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

PCAOB Rulemaking Docket Matter No. 021
Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals*

Dear Mr. Secretary:

KPMG appreciates this opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) Release No. 2006-007 that includes the following Appendices (collectively, the Proposals):

- Proposed Auditing Standard - *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*
- Proposed Auditing Standard - *Considering and Using the Work of Others in an Audit*
- Proposed Rule 3525 - *Audit Committee Pre-approval of Services Related to Internal Control Over Financial Reporting*
- Auditing and Related Professional Practice Standards - *Proposed Amendments to PCAOB Interim Standards* (Conforming Changes Proposal)

We would like to take this opportunity to formally recognize the significant effort of the PCAOB and its staff in development of the Proposals. Overall, we believe that the changes reflected in the Proposals relative to auditing internal control over financial reporting (ICFR) will serve to enhance auditors' effectiveness and efficiency in conducting an integrated audit and, combined with the Securities and Exchange Commission's (SEC) proposed guidance, will result in a reduction of the total Section 404 compliance effort. We do, however, have concerns relative to the Board's proposed standard on considering and using the work of others that are addressed later in this letter.

Fundamentally, we believe that compliance with the provisions of Section 404 of Sarbanes-Oxley provides needed protections to investors of all companies, regardless of size or complexity. We believe that internal control reporting pursuant to Section 404 has made, and will continue to make, a significant contribution toward improving financial reporting, corporate governance and audit quality, all serving to further the public interest and restore confidence in our capital markets.

Since adoption of the initial rule requiring reporting on ICFR pursuant to the provisions of Section 404, significant improvements have been made to issuers' financial reporting and disclosure processes and the effectiveness of their internal controls. In addition, the benefits realized by compliance with Section 404 extend beyond improved internal control and financial reporting. Many issuers that have implemented robust management evaluation and assessment processes initially designed to support Section 404 compliance have realized enhancements in operations, regulatory compliance, communications and documentation.

We fully support the direction of the Board evidenced in the proposed standard requiring a single model of auditor reporting on ICFR; specifically, that the auditor obtain reasonable assurance relative to the operating effectiveness of internal control. In addition, we support the Board's emphasis on the importance of sound professional judgment and believe that the exercise of appropriate auditor judgment is fundamental to the execution of an effective and efficient audit.

We also fully support the Board's ongoing project to develop practical guidance for auditors in conducting integrated audits of smaller, less complex organizations. Our participation in this project should benefit our engagement teams when addressing the particular challenges encountered in smaller, less complex environments. We look forward to our continued participation in this project, which we believe will further facilitate scalability of the proposed standard in an effective and efficient manner. This project, and the Proposals and the SEC's proposed guidance, have the potential to drive the greatest benefits, in terms of efficiencies and cost-effectiveness, for the non-accelerated filers and new public companies that have yet to comply with the provisions of Section 404.

Compliance with the provisions of Section 404 has placed important responsibilities on issuers and auditors that, in many instances, have required the dedication of significant resources. We believe that the Proposals, taken together with the SEC's proposed guidance, will result in a reduction of total Section 404 compliance effort. We support the enhancements to the auditing standards emphasizing or providing for (i) the increased use of professional judgment, including the assessment of audit coverage; (ii) the ability to use cumulative knowledge obtained during prior audits in considering the nature, timing and extent of current year audit procedures; and (iii) the elimination of the requirement to evaluate management's assessment process. We also believe that the proposed standard on auditing ICFR has the ability to allow for increased use of the work of others, assuming certain conditions are met, notwithstanding our concerns relative to the proposed standard on considering and using the work of others, which we address below.

The extent of these reductions in effort will vary significantly based on each issuer's particular facts and circumstances. The quality of an issuer's control structure and processes, the relative complexity and business risks of an issuer, and the quality of management's evaluation and assessment process, including relevant documentation, all are factors that will affect reductions to the overall Section 404 compliance effort and the relative balance of such reductions between management and the auditor.

