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PCAOB RELEASE NO. 2006-007; 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

Ladies and Gentlemen:

This letter is submitted on behalf of the Financial Reporting Committee of the Association of the Bar of the City of New York (the "*Committee*")¹ in response to Release No. 2006-007, December 19, 2006 (the "*Proposing Release*"), in which the Public Company Accounting Oversight Board (the "*PCAOB*") proposed a new auditing standard entitled "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements" (the "*Proposed Standard*") and related other proposals (such other proposals, collectively with the Proposed Standard, being referred to herein as the "*Proposal*"). The Proposed Standard would supersede the PCAOB's Auditing Standard No. 2 ("*AS No. 2*").

Our Committee is composed of lawyers with diverse perspectives on financial reporting matters, including members of law firms and counsel to major corporations, investment banks, public accounting firms and institutional investors. A list of members of the Committee is attached as Annex A to this letter.

¹ Please note that this letter does not necessarily reflect the individual views of each member of the Committee, nor does it necessarily reflect the views of the institutions with which Committee members are affiliated.

Introduction

The Committee supports the goal of improving the effectiveness and efficiency of audits of internal control over financial reporting by public accounting firms as part of the performance of an integrated audit of financial statements and applauds the efforts of the PCAOB in developing the Proposal. We believe that the Proposed Standard, if properly implemented, will advance the goal of producing internal control audits to which both management and external auditors apply reasoned judgment and a top-down, risk-based approach.² We agree with the PCAOB that to achieve this result it is desirable to promulgate a new standard on auditing internal control rather than revise AS No. 2.

We strongly support the PCAOB's proposal to eliminate unnecessary procedures and commend the PCAOB's efforts in developing the Proposal. By refocusing multi-location testing requirements on risk rather than on coverage, permitting consideration of knowledge obtained during previous audits, easing barriers on the use of work of others and removing the requirements to evaluate management's process, the PCAOB has made significant improvements to the efficiency of the audit of internal control while, in principle, safeguarding the quality of the audit of internal control. We believe that it is appropriate to shift the focus of the audit of internal control from a bottom-up to a top-down approach. We further believe that auditors can and should be empowered to utilize reasoned professional judgment in the performance of the audit, and doing so does not constitute a relaxation or scaling back from AS No. 2 so long as the Proposal as finally adopted is properly implemented. We place significant reliance on the PCAOB's inspection function to facilitate proper implementation.

Despite these commendable aspects of the Proposal, we believe changes are warranted if the PCAOB is to fully realize the potential for improving the audit of internal control over financial reporting. Our comments and recommendations are set forth below.

As noted in the Proposing Release, the audit of internal control over financial reporting has produced significant benefits since the adoption of Section 404 of the Sarbanes-Oxley Act in 2002, but at significant cost.³ In a period of heightened international competition among different capital formation markets, as well as domestic competition between the public and private capital markets, it is of critical importance that regulatory imperatives such as Section 404 be implemented and interpreted so as to promote benefits while balancing costs.

² Securities and Exchange Commission Statement on Implementation of Internal Control Reporting Requirements, Press Release No. 2005-74 (May 16, 2005), available at <http://www.sec.gov/news/press/2005-74.htm>.

³ The Securities and Exchange Commission made similar observations in its companion rulemaking proposal relating to Management's Report on Internal Control Over Financial Reporting. Release No. 33-8762 (Dec. 20, 2006) (the "SEC Release").

We have divided our comments into two categories. First, we identify significant comments relating to broad themes contained in the Proposal. These comments are organized by the importance we believe that each comment merits.⁴ Second, we identify comments on drafting or analysis relating to specific paragraphs of the Proposed Standard or other components of the Proposal. We have organized these comments sequentially, following the order in which they arise in the Proposal.

