depending on the level of complexity of the organization, size, systems etc., and no one approach to documentation should be prescribed.

Report Date

The proposed standard indicates that the independent auditor cannot audit internal control without also auditing the financial statements. As a technical matter, we do not believe that this requirement should preclude the independent auditor from issuing their report on internal controls at a date subsequent to the financial statement audit report date.

The proposed standard indicates that an auditor could issue an updated report on internal controls in response to the subsequent discovery of information existing at the date of their original report on internal controls if such information would have affected their internal control opinion (see paragraph 180). If the information leading to an updated internal control report does not impact the original financial statement audit opinion, this could create a situation where the revised internal control report and the audit report would have different dates. While we expect that the internal control report and the financial statement report will have the same date because the work on both will coincide, we believe it is more appropriate to tie the date of the internal control report to the completion of the fieldwork related to the assessment internal controls. Ultimately the dates on both reports will be driven by the underlying requirement for the reports (e.g., the requirement to file a certification with the SEC or the issuance of the financial statements). As a technical matter, we believe that the proposed standard should be amended to remove the requirement that the two opinions share the same date.

Conclusion

Citigroup is appreciative of the opportunity to comment on the proposed auditing standard and we thank you for considering our comments. If you have any questions regarding this letter, please contact me at your convenience.

Sincerely,

William P. Hannon
Controller