Because of the myriad factors involved, we do not believe that reductions in the total Section 404 compliance effort can be synthesized into specific or across-the-board reductions in Section 404-related compliance costs for all issuers. While the reductions in effort will vary, a constant in the equation is the acknowledgement that maximum benefits will be achieved when management and the auditor work in a coordinated manner, and when the auditor can make effective use of the work of others. For example, the quality of management's evaluation and assessment of internal control, including relevant documentation, directly impact the effectiveness and efficiency of the external audit.

We are committed to supporting continued improvements in the effectiveness and efficiency of Section 404 compliance and believe that the Board's Proposals facilitate progress in that direction and uphold investor protections that are critical to the effective functioning of our capital markets.

We encourage the Board to expedite issuance of its Proposals in final form to allow sufficient time for auditors to be trained and methodologies to be developed evidencing the revised requirements and guidance. This accelerated consideration and issuance of the Proposals in final form is important to ensure that the Board's final standards will impact integrated audits performed for the year ending December 31, 2007.

This letter is organized by first providing a number of general observations and comments on the proposed standard on auditing internal control over financial reporting, followed by observations and comments on the proposed standard on considering and using the work of others. Less significant and editorial comments and suggestions are included in the Appendix to this letter.

General

We note that the Proposals include a number of presumptively mandatory provisions directing the auditor to perform procedures for the purpose of identifying potential sources of audit efficiencies. As previously noted, we fully support the Board's objective to enhance the effectiveness and efficiency of integrated audits. However, we firmly believe that the auditor's objective is to perform effective, high-quality audits, and that highly effective audits promote process efficiencies. The precedence set by including such presumptively mandatory provisions relative to efficiencies is inconsistent with the nature of professional standards and may detract from the objective of enhancing audit quality and protecting investor interests.

Proposed Standard on Auditing Internal Control Over Financial Reporting

We believe that the proposed standard on auditing internal control over financial reporting evidences the Board's commitment to simplify the requirements of Auditing Standard (AS) No. 2 and focuses the auditors' attention on matters most important to ICFR. In addition, we believe that the proposed standard strikes an appropriate balance between effectiveness and efficiency relative to performance of an integrated audit. We fully support the Board's objective to improve the effectiveness and efficiency of integrated audits and hope that the comments and observations provided in this letter assist the Board in achieving that objective.

Company-level controls. Paragraph 17 of the proposed standard states that, "[t]he auditor must test those company-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting," and that "[t]he auditor's evaluation of company-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on controls at the process, transaction, or application levels." Company-level controls that operate at a sufficient level of precision and may be linked directly to financial statement assertions represent a concept that has not been fully developed in practice.

We note that paragraphs 43 and 44 of the proposed standard address the linkage of company-level controls to financial statement assertions and the level of precision at which company-level controls operate. We believe that this guidance will serve to clarify the evaluation of company-level controls and the implications on process or transaction level controls and suggest that the concepts included in paragraphs 43 and 44 be reiterated in paragraphs 17 and 18 of the proposed standard. In addition, we believe that the final standard should specifically acknowledge that, in many instances, company-level controls relate only indirectly to relevant financial statement assertions and do not operate in a manner sufficient to address risk of material misstatement to specific accounts and disclosures in the financial statements.

Recognizing the emphasis the proposed standard places on identifying and relying upon effective company-level controls, we believe that the Board should consider advising the auditor of the audit evidence limitations and challenges associated with relying on company-level controls. For example, we believe that the final standard should indicate that testing company-level controls ordinarily does not obviate the need to test some process or transaction level controls. The effective operation of company-level controls may be dependent upon the completeness and accuracy of data generated by transaction processes. In such instances, it may be necessary for the auditor to test process or transaction level controls associated with data utilized in the performance of company-level controls.

In addition, we believe that company-level control examples illustrating the consideration of sufficient precision and direct linkage to financial statement assertions would assist auditors in planning and executing an effective and efficient integrated audit. We recommend that the Board consider including such examples in an appendix to the final standard.

