Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision

December 1, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 008

Dear Board Members:

We appreciate the significant efforts of the Public Company Accounting Oversight Board (PCAOB) to propose and implement enhanced standards for the auditing of and reporting on the internal controls over financial reporting of public companies. In addition, we found the roundtable discussion on July 29, 2003, to be a useful and important aspect of the due process in the development of this proposal and we appreciated the opportunity to have participated in that discussion. Effective auditing, strong internal controls, and reliable financial reporting are critical to the safety and soundness of the organizations we regulate and, thus, we recognize the importance of an open and productive dialogue on these matters of mutual interest.

Since 1993, the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (collectively, the Agencies) have been responsible for evaluating insured depository institutions' implementation of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA 112). As you know, FDICIA 112 requires management of insured depository institutions with total assets of $500 million or more to annually assess and report on whether their internal controls over financial reporting are effective, and requires an independent accountant's attestation report on management's assertion. Thus, our collective experience examining depository institutions' internal control assessments and independent accountants' attestation reports provides unique insight into the practice of auditing and reporting on internal controls over financial reporting.

Overall, the PCAOB's proposed auditing standard, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," is a significant improvement over the existing attestation standard, "Reporting on an Entity's Internal Control Over Financial Reporting." The proposed standard presents improvements in the areas of (1) identifying management's responsibilities in an internal control audit, (2) explaining the relationship between audits of internal controls and of financial statements, (3) describing the effect of internal control deficiencies on the auditor's conclusion, and (4) specifying appropriate reporting approaches.

Based upon our review of the proposed standard, we are providing you with specific answers to certain questions in the release, as well as additional comments that we recommend to further improve the standard. The attachments to this letter provide our detailed comments. Please feel free to contact us if you wish to discuss our comments further.

Sincerely,

Zane D. Blackburn
Chief Accountant
Office of the Comptroller of the Currency

Gerald A. Edwards, Jr.
Associate Director and
Chief Accountant – Supervision
Federal Reserve Board

Robert F. Storch
Chief Accountant
Federal Deposit Insurance Corporation

Timothy J. Stier
Chief Accountant
Office of Thrift Supervision

Attachment 1 – Response to Specific Request for Comments - PCAOB Rulemaking Docket No. 008
Attachment 2 – Comments on Proposed Auditing Standard – PCAOB Rulemaking Docket No. 008

cc Donald T. Nicolaisen, Chief Accountant, Securities and Exchange Commission
Scott A. Taub, Deputy Chief Accountant, Securities and Exchange Commission
Eric J. Schuppenhauer, Professional Accounting Fellow, Securities and Exchange Commission

Attachment 1
Response to Specific Request for Comments
PCAOB Rulemaking Docket No. 008

General Responses

The federal banking agencies support the position outlined in the PCAOB's proposal with regard to the issues raised in questions 1 – 7, 9 – 10, 13 – 15, 17 – 18, 21 – 22, and 30 – 31. We have, therefore, not provided specific responses to these questions. However, we are providing responses to questions 8, 11 – 12, 16, 19 – 20, and 23 – 29, because we believe the PCAOB will find it useful to consider the agencies' experience with similar matters in the attestation process for internal controls at insured depository institutions.

Specific Responses

Questions regarding evaluation of management's assessment:

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?

Response: In our experience, management's inability to adequately document its internal controls or its assessment of internal controls can be an indicator of a significant control deficiency within an organization. Thus, the standard should require the auditor to evaluate whether documentation deficiencies rise to the level of a significant deficiency or a material weakness as indicated in paragraphs 46, 47, and 125.

Question regarding testing operating effectiveness:

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?

Response: Paragraphs 94 – 100 indicate the timing of the auditor's tests should be adequate to determine whether the controls are effective as of the date specified in management's report. The clear implication of these paragraphs is to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year. Prior evidence would not be sufficient, particularly when business practices and internal controls have changed.

Questions regarding using the work of management and others:

12. To what extent should the auditor be permitted or required to use the work of management and others?

Response: Paragraphs 104 – 105 provide guidance on instances where the auditor is either prohibited or limited from relying on the results of procedures performed by others when rendering an opinion on internal controls. In our experience, auditors have a tendency to rely too heavily on the work of management and others when performing internal control attestations. The inherent risk of such over-reliance diminishes the independence and objectivity of the auditor's opinion on control effectiveness. The requirement that the auditor obtain the principal evidence for the audit opinion would seem to preclude the auditor from relying on the work of management and others for most of the relevant assertions on significant accounts and disclosures. Thus, we recommend that the PCAOB clarify the meaning of the term "use the work of management or others" in the context of paragraphs 104-106. In addition, the standard should better explain the extent to which the results of tests performed by others, such as internal auditors, may or may not be relied upon by the auditor.

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?

    Response: Our expectation is that the principal evidence standard would preclude the auditor from relying primarily on the work of management and others. Thus, the proposed approach appears to be an appropriate benchmark.

Questions regarding evaluating results:

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

    Response: Yes. It appears that an auditor would need to evaluate the severity of all deficiencies to appropriately determine whether the deficiencies collectively or individually rise to the level of a significant deficiency or material weakness. In our experience, auditors routinely make such judgments in the normal course of an audit. As a result, the requirement to assess the severity of deficiencies should not significantly increase the amount of work performed by an auditor.

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?

