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Le Président

Fédération des Experts Comptables Européens AISBL
Avenue d'Auderghem 22-28/8
1040 Bruxelles
Tél. 32 (0) 2 285 40 85
Fax: 32 (0) 2 231 11 12
E-mail: secretariat@fee.be

Nancy M. Morris
Secretary
Securities Exchange Commission
100 F Street, NE
USA - Washington DC 20549-1090
Email: rule-comments@sec.gov

J. Gordon Seymour
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
USA - Washington D.C. 20006-2803
Email: comments@pcaobus.org

Dear Ms Morris and Mr Seymour,

Securities and Exchange Commission Release on Management's Report on Internal Control over Financial Reporting

Public Company Accounting Oversight Board Proposed Auditing Standard on An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals

FEE (Fédération des Experts Comptables Européens – European Federation of Accountants) is the representative organisation for the accountancy profession in Europe. FEE's membership consists of 44 professional institutes of accountants from 32 countries. FEE Member Bodies are present in all 27 Member States of the European Union and they represent more than 500,000 accountants in Europe.

FEE is pleased to comment on:

- the Securities and Exchange Commission (SEC) Release Nos. 33-8762 and 34-5476 on Management's Report on Internal Control over Financial Reporting (the SEC's proposals); and
- the Public Company Accounting Oversight Board (PCAOB) Rulemaking Docket Matter No. 021 of 19 December 2006 – Proposed Auditing Standard on An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals (the PCAOB's proposed standard).

In the case of the PCAOB's document, FEE has only commented on the Proposed Auditing Standard in Appendix 1 of that document and not on the other appendices in the PCAOB's document.

FEE notes with interest the SEC's proposals and the PCAOB's proposed Auditing Standard in view of FEE's own substantial contribution to recent discussions in Europe over the future direction of requirements and guidance relating to risk management and internal control. In particular FEE:

- published in March 2005 its Discussion Paper "Risk Management and Internal Control in the EU"[1];

[1] http://www.fee.be/publications/default.asp?library_ref=4&content_ref=351

held a high level conference on 25 October 2005[2] (at which a senior staff member from the SEC spoke) on the issues raised by the Discussion Paper; and

- issued in May 2006 a Comment Paper "Analysis of Responses to the FEE Discussion Paper on Risk Management and Internal Control in the EU"[3].

We are supportive of the proposed objectives of the SEC and the PCAOB which we believe include:

- improving the effectiveness and efficiency with which management and auditors assess a company's internal control over financial reporting;
- adopting a top down, risk-based approach with emphasis on the control environment;
- providing flexibility in the approach to assessing internal control;
- increasing the focus on the exercise of judgement, rather than encouraging a check-list mentality; and
- considering issues related to the scalability of the requirements as applied to different companies.

Overall, whilst FEE considers the initiative of both the SEC and the PCOAB to be a step in the right direction, particularly the aim of providing high-level guidance to management which was previously a major omission, we have a number of concerns about the two documents and question whether the proposed objectives will actually be achieved in practice. Matters may not have been resolved and everything depends on how the words in the SEC's and PCAOB's documents affect the behaviour of people in registrants' management teams, audit firms and the regulatory agencies' inspection functions.

Overriding principles based on existing FEE policy

In preparing this response, we have applied three overriding principles which are based on FEE policy previously established in our Discussion Paper *Risk Management and Internal Control in the EU* and which FEE continues to fully support:

1. Internal control over financial reporting is primarily about the people at the top of a company who manage the business. The focus should be on management.

2. Whatever work auditors undertake, it must be performed within the context of the work that management undertakes and it should be aligned with that work and based on evidence of what management has done.

3. FEE supports the application Assurance Framework for Assurance Engagements of the International Auditing and Assurance Standards Board (IAASB) for any auditor involvement in respect of internal control over financial reporting.

Main Comments

1. One approach versus two separate exercises

The SEC's May 2005 guidance emphasises that management, not the auditor, is responsible for determining the appropriate nature and form of internal controls for the company as well as their evaluation methods and procedures. The work that auditors are required to undertake should be performed within the context of, and aligned to, the work that management undertakes.

Under the current proposals, both the auditor and management will undertake separate exercises to assess internal control over financial reporting using their own methodologies, guidance and frameworks. We think that the SEC and PCAOB proposals are at variance with our principles 1 and 2 noted above.