Scaling the audit for smaller companies. Paragraph 9 of the proposed standard states that, "[t]he auditor should evaluate the size and complexity of the company when planning and performing the audit of internal control." This evaluation requirement appears to apply to issuers of all sizes and complexity. However, the Note included in paragraph 9 refers to definitions included in the final report of the SEC Advisory Committee on Smaller Public Companies.

The requirements and guidance in paragraphs 10 through 12 of the proposed standard are directed to the auditors' evaluation of how the audit of internal control is affected by the attributes of a smaller, less-complex company. If the Board's intention is for these requirements and related guidance to be applicable only to smaller, less-complex companies, we believe that the final standard should include a definition of "smaller, less-complex." Alternatively, if the intention is for these requirements and related guidance to be applicable to companies of all sizes and complexity, we believe that intention should be clearly stated.

An auditor considers company size and complexity when planning and performing an integrated audit. However, we believe that a requirement to "*evaluate*" size and complexity contemplates auditor performance beyond one to "*consider*." We believe that the guidance in paragraphs 10 through 12 of the proposed standard, if applicable, is helpful for the auditors' consideration in planning and performing an effective and efficient integrated audit. Accordingly, we suggest that the auditor performance emphasis in these paragraphs be recharacterized as matters to consider rather than evaluation requirements.

Controls that address fraud risk. Page 6 of the Board's Summary Memorandum indicates the Board's intention "to encourage an appropriate focus on controls important to the prevention and detection of fraud." We believe that the proposed standard could be more definitive in outlining auditor performance expectations relative to evaluation of internal controls designed to address the risk of fraud, specifically internal controls associated with the risk of management override. Also, we believe that the discussion of risk assessment in the proposed standard should be expanded to require the auditor to consider whether information obtained about the entity and its control environment indicates that one or more fraud risk factors may be present and, if so, to consider the adequacy of the company's controls to address the identified fraud risks.

Roll-forward procedures**.** Paragraphs 63 and 64 of the proposed standard indicate that additional testing to update evidence regarding the operating effectiveness of controls obtained at an interim date may not be necessary. However, PCAOB interim auditing standards regarding substantive audit procedures state that the auditor should design substantive audit procedures "to cover the remaining period in such a way that the assurance from those tests and the substantive tests applied to the details of the balance as of an interim date…achieve the audit objectives at the balance-sheet date."[1]

We believe that it is equally important in an integrated audit to perform roll-forward procedures to provide a reasonable basis for extending to the as-of date conclusions regarding control effectiveness reached at the interim date. Accordingly, we believe that the Board's final standard should be aligned with guidance relative to roll-forward procedures necessary to extend interim-date conclusions to the as-of date in existing interim auditing standards.

Walkthroughs. Paragraph 36 of the proposed standard states "[i]n performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records." Acknowledging the significance of effective company-level controls in the conduct of an integrated audit, we believe that the Board's final standard should provide guidance on how the existence of effective company-level controls impacts the requirement in paragraph 36. For example, if the auditor plans to evaluate the operating effectiveness of company-level controls that directly address relevant assertions associated with the financial statement amount reported for interest expense, is a walkthrough of the interest expense process required? This matter is particularly relevant in a multi-location environment where the auditor may evaluate the effectiveness of company-level controls executed at a regional level and find such controls to be operating effectively and at a sufficient level of precision, yet be required to visit individual remote locations solely to perform walkthroughs of significant processes at those locations.

Paragraph 50 of the proposed standard indicates that a walkthrough may be used as a procedure to test the operating effectiveness of controls. Paragraph 37 of the proposed standard outlines the objectives of a walkthrough as follows:

- Verify that the auditor has identified the points in the process at which significant risk of misstatement to a relevant assertion exists (i.e., risk assessment);
- Verify the auditor's understanding of the design of controls, including those related to the prevention or detection of fraud;

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[1] See paragraph .08 of AU 313, *Substantive Tests Prior to the Balance Sheet Date,* and PCAOB Release No. 2007-001, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud*.

