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February 2, 2007

Office of the Secretary, PCAOB,
1666 K Street, N.W., Washington, D.C. 20006-2803

Ref: PCAOB
Rulemaking Docket Matter No. 021

Dear Sir:

I have reviewed your latest auditing standard proposals. I currently work with two SEC registrants, mainly in an advisory capacity to assist them to set up internal management processes that will allow them to carry out an effective evaluation of their control processes. I also work with several Canadian public companies that are establishing management control evaluation processes to meet the latest Canadian regulations.

I use your standards as guidance in advising my clients on their internal processes. Many of your proposals will be effective in changing some of the difficulties that both external auditors and management teams are encountering with the existing standards. I do not act as an external auditor. Yet my comments refer to the part of your proposals that change the scope of the external auditors' report. I believe the latest proposals have missed the point of having an external auditor examine and report on these matters.

With respect to the auditors' role in evaluating and reporting on internal controls in a separate report, other than the financial audit report, I believe it was the intention of the Sarbanes Oxley Act to ensure that management's evaluation of controls was based on a process which could be substantiated and which provided appropriate evidence for management to make their conclusions.

13. Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?

I cannot agree with this, as I feel it is entirely the point to involve external auditors to evaluate management's process, and to report on whether the process was sufficiently valid to support management's conclusion. I do not think the auditors need to repeat management's work to be able to conclude on whether it is a sufficient and appropriate basis for management's conclusions or not. A certain amount of testing is required in order to evaluate effectiveness, but it should be a subset with the intention of evaluating the process, not for re-auditing controls as a second exercise. Yet the standard still requires the auditor to test controls and give an opinion, which is what the Act requires management to do already.

Furthermore, the audit report that is suggested in the standard still states "…We also have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X8, based on…". This statement definitely gives the impression that the audit was of management's assessment of an effective control environment, not a separate audit of controls.

The report then goes on to state, "Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits." This is contradictory to the first statement. Is the audit to express an opinion on management's assessment of an effective control environment, or is it an opinion on the company's internal control over financial reporting?

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?

The direct answer to your question is yes, it is possible. Again, I do not believe the point was for the auditors to do an internal control audit. The point was to evaluate management's basis for evaluation of its own controls. In the same way that a financial auditor tests management's financial statements, based on testing and sampling, rather than reperforming all transactions. In order to add value to the reader of management's evaluation report, the auditor should attest on management's process of evaluation, and whether it supports the evaluation itself. The important point is – does management have sufficient basis and evidence to draw the conclusions it has reported, or is it likely that their process is flawed and would not have uncovered a material weakness?

15. Will an opinion only on the effectiveness of internal control, and not on management's assessment, more clearly communicate the scope and results of the auditor's work?

I have already stated under question #13, that I believe the proposed auditor's report is contradictory and unclear as to what opinion is being expressed. The scope and results are not clear, but I would like to take this further.

Presumably management is taking steps, above and beyond its daily management activities, in order to perform an evaluation of its control effectiveness and to meet its obligation under the Act. While there are no standards that management is obliged to follow, presumably most are attempting to perform a valid, professional exercise which will obtain sufficient evidence to support their conclusions. While it is not independent, management is generally trying to achieve an auditors' level of evidence. The SEC has given guidance to management, and many managers are also using the audit standards of the PCAOB and other professional standards to design their assessment programs.

In effect, under your proposal, what will happen is that both management and the external auditor will perform an audit of controls.

Both audits could in fact arrive at the conclusion that there are no material weaknesses in controls. In fact, we would expect that this will happen in the majority of cases. What is the benefit of having two such reports?

Consider the following possibility. The external auditor's conclusion, after testing controls according to professional auditing standards, is that there were no material weaknesses found and controls are effective. At the same time management has made the same conclusion, but without actually gathering any, or gathering much less, persuasive evidence to support its conclusions.

Since the auditor's conclusions are based on testing it is probable that their tests were appropriate and and supportable, and their conclusions were correct according to professional standards. Yet at the same time management's conclusions were not based on a rigorous process or evidence. Under the new standards what would the auditor have to say about this? It appears to me that nothing would be reported publicly, although the auditors may inform the audit committee.

Also consider the situation where the auditor has discovered a material weakness based on testing, but management had not identified this weakness. Consider also that management's failure was due to a poor evaluation process, rather than say a different test sample. The poor evaluation process may extend to other control areas where no weaknesses were found by the external auditor. The auditor will report publicly on the material weakness found, but not report on management's weak assessment process?