[2] http://www.fee.be/news/default.asp?library_ref=2&content_ref=518
[3] http://www.fee.be/publications/default.asp?library_ref=4&content_ref=564

We believe that there should be one approach to internal control over financial reporting, not two separate exercises.

2. The elimination of the requirement on the auditor to evaluate management's process

We [strongly] approve of the SEC's and the PCAOB's objective of improving the effectiveness and efficiency with which management and auditors assess a company's internal control over financial reporting.

In attempting to bring about this objective, changes are proposed to the current requirements that the auditor form two opinions on internal control over financial reporting; the first being on management's work (process) and the second being the auditors' own assessment of the company's internal control over financial reporting. Whatever the words used in the documents for management's work – be it management's assessment or management process – the essential matter is that it is the work undertaken by management. We note that the SEC and the PCAOB both propose the elimination of the auditor's opinion on management's process – i.e. the work undertaken by management.

Our second principle, noted earlier in this letter, in practical terms means that whatever work the auditors undertake, it must be performed within the context of, and aligned to, the work that management undertakes and should be based on evidence of what management has done.

We note that, on page 52 of the SEC Proposed Release, the SEC states that it is "proposing to revise Rule 2-02(f) to require the auditor to express an opinion directly on the effectiveness of internal control over financial reporting" and goes on to state that "We believe this opinion necessarily conveys whether management's assessment is fairly stated."

It is questionable whether the above-quoted belief is well-founded. Section 404 (b) of the Sarbanes-Oxley Act states (our emphasis in italics) "Internal Control Evaluation And Reporting - With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues an audit report for the issuer shall attest to, and report on, *the assessment made by the management* of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement."

Additionally, we note that, on page 16 of the PCAOB Proposed Auditing Standard, the PCAOB "believes that the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process". However later on that page the PCAOB Proposed Auditing Standard notes that "an auditor still would need to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which he or she will use the work of others". These statements appear to contradict each other.

We believe that the removal of the requirement on the auditor to evaluate management's work/process does not follow our second principle noted above and in conjunction with our comments in the first section above (re 'one approach') we suggest that the wrong opinion has been proposed for elimination.

3. PCAOB regulatory and enforcement functions - lack of symmetry between them

The focus of the inspection reports published by the PCAOB on audit firms is on auditor shortcomings, inadequacies in audit work, on the *under-audit* of financial statements. The focus of the PCAOB Proposed Auditing Standard however, is on the prevention of the *over-audit* of internal control over financial reporting as evidenced by a significant number of notes referring to the fact that auditors 'need not' or are 'not required to' perform a particular procedure.

It is important that the PCAOB sends out a consistent message to auditors. Auditor behaviour is likely to be more sensitive to the approach taken by the PCAOB in its enforcement activities than it is to changes in auditing standards and it is therefore important that one reinforces the other.

If the enforcement approach focuses on detailed disclosure errors in published financial statements and compliance with the letter of standards rather than on the manner in which the audit was conducted and audit quality, and in particularly the quality of significant audit judgements, then changes to auditing standards will have a very limited effect on auditor behaviour.

The PCAOB Proposed Auditing Standard does not prevent auditors from 'over-auditing' in that it does not say that auditors must not perform a particular procedure. It is quite possible that auditors will continue to 'over-audit' despite the changes if their behaviour is being driven by an enforcement approach that encourages defensive auditing.

4. SEC's guidance to management is rooted in an audit approach

It is the management of an organisation that is responsible for its internal control over financial reporting, and therefore the guidance should be user-friendly for them.

The SEC interpretive guidance included in the SEC Proposed Release is unlikely to resonate with management. The approach taken by the guidance, and the language used therein, is rooted in an auditors' approach to internal control over financial reporting instead of language that may be better understood by management. For example, the proposed guidance makes reference to the 'design' and 'operation' of controls which is perceived as 'auditor' parlance

The PCAOB proposal makes reference to 'identifying' and 'testing' controls – language which is not used in the SEC guidance. It would be helpful that the terms are more aligned when discussing the same areas.

5. Potential implementation problems

The SEC's Proposed Release anticipates cost savings, both for the entity directly and indirectly in respect of consulting and audit fees. For example, in removing the necessity for auditors to test management's assessment process, the SEC hopes to eliminate unnecessary duplication of work. Whilst to some extent this is likely to be true, given that management's assessment process constitutes an internal control over financial reporting from the auditor's point of view, the auditor will not be able to discount the process entirely and thus cost savings may not be as great as anticipated.