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- Evaluate the effectiveness of the design of controls; and
- Verify whether controls have been placed in operation.

It is not clear to us how the auditor performs risk assessment procedures directed toward determining the nature, timing and extent of other audit procedures to perform and, at the same time satisfies performance of those other audit procedures. In other words, it seems somewhat illogical for a risk assessment procedure to also serve as another audit procedure intended to respond to an assessed risk when the results of the risk assessment procedure are relevant to determining the nature, timing and extent of other audit procedures to perform. In order to reconcile this apparent inconsistency, we believe that the Board should acknowledge that the auditors' risk assessment may be concluded without performing a walkthrough.

Proposed Standard on Considering and Using the Work of Others in an Audit

We do not believe that extant AU 322 should be superseded by the proposed standard on considering and using the work of others. Further, we do not believe that the provisions of the proposed standard will result in measurable integrated audit efficiencies and may result in the dilution of audit effectiveness through the inappropriate use of the work of others in conducting an audit. We believe that extant AU 322, combined with the changes outlined in the Board's proposed standard on an audit of internal control over financial reporting, introduces the flexibility necessary to expand use of the work of others by auditors in an appropriate and responsible manner.

If the Board concludes that it will move forward with a final standard to supersede extant AU 322, we offer the following comments:

High risk of material misstatement or high degree of subjectivity. We note that the proposed standard does not include guidance currently in extant AU 322 relative to the auditors' ability to use the work of others where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high. In these circumstances, extant AU 322 indicates that the "internal auditors' work cannot alone reduce audit risk to an acceptable level to eliminate the necessity to perform tests…directly by the auditor." Paragraphs 21 and 22 of extant AU 322 illustrate this important concept and we recommend that these paragraphs be included in the Board's final standard.

Principal Evidence. We note that explicit reference to "principal evidence" has been eliminated from the Board's Proposals. Elimination of the principal evidence terminology, currently included in AS No. 2, could result in an expectation that the auditor no longer is required to obtain principal evidence to support his or her opinions. We believe that a fundamental tenet to expressing a reasonable assurance opinion on management's assertions involves the auditors' requirement to obtain principal evidence. In addition, we recognize that the determination of what constitutes principal evidence is not formulaicrather, it is a qualitative determination based on professional judgment. We believe that the fundamental concept of principal evidence was implicit in the Board's interim standards prior to the issuance of AS No. 2.

We do not object to the elimination of the terminology, "principal evidence," and acknowledge that paragraph 8 of the proposed standard indicates that the responsibility to report on financial statements and ICFR rests solely with the auditor. However, we believe that a final standard on use of the work of others should make it very clear, particularly in light of the verbiage in the Summary Memorandum (pages 23 - 24), that judgments about sufficiency of procedures performed and evidence obtained are *solely* those of the auditor, and caution against inappropriate use of the work of others in an audit.

Identification of relevant activities. Paragraphs 3 through 6 of the proposed standard describe the auditors' responsibility to determine whether there are activities performed by others that can be used in connection with the audit. We are concerned with the practicality and cost effectiveness of requiring the auditor to search for "relevant activities" performed by company personnel or others working under the direction of management or the audit committee.

Further, we believe that compliance with the provisions of these paragraphs likely will lead to unnecessary effort expended searching for activities significantly removed from those of internal auditors and similar groups described in AU 322 that, upon consideration, will not be useable due to competency or objectivity constraints, or do not represent tests that provide audit evidence as described in the proposed standard. In addition, we believe that management has a responsibility to adequately inform the auditor of those activities performed by management, or those under the direction of management, that may be relevant to the auditor. Accordingly, we believe that the auditor's obligation in the Board's final standard should be to consider whether there are activities performed by others that may be relevant to the audit.

If the Board decides to retain these paragraphs in its final standard, then we recommend that the discussion of competence and objectivity precede the consideration of relevant activities in order to more appropriately reflect the thought process of the auditor in considering the work of others.