Significant Comments

1. Incremental Compliance Costs. The Committee believes that companies and investors are very supportive of improvements to the process of auditing internal control over financial reporting. We believe it is important, however, that changes made in the interest of achieving improved efficiency and efficacy not force public companies to restructure their internal control over financial reporting or otherwise incur costs that come anywhere close to the costs incurred in connection with the “year one” implementation of Section 404. We further believe that the PCAOB shares this view. To assist companies and their auditors, we suggest that a clear statement be included in the final version of the Proposed Standard (and not just in accompanying press releases or similar materials) to the effect that the changes being adopted are intended to promote greater efficiency in the audit of internal control while preserving efficacy, and should be implemented in a manner that does not require public companies to significantly restructure existing procedures or to incur significant additional costs.
2. Definitions of Significant Deficiency and Material Weakness. The Committee agrees that the definitions of Significant Deficiency and Material Weakness require amendment, but disagrees that the existing framework underlying these definitions as set forth in AS No. 2 is fundamentally sound. We therefore suggest that more significant amendments than have been proposed by the PCAOB are warranted.

In adopting AS No. 2, the PCAOB chose to use the same formulations of Material Weakness and Significant Deficiency as found in FAS No. 5, *Accounting for Contingencies*. The PCAOB stated that it believed that using terms with which auditors were already familiar would promote consistency in the evaluation of deficiencies.⁵ While we have no doubt that auditors are fully familiar with these terms, the application of these terms to audits of internal control has resulted in the unintended over-inclusiveness and inefficiencies that the PCAOB and the SEC

⁴ We note that none of the topics that we identify as significant were part of the agenda at the PCAOB’s Standing Advisory Group Meeting of February 22, 2007, at which various other aspects of the Proposal were discussed. The Committee urges the PCAOB to focus on issues raised in the comment process beyond the important issues discussed at the February 22, 2007 SAG meeting.

⁵ AS No. 2, paragraph E73; *see also* PCAOB Release No. 2005-023 (Nov. 30, 2005) at pp. 16-17.

now seek to rectify. Simply changing the references in AS No. 2 to “more than remote” to read “reasonable possibility,” when these terms are viewed as being synonymous in the accounting literature, does not address this issue. We also believe that there is no substantive justification for reliance on FAS No. 5 standards in the context of audits of internal control, particularly given the empirical evidence now available as to the outcome of the use of these definitions in this context.

The Committee therefore recommends that the definitions of both Significant Deficiency and Material Weakness be calibrated to the standard of “reasonable likelihood,” on the basis that this is a higher standard than “reasonable possibility” but a lower standard than “probable.”

We note that the concept of “reasonable likelihood” is familiar to auditors, companies and investors. It is the standard governing the disclosure of known trends or uncertainties in Management’s Discussion and Analysis.⁶ It also governs the analysis of whether an off-balance sheet arrangement requires disclosure. As stated by the SEC in 2003, disclosure of an off-balance sheet arrangement is required if the arrangement “[will] have, or [is] *reasonably likely* to have, a current or future effect on the registrant’s financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.”⁷

In addition, the PCAOB proposes to modify the definition of Material Weakness to provide that one or more Control Deficiencies constitute a Material Weakness. In contrast, AS No. 2 defines Material Weakness as one or more Significant Deficiencies. We agree with the PCAOB’s observation that the existing definition has raised concern that auditors may be performing their audits at an unduly low level of detail so as to ensure that all Significant Deficiencies are identified.⁸ The PCAOB proposes to rectify this concern by calibrating the definition of Material Weakness to a lower standard - that of Control

⁶ See Release No. 33-6835 (May 18, 1989) and Release No. 33-8056 (Jan. 22, 2002).

⁷ Release No. 33-8182 (Jan. 28, 2003) at text accompanying note 98 (emphasis supplied). The “reasonably likely” standard was adopted after many commenters, including each of the four largest auditing firms, objected to the lower standard initially proposed by the SEC. The initially-proposed standard would have required disclosure if the likelihood of a material effect was more than remote; objections to this proposal pointed out that investors could be overwhelmed by voluminous disclosure of insignificant and possibly unnecessarily speculative information under the lower standard. *Id.* at notes 38-45 and accompanying text.