Wouldn't the reader of the certifications want to know whether management had any or sufficient evidence to support its conclusions? I propose that this is in fact the only useful information that the reader wants from the auditors. They do not want the auditors to repeat what they are expecting management to do correctly the first time.

Similarly, what role does the auditor play in evaluating and reporting on management's risk assessment? In order to perform its audit of controls, your standard requires the auditor to evaluate risk and test controls related to its risk assessment. It does not state what would happen if the auditor feels there is a major risk factor that management has not considered to be a major risk factor, or for which management has not tested related controls. The standard requires the auditor to determine whether controls exist to address this risk, and if so, to test those controls. If the auditor does audit these controls, and finds that the controls are effective for that period, does it not have any obligation to identify this difference it has with management's risk assessment?

Lastly, what would happen if management gives a clean assessment of its controls, and the auditor performs its own tests of controls, and also gives a clean opinion, yet a major weakness is uncovered later, possibly leading to a re-statement. If management has essentially performed a poor or minimalist evaluation process, and this was "vindicated" by a proper audit, then management's process has essentially been given a clean bill of health when it should not have been. What basis will the SEC or the courts have to find against management? The auditor will be able to protect itself by showing that its audit of controls was done according to professional audit standards. Management will claim that its processes resulted in the same conclusion as the auditors', and that while a different method was followed, they had no reason to believe their method was faulty or inappropriate at the time.

I view the auditor's role in this process as similar to a professional standards audit that the PCAOB might perform on an auditing firm. The PCAOB would check whether professional standards were followed and that there was sufficient evidence of the process followed by an audit firm in arriving at their audit report. You would not reperform the audit itself to any great extent. To my mind, it is the auditor's role to challenge, test and report on management's methods of performing its evaluation that is the important value-add for the readers.

In the case where management has performed a credible, evidence based evaluation of its controls, having a second report stating the same thing is a waste of time and money, and tells the reader nothing. But giving the reader an opinion that management's certification is based on a credible process is worthwhile, whether management issues a clean opinion or otherwise.

<u>An Alternative Approach</u>

There is an alternative to all of this but it would require changes to the Act as well as to the auditing standard. That alternative would be to remove the responsibility of management to audit and evaluate their own control systems. Then require auditors to perform tests of controls over high risk accounts as part of the financial statement audit. Remove the professional judgement possibility of auditors to rely on substantive testing alone, and require that control testing be performed in all financial statement audits. Auditors would then be required to define risk, in conjunction with management, and to conduct appropriate professional testing of controls related to those risks. Management would still certify that they are responsible for assessing risk and for designing and implementing appropriate controls. In this way audits and opinions are done by professional auditors, but the entire responsibility for all aspects of financial statements, including controls, clearly rests with management.

I believe that this approach would substantially reduce overall cost as well. The scope of a financial audit would be increased but not exceptionally. Costs of an audit would be higher than they would have been prior to Sarbanes Oxley, but less than the current approach. The evaluation efforts of management would be reduced, although control systems would still have monitoring systems in place that could be audited. A separate evaluation exercise by company staff would likely be avoided, and the emphasis would be on proper design and daily execution of controls, where it should be.

In this case your new standard could almost stand as is, except for removing the words "We also have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting". This would be replaced by "We have also audited W Company's effective internal control over financial reporting…"

I believe that many readers of financial statements are still unclear as to the possibility that an auditor could, in the past, give an audit opinion on financial statements without in fact testing internal controls. Your proposal of a new combined audit report makes it fairly clear that auditors can no longer do this, at least for large public companies. But we could make it more clear, if the Act itself didn't create confusion by having both management and auditors responsible for proving and certifying that controls are effective.

This suggestion might be complicated by any structure that has separate reporting standards for companies of various sizes. However I also believe that the extent of audits of controls can be different for companies of different sizes, and you have efforts underway to support this. So long as all public companies are required to have an external audit of their financial statements I don't see why audits of controls could not be included, given appropriate guidance for relative size and complexity.

Management of smaller companies have already been certifying their statements, short of a separate evaluation process. We could just stop the progression entirely, at the stage they are now at, and put the responsibility for auditing onto the auditors. Then do the same for larger companies.

I hope that these comments are helpful.

Sincerely,

Christopher Loucks, CA