Performance of substantive audit procedures. Auditing standards have long provided for use of the work of internal auditors in conducting a financial statement audit. AS No. 2 expanded this concept, for purposes of auditing the effectiveness of ICFR, to provide for the use of work of third parties and company personnel, other than internal auditors, working under the direction of management or the audit committee. We support the position in the proposed standard that tests of internal control performed by management and those under the direction of management or the audit committee may be used in conducting audits of financial statements (consistent with use of the work of others in an integrated audit). However, we believe that it is inappropriate to use the work of management and those under the direction of management or the audit committee for performance of audit procedures directed toward identifying financial statement misstatements (i.e., substantive audit procedures).

Auditors frequently use the work of internal auditors in performing substantive audit procedures in an audit of financial statements. Ordinarily, internal auditors are proficient in auditing, are well-versed in the relevant professional auditing and accounting literature and are subject to the internal auditing profession's formal standards and code of conduct. We believe that proficiency as an auditor is essential to the performance of substantive audit procedures.

If the final standard provides for use of the work of management and others under the direction of management or the audit committee in the performance of substantive audit procedures, auditors may spend significant time evaluating the competence and objectivity of non-internal audit personnel and debating those conclusions with management, only to result in conclusions that these individuals lack competency and/or objectivity relative to the performance of substantive audit procedures. Accordingly, we recommend that the auditors' use of the work of non-internal audit company personnel and third parties be limited to tests of controls.

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We fully support the Board's efforts to simplify the requirements associated with performing integrated audits and focus the auditors' attention on matters most important to internal control over financial reporting. We share the Board's goal of enhancing auditors' effectiveness and efficiency in conducting an integrated audit, without diluting investor protections. If you have any questions about our comments or other information included in this letter, please do not hesitate to contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or Craig W. Crawford, (212) 909-5536, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP

cc: PCAOB Board Members

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Mr. John W. White, Director, Division of Corporation Finance - SEC
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Appendix

The following comments and other suggestions considered less significant or editorial in nature are presented for your consideration.

Proposed Auditing Standard – *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*

Scoping Matters

1 We believe that the proposed standard appropriately incorporates the value of cumulative knowledge by enabling the auditor to consider the results of previous testing in performing risk assessments. We also fully support the Board's decision to not permit rotation of testing of controls and to emphasize effectively altering the nature, timing and extent of related audit procedures.

2 The term "significant process" as used in the context of performing walkthroughs is not adequately defined in the proposed standard. We believe that walkthroughs should be performed at the level necessary to understand the flow of major classes of transactions captured in the financial statements. Introduction of the term "significant process" implies that walkthroughs may be performed at an aggregated level, consolidating major classes of transactions that are subject to varying processes and controls. We believe that major class of transaction flows that are subject to the same processes and controls may be consolidated in performance of a process walkthrough and that this concept should be clarified in the final standard.

Evaluation Matter

3 "Restatement of previously issued financial statements to reflect the correction of a misstatement" is one of the strong indicators of material weaknesses in paragraph 79 of the proposed standard. We recommend that the indicator refer to "material misstatement" or, alternatively, commentary be added to address restatements of previously issued financial statements that result from immaterial error corrections that might occur under the provisions of SEC Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*.

Reporting Matter

4 Paragraph C6 of the proposed standard indicates that "[t]he auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion." We are unclear as to whether the guidance in paragraph C6 would permit the auditor to issue a report disclaiming an opinion on internal control if the auditor is able to conclude, without having performed any procedures, that a scope limitation will prevent the auditor from obtaining

reasonable assurance necessary to express an opinion. We believe that this paragraph should be clarified to address this possibility.

Proposed Auditing Standard – *Considering and Using the Work of Others in an Audit*

1. AU 322.27 in the PCAOB's interim standards includes the following guidance regarding direct assistance:

   > The auditor should inform the internal auditors of their responsibilities, the objectives of the procedures they are to perform, and matters that may affect the nature, timing, and extent of audit procedures, such as possible accounting and auditing issues. The auditor should also inform the internal auditors that all significant accounting and auditing issues identified during the audit should be brought to the auditor's attention.