⁸ Proposing Release, p. 10. While we do not believe rigid numerical standards for materiality should be adopted, we agree with the discussion regarding AS No. 2’s tendency to force auditors to search for all Significant Deficiencies that is contained in Joseph A. Grundfest & Steven E. Bochner, *Fixing 404*, 105 MICH. L. REV. (forthcoming 2007, Issue No. 8) (manuscript at pp. 32-35, available at <http://www.michiganlawreview.org/symposium/abstracts.htm#grundfest>) (“Grundfest & Bochner”).

Deficiencies—without explaining how this change will improve the efficiency of audits of internal control. The Committee is concerned that auditors may interpret this as requiring them to ensure that all Control Deficiencies are identified, which we believe will exacerbate existing tendencies to focus on deficiencies that are not sufficiently important to the company's overall system of internal control. Absent a clearer understanding of the reasons underlying this change, the Committee recommends that the PCAOB not make this modification. We also strongly encourage the PCAOB to clearly state in the final version of the Proposed Standard that the audit of internal control does not require that every Significant Deficiency (or Control Deficiency, if that standard is adopted) needs to be identified, and that this type of inquiry should not be undertaken by auditors.

Regardless of the standard adopted, the Committee believes further clarity can be added to the concept of aggregation. AS No. 2 provides that multiple Significant Deficiencies can, in the aggregate, constitute a Material Weakness (and similarly, multiple Control Deficiencies can, in the aggregate, constitute a Significant Deficiency). It is not clear how unrelated deficiencies are to be analyzed for aggregation purposes. It is certainly possible that one control can have an impact on the effectiveness of another seemingly related control – in this situation, we agree that aggregation can be appropriate. However, if two controls are wholly unrelated, it is difficult to see how they are to be aggregated, other than assigning a quantitative probability of misstatement to each, totaling all such probabilities and then determining whether the quantum is material. We believe this form of aggregation is not intended by the PCAOB, nor is it appropriate for the protection of investors. This ambiguity can be addressed by modifying the definitions to provide for aggregation of “related” deficiencies, with discussion of how deficiencies can be related (*e.g.*, they can arise in a similar reporting area, or can be sequentially linked such that a flaw in a particular control directly affects the effectiveness of a later control).⁹

Finally, we suggest that the PCAOB clarify that the definition of Significant Misstatement is meant to focus on those individuals principally responsible for oversight of the company's financial reporting taken as a whole. This would remove any ambiguity as to whether lower-level employees with responsibility for discrete components of the company's financial reporting are intended to be included in this definition.

⁹ We note that the SEC proposes in the SEC Release that aggregation should be limited to related deficiencies:

Therefore, management should evaluate individual control deficiencies that affect *the same account balance disclosure, relevant assertion, or component of internal control*, to determine whether they collectively result in a material weakness.

SEC Release at text accompanying footnote 76 (emphasis supplied).

We thus propose the following revised definitions:

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

Note: There is a **reasonable likelihood** of an event, as used in the definitions of *material weakness* and *significant deficiency* (see paragraph A12), when the likelihood of the event is "probable" or more than "reasonably possible" (as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*), although in the latter case it need not be more likely than not.

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

A **significant misstatement** is a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting taken as a whole.

3. Strong Indicators of Material Weaknesses (Paragraph 79 of the Proposed Standard). The determination of whether a Material Weakness exists is one of the most fundamental aspects of the evaluation of the effectiveness of internal control over financial reporting. We note that the Proposed Standard deletes the requirement in AS No. 2 that the presence of any of the six identified situations constitutes a Significant Deficiency. We understand that, in so doing, the PCAOB sought to indicate that auditors have the discretion to utilize their professional judgment to evaluate the significance of the discovery of any of the identified situations based on facts and circumstances. The Committee supports this change. We believe, however, that this change, without more, does not appreciably improve the existing treatment of strong indicators of Material Weaknesses under AS No. 2, as many of the other most important provisions of this part of the Proposed Standard are repeated from AS No. 2 without change.

We also note that in several instances the terminology used to express a strong indicator of material weakness varies in substantive ways between the Proposed Standard and the SEC Release. We point out these and other substantive comments on Paragraph 79 of the Proposed Standard below.