The PCAOB proposed Auditing Standard is built upon the assumption that audit costs can be reduced. We are not sure that this can be the case in every audit and are concerned that entities may have overly optimistic expectations as to the magnitude of cost savings that can be achieved in practice. When, and only when, management has designed and is operating, an effective and well-documented system of internal controls (including documentation of management's assessment) can audit costs be kept to a minimum.

Therefore, an impact assessment of the proposals is recommended to test in the field whether the anticipated cost savings will materialise in practice.

6. Consistency issues

We believe that it is important that both the SEC and the PCAOB documents are aligned and consistent within themselves. If they are not, this could cause confusion and may result in unintended consequences such as unnecessary costs.

As the documents currently stand, there are a number of inconsistencies both within each document and between the two documents. Although we only highlight two such matters, we are sure that other commentators will identify a number of other matters that will need to be rectified by the SEC and PCAOB working together.

Definition of material weakness

The SEC's definition of 'Material Weakness' (page 13) is:

A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's internal control over financial reporting.

The PCAOB defines 'Material Weakness' (paragraph A8) as:

A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.

We believe that a control deficiency, as part of the auditor's definition, can be wider than a deficiency in internal control over financial reporting, which forms part of the SEC's definition of a material weakness for management. We also note that the concept of prevention or detection on a timely basis is included in the SEC's definition of material weakness for management but not in the PCAOB's definition of material weakness for auditors. [Both of these differences violate FEE principle 2 as further detailed above.] On a matter as important as this, we suggest that the SEC and PCAOB adopt one definition of material weakness with primacy being given to the SEC. Having inconsistent definitions is problematical and unnecessary.

Controls with lower risk

There is an apparent discrepancy between the auditor's required treatment of controls regarded as having a lower risk in the PCAOB proposed AS 5 and that proposed in the SEC guidance for management. In the latter, for example on page 36, self-assessment may be used by management, whereas the auditor is not afforded similar treatment for controls regarded as having a lower risk in the proposed AS 5. Another such example is paragraph 36 on page A1 – 17 of the PCAOB document whereby the auditor should perform a walkthrough for each significant process. The SEC has not proposed a similarly stringent measure for management's assessment of internal control.

Questions asked by the SEC

We comment below on some of the questions posed by the SEC:

- Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process? Does the proposed guidance allow for management to conduct an efficient and effective evaluation? If not, why not?

  We refer you to our main comments number 1 on 'One approach versus two separate exercises', number 2 on 'The elimination of the requirement on the auditor to evaluate management's process, number 4 on 'SEC's guidance to management is rooted in an audit approach' and number 5 on 'Potential implementation problems'.

- Considering the PCAOB's proposed new auditing standards, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Considering and Using the Work of Others In an Audit, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to resolve the incompatibility?

  We refer you to our main comments number 6 on 'Consistency issues'.

Questions asked by the PCAOB

We have chosen to answer a selected number of the questions asked by the PCAOB – as detailed below:

4. Does the proposed standard adequately articulate the appropriate consideration of company-level controls and their effect on the auditor's work, including adequate description of when the testing of other controls can be reduced or eliminated?

   We refer you to our main comments number 3 on 'PCAOB regulatory and enforcement functions – lack of symmetry between them.'

6. Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?

   We refer you to our main comments number 6 on 'Consistency issues' on controls with lower risk.

8. Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or the auditor? How could the proposed standard on auditing internal control further encourage auditors to appropriately identify material weaknesses when an actual material misstatement has not occurred?

   We refer you to our main comments number 6 on 'Consistency issues' on definition of material weakness.

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

    We refer you to our main comments number 1 on 'One approach versus two separate exercises'.

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?

    We refer you to our main comments number 2 on 'The elimination of the requirement on the auditor to evaluate management's process.

28. Does the proposed standard on auditing internal control appropriately describe how auditors should scale the audit for the size and complexity of the company?

    We refer you to our main comments number 5 on 'Potential implementation problems'.

We would be pleased to discuss with you any aspect of this letter you may wish to raise with us and to send you copies of the two papers produced by FEE if these would be of interest to the SEC or PCAOB.

Yours sincerely,

Jacques Potdevin
President