   We believe this guidance is helpful and pertinent and should be retained in the Board's final standard.

2. Paragraph 21 of the proposed standard states, "[w]hen direct assistance is provided, the auditor should supervise, review, evaluate, and *test* the work performed by others as described in AU sec. 311, *Planning and Supervision*" [emphasis added]. AU 311 specifically addresses supervision and review, and implicitly addresses evaluation, but does not, implicitly or explicitly, address *testing* others' work. Therefore, it appears that there is no requirement in the proposed standard to test the work performed by others in a direct assistance arrangement.

   Paragraph 27 of extant AU 322 indicates that, "[w]hen direct assistance is provided, the auditor should assess the internal auditors' competence and objectivity (see paragraphs .09 through .11) and supervise, review, evaluate, and *test* the work performed by internal auditors to the extent appropriate in the circumstances" [emphasis added]. We believe that the provisions of the proposed standard do not appropriately address testing the work of others in a direct assistance arrangement and that the auditors' requirement to test the work of others in such arrangements should be explicitly referenced in the final standard.

3. Paragraph 15 of the proposed standard indicates that, in assessing the objectivity of others performing tests, the auditor should consider "[p]olicies designed to assure that compensation arrangements for individuals performing the work do not adversely affect objectivity, and whether the policies are being complied with." While we believe compensation is an appropriate factor to consider relative to objectivity, we recommend that the Board provide further guidance regarding its related expectations. For example, guidance regarding the following would be helpful:

   - the types of compensation arrangements that may be problematic;

- whether participation in such arrangements should be considered in conjunction with all other factors relative to objectivity; and
- the nature of compensation arrangement policies designed to maintain objectivity auditors should consider.

Proposed Rule 3525 - *Audit Committee Pre-approval of Services Related to Internal Control Over Financial Reporting (Proposed Rule)*

1. Proposed Rule 3525 requires the auditor, among other things, to "describe, in writing, to the audit committee of the issuer the scope of the service." We recommend that auditors be required to describe the nature as well as the scope of the internal control services to be provided and the related proposed fee arrangement. These changes would align the requirements of Proposed Rule 3525 with the Board's requirements for disclosures and related discussions with a client's audit committee regarding the pre-approval of tax services in accordance with PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services* (Rule 3524).
2. We suggest that the Board consider establishing a transition period for audit committees that pre-approve services on the basis of policies and procedures. Such a transition period would facilitate orderly implementation of this Proposed Rule and would be consistent with the provisions of Rule 3524.

Auditing and Related Professional Practice Standards – *Proposed Amendments to PCAOB Interim Standards*

1. The note to paragraph 65 of AU 319, *Consideration of Internal Control in a Financial Statement Audit*, should be deleted to conform to the PCAOB's proposed change to paragraph 83 of that standard.
2. The reference to AS No. 2 should be replaced with a reference to PCAOB Proposed Auditing Standard, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements, in paragraph 11 of AU 332, *Auditing Derivative Instruments*, and in the footnote to paragraph 1 of AU 380, *Communication with Audit Committees*, to be consistent with other proposed amendments.
3. We concur with the Board's proposed amendment to AU 530, *Dating of the Independent Auditor's Report*, that would require the auditors' report to be dated no earlier than the date on which the auditor has obtained sufficient competent evidential matter to support the opinion. We recommend that the Board provide guidance regarding when sufficient competent evidential matter has been obtained by adding the following sentences after the first sentence of paragraph 1 of AU 530:

   > Among other things, sufficient competent evidential matter includes evidence that the audit documentation has been reviewed and that the entity's financial

statements, including disclosures, have been prepared and that management has asserted that it has taken responsibility for them. This will ordinarily result in a report date that is close to the report release date.

We believe that this modification will promote consistency in dating of independent auditors' reports.

In addition, we recommend that paragraph 9 of AU 333, *Management Representations*, be revised, in part, as follows, "the [written] representations should be made as of the date of the auditor's report," to conform with the proposed amendment to AU 530.

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