- The first sentence of Paragraph 79 of the Proposed Standard states that "the auditor should treat each of the following circumstances as a strong indicator that a material weakness in internal control over financial

reporting exists.” This language is unchanged from the corresponding language in AS No. 2. The Committee believes that this congruity may fairly be read to suggest that auditors lack the ability to exercise precisely the sort of professional judgment that the PCAOB seeks to encourage in the Proposed Standard, despite the deletion of the statement that the presence of any listed factor constitutes a Significant Deficiency. We recommend that language be added to Paragraph 79 stating that any of the identified circumstances may constitute a strong indicator that a Material Weakness exists, but that, based upon an evaluation of the facts and circumstances relating thereto, an auditor may conclude that no Significant Deficiency exists, or that if one does exist, it does not rise to the level of a Material Weakness.¹⁰

- We believe that the first identified strong indicator in the Proposed Standard under the “ineffective control environment” indicator (identification of fraud of any magnitude on the part of senior management) is too prescriptive. While we agree that fraud of any nature on the part of senior management is a serious matter, we believe it does not necessarily constitute a strong indicator of a Material Weakness. For example, discovery of the fraud by the normal operation of the company’s internal control over financial reporting may well be a strong indicator of the effectiveness of internal control. Also, if the fraud in question was immaterial in amount and appropriate disciplinary action was taken by the company, we believe that these facts and circumstances could militate against a determination that a Material Weakness exists. We question whether the current formulation of this item permits this sort of analysis (even if our prior comment is accepted).
- The definition of “senior management” in the note at the top of page A1-30 of the Proposed Standard is unnecessarily subjective. Without further guidance, it will be difficult for auditors to develop a consistent interpretation of who in management plays a “significant” role in the company’s financial reporting process. Moreover, as written, it is not clear whether “significant” modifies the company’s financial reporting process as a whole or instead connotes a meaningful role in a particular sub-process. We suggest that this definition be modified to describe

¹⁰ We note that the language at page 11 of the Proposing Release helpfully suggests that the auditor possesses some degree of latitude in evaluating the import of the identification of one or more of the strong indicators. We find it difficult to gauge the relevance of this language, which is not proposed to be part of the auditing standard itself. Since the Proposed Standard includes many explanatory notes in the body of the standard (including in Paragraph 79), the relevance of this explanatory text in a location outside the actual standard is unclear. We suggest that language along these lines be added to the body of Paragraph 79, either as introductory text or as an explanatory note.

management that plays a significant role in the company's financial reporting process taken as a whole.

- We note that the second identified strong indicator in the Proposed Standard under the "ineffective control environment" indicator is phrased differently from the corresponding reference in the SEC Release (emphasis supplied):

Proposed Standard: Significant deficiencies that have been *communicated to management and the audit committee* and remain *uncorrected* after some reasonable period of time.

SEC Release: Significant deficiencies that have been *identified* and remain *unaddressed* after some reasonable period of time (page 45 of the SEC Release).

We recommend that the PCAOB utilize the formulation set forth in the SEC Release. As this speaks to Significant Deficiencies, not Material Weaknesses, we believe that the PCAOB's suggestion that each Significant Deficiency must be formally communicated to the Audit Committee and corrected, rather than acted on, entails excessive detail. We also believe this approach is inconsistent with the PCAOB's goal of focusing auditors on Material Weaknesses.

- We believe that the Note to the second identified strong indicator (restatements of previously issued financial statements to correct a misstatement) should also explicitly exclude restatements due to clarification, or change in interpretation, of existing accounting standards by auditors or regulators. Given the complexity of financial statements and accounting principles, it is neither uncommon nor troubling that auditors and those responsible for the promulgation of GAAP from time to time issue clarifications or changes. Recent examples include the treatment of certain aspects of accounting for leases and derivative transactions. In these circumstances, the company has relied in good faith on prior positions or interpretations and the change does not reflect a flaw in its internal control. While one could take the position that neither of these circumstances constitute a "misstatement" in the prior accounting, the same can be said for the other examples in the Note (retrospective application of a change in accounting principle or voluntary change from one generally accepted accounting principle to another).