    Response: Yes. Paragraphs 190 – 192 require auditors to communicate all control deficiencies and fraud to management and the audit committee. This type of communication is consistent with the objective of Section 404 of the Sarbanes-Oxley Act of 2002, which is intended to ensure that the organization maintains an effective system of internal control. Since auditors routinely become aware of deficiencies of lesser magnitude than a material weakness in the course of an audit, there should be little added burden associated with communicating these deficiencies in writing. In addition, written communication provides a

clear audit trail for the audit committee, management, auditors and regulators. In our experience, written communication of all identified deficiencies to management and the audit committee facilitates prompt resolution of the deficiencies.

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

    Response: Yes. Despite the inherent difficulties in evaluating the body directly responsible for appointing and compensating the auditor, it is quite appropriate for the auditor to evaluate the effectiveness of the audit committee. Paragraphs 57 – 58 enumerate factors that the auditor should evaluate related to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting. We believe that auditors have the professional qualifications, experience and knowledge to effectively carry out this responsibility.

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?

    Response: No. Paragraph 59 appropriately indicates that an auditor's determination that an audit committee is ineffective should, at least, be regarded as a significant deficiency. If the auditor concludes that the deficiencies in audit committee oversight rise to the level of a material weakness, the auditor should be required to issue an adverse opinion on the effectiveness of controls. It would seem to be inconsistent with the objective of the standard to suggest that an auditor should withdraw from an engagement rather than issue an adverse opinion on internal control effectiveness.

Questions regarding forming an opinion and reporting:

25. Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?

    Response: Yes. It is appropriate for the existence of a material weakness to result in an adverse audit opinion. Paragraphs 162 – 164 and Appendix A provide appropriate guidance on adverse opinions resulting from the existence of material weaknesses. Based on this guidance, users of internal control reports would reasonably expect the existence of a material weakness to result in an adverse conclusion by both management and the auditor. The only logical outcome of the existence of a material weakness would be that internal control is not effective.

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

Response: No. Paragraphs 15 – 18 explain the inherent limitations of internal control and the level of assurance users expect from reports on internal control. The use of "except for" opinions to explain the impact of deficiencies of a lesser magnitude than a material weakness would not send a clear message to users of internal control reports. Users expect the auditor's report to render an opinion on internal control taken as a whole. Qualified (i.e., "Except for") opinions diminish the usefulness of these reports.

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?

    Response: Yes. Consistent with our responses to questions 25 and 26, users expect audit opinions on internal control to be meaningful. As such, it would be more beneficial to users for the opinion to speak directly to the effectiveness of internal control rather than opine on management's assertion.

Questions regarding auditor independence:

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

    Response: No. The Securities and Exchange Commission (SEC) adequately addressed auditor independence in its final rule release *Strengthening the Commission's Requirements Regarding Auditor Independence*. The PCAOB should work with the SEC to develop questions and answers and other implementation guidance on auditor independence.

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

    Response: Consistent with our response to question 28, we recommend the PCAOB work with the SEC to develop consistent guidance on any prohibition of specific internal control-related non-auditor services.

Attachment 2
Comments on Proposed Auditing Standard
PCAOB Rulemaking Docket No. 008
An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Requirements for Written Representations

Paragraph 128(g) directs the auditor to obtain written representation from management stating whether, subsequent to the date being reported on, there were "any changes in internal control or other factors that might significantly affect internal control." Since the determination of what constitutes a significant change in internal control is subjective, we recommend requiring the auditor to review the documentation management used to make its written representation regarding changes in internal control. This would enable the auditor to make an independent determination as to whether management had a reasonable basis to support its written representation regarding the significance of any changes in internal control.

Appendix A

2. The illustrative reports on the effectiveness of internal control over financial reporting expressing a qualified opinion and disclaiming an opinion, Examples A-3 and A-4 respectively, do not indicate the effect of such opinions on the financial statement audit. We recommend that language similar to that in the last sentence of the "Explanatory Paragraph" of Example A-2, which is an adverse opinion, be included in the illustrative reports for Examples A-3 and A-4.

Appendix B

3. Paragraphs B3, B12, and B13, and Illustration B-1 indicate that it is not necessary to test any controls at locations and business units that "...individually, and when aggregated with others, could not result in a material misstatement to the financial statements." Since controls exist for designated purposes, we do not consider it appropriate or constructive to simply exclude groups of locations and units from potential testing. For the hypothetical company depicted in Illustration B-1, 40% (60 of 150) of the company's locations would never be tested. In our opinion, this process could result in a scope limitation on management's assertion because it, by design, restricts the locations or business units that are actually evaluated by management. While individual locations or business units may not be significant and may not result in a material misstatement to the financial statements as of a point in time, the nature of the activities and transactions at ostensibly "insignificant" locations or business units, together with a lack of managerial oversight and internal control testing, could be conducive to and result in material internal control weaknesses, improper transactions, or fraud. Removing any location or business unit from the population of locations or business units to be considered in the review of internal control or audit of the financial statements could create a wrong impression or create a climate whereby management or other employees may take advantage of the lack of review of internal controls at these so-called "insignificant" locations or business units. We suggest the aforementioned paragraphs and illustration

be revised to require management and the auditor to include testing of at least a sample of the controls over financial reporting at "insignificant" locations or business units to allow management and the auditor to assert that all controls are operating effectively. We believe no business unit or location should be permanently excluded from testing. We recommend paragraphs B3, B12, and B13, and Illustration B-1 be revised to read as follows:

> "Management and auditors should periodically test controls at a sample of locations and business units regardless of whether they are individually significant or, when aggregated, may result in a material misstatement to the financial statements."