We note that the version of this concept in the SEC Release refers to the correction of material misstatements (see SEC Release at p. 46), whereas the Proposing Release refers to the correction of any misstatement. We believe that the SEC version is the appropriate standard for this strong indicator.

- The next bullet point in Paragraph 79 (identification by the auditor of certain material misstatements in financial statements) could be read to include misstatements contained in drafts shared by the company with its auditors or proposed accounting treatments raised by the company with its auditors for discussion purposes. Any such implication could cause a reoccurrence of the chilling of communications between companies and their external auditors for fear that raising questions or sharing drafts could give rise to allegations of Material Weakness by the auditors. We believe that open dialogue between a company and its auditor in the context of the preparation of financial statements or the analysis of potential accounting treatments is in fact part of a company's internal control over financial reporting.¹¹ We recommend that the language in this paragraph be clarified to remove any such suggestion, preferably with citations to the authorities referred to in footnote 11 below.
 - The next bullet point in Paragraph 79 (ineffective oversight by the audit committee) places the auditor in the position of evaluating the competence of the entity that supervises it. We believe this raises potentially troubling conflict and independence issues, despite the text in the note accompanying this item. We also believe that the last sentence of the first full paragraph on page A1-31 of the Proposed Standard poses the same potential chilling effect on communications between the audit committee and the auditor as noted above and is thus contrary to prior SEC and PCAOB guidance.¹²
 - The next bullet point in Paragraph 79 (ineffective internal audit function) is not set forth in the SEC Release. We believe the definitive SEC and PCAOB pronouncements need to be consistent on this point.
4. Evaluating Identified Deficiencies (Paragraph 78 of the Proposed Release). Paragraph 78 of the Proposed Release identifies four categories of deficiencies, the occurrence of any one of which would "ordinarily result in at least significant deficiencies in internal control over financial reporting." We believe this language shares the same lack of scope for the exercise of professional judgment of the auditor as the strong indicators of Material Weakness provisions analyzed above. While the use of the word "ordinarily" could be read to connote the ability on the part of the auditors to exercise judgment, we believe that greater emphasis

¹¹ See SEC Staff Statement on Management's Report on Internal Control Over Financial Reporting (May 16, 2005), Section G (available at www.sec.gov/info/accountants/stafficreporting.htm); PCAOB Staff Questions and Answers, Auditing Internal Control Over Financial Reporting (June 23, 2004) (Revised July 27, 2004), Question No. 7.

¹² See footnote 11, *supra*, and accompanying text.

of this point is warranted. We therefore recommend that an explicit expression of this concept be added to Paragraph 78.

5. Potential Chilling Effects on the Level and Extent of Communications Between Auditors and Management. Both the SEC and the PCAOB noted after the first roundtable on the implementation of internal control reporting provisions that an unintended consequence of Section 404 and AS No. 2 was a chilling effect in the level and extent of communications between auditors and management regarding accounting and financial reporting issues.¹³ Both the SEC and the PCAOB clearly stated that neither Section 404 nor AS No. 2 should impair the free and open dialogue between management and their auditors. The Committee believes that, notwithstanding this background, in several instances the Proposed Standard contains references that could create a similar chilling in management/auditor communications. Several of these instances are noted above in our discussion of the Proposed Standard's treatment of strong indicators of material weaknesses. In addition, we note Paragraph 80 of the Proposed Standard, which refers to "misstatements detected during the financial statement audit" as a factor to be considered by the auditor in forming its opinion on the effectiveness of internal control.

We believe that the PCAOB should make clear that the Proposed Standard as adopted is not intended to, and should not be read to, suggest that companies should not engage in open and frequent dialogue with their auditors during the audit process.

We also note that this reference creates a lower standard than the similar concept expressed in Paragraph 79 of the Proposed Statement, which posits a *material* misstatement as a potential indicator of a Material Weakness. We believe the reference in Paragraph 80 should also be conditioned by materiality.

6. Inconsistent Use of Normative Standards. Throughout the Proposing Release and the Proposed Standard, the PCAOB uses varying normative standards, in particular the terms "should" and "must." As a matter of plain English, we understand the difference in the meanings of these words. If taken literally, however, the less directive standard of "should" could create confusion between audit clients and their auditors as to the intent of the PCAOB.¹⁴ To the extent auditors may interpret provisions that are designed to promote efficiency as optional rather than required, this could compromise the goals of the PCAOB in its evaluation of the audit of internal control. Examples of potentially undesirable permissiveness introduced into statements that we would expect to be mandatory

¹³ Id.

¹⁴ We note the statement of the PCAOB at page 30 of the Proposing Release that "the requirements have been articulated in a more readable manner that should be understandable to audit clients as well as auditors."

in nature include, but are not limited to, the following (in each quotation, emphasis is supplied):

- “[T]he auditor *should* continuously adjust his or her procedures to reflect information that the auditor has learned” (Proposing Release, Page 7, paragraph 1, line 6).
- “The auditor *should* use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses . . .” (Proposed Standard, paragraph 5).
- “The audit of internal control over financial reporting *should* be integrated with the audit of the financial statements” (Proposed Standard, paragraph 7).¹⁵
- “[T]he auditor *should* focus the majority of his or her attention on the areas of greatest risk . . .” (Proposed Standard, paragraph 8).
- “[T]he auditor *should* use the same materiality considerations he or she would use in planning the audit of the company’s annual financial statements” (Proposed Standard, paragraph 14).
- “The auditor *should* use a top-down approach to the audit of internal control over financial reporting . . .” (Proposed Standard, paragraph 16).
- “In subsequent years’ audits, the auditor *should* incorporate knowledge obtained during past audits he or she performed of the company’s internal control over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary” (Proposed Standard, paragraph 65).

These “should” references suggest an unwarranted degree of optionality in light of numerous other statements in the Proposal that are expressed as mandatory statements. Examples of mandatory formulations (in addition to the formulation noted in footnote 15) include, but are not limited to, the following:

- “[T]he proposed standard states that to obtain evidence about whether a control is effective, the control *must* be directly tested” (Proposing Release, page 8, carryover paragraph, lines 6-7).
- “[T]o attest to and report on management’s assessment, the auditor *must* test controls directly . . .” (Proposing Release, pages 15-16, in particular line 1 of carryover paragraph on page 16).
- “The auditor *must* test those company-level controls that are important to the auditor’s conclusion . . .” (Proposed Standard, paragraph 17).

¹⁵ Note that this “should” reference is immediately followed by a sentence stating that “the auditor *must* plan and perform the work to achieve the objectives of both audits.”

7. Account-balance Versus Overall Materiality The Proposing Release states that one of the goals of the Proposal is to clarify the role of materiality in the audit of internal control.¹⁶ One of the concerns with AS No. 2 expressed by companies and auditors was the need to focus on individual account balance materiality in scoping the audit of internal control.¹⁷

The discussion of materiality in the Proposed Standard itself (at paragraphs 14-15) is, however, silent on this issue. The Proposed Standard helpfully omits the first sentence of Paragraph 22 of AS No. 2, which stated that the auditor should apply the concept of materiality in the internal control audit at both the financial statement and individual account-balance level. However, this silence is not necessarily helpful, as the only remaining analysis of materiality in the Proposal requires the auditor to “use the same consideration of account-level materiality” in scoping the audit of internal control as is used in the financial statement audit.¹⁸

The Committee believes that account-balance materiality should only be relevant in scoping the audit of internal control in limited circumstances. Just as the audit of the financial statements is designed to permit the auditors to express an opinion on the financial statements taken as a whole, the audit of internal control is designed to result in an opinion on the overall effectiveness of the company’s controls. In the interest of furthering the ability of the auditors to exercise their reasoned judgment in a risk-based, top-down audit, we recommend that the Proposed Standard make clear that account-balance materiality should be relevant in scoping audits of internal control only when the account balance itself is presumptively material to the financial statements taken as a whole.

8. Walkthrough Requirements. The Committee believes that the PCAOB should not only permit, but encourage, auditors to rotate their performance of certain walkthroughs based on the auditor’s risk assessment. We acknowledge that certain controls are so fundamental that annual walkthroughs are called for. We believe, however, that in many instances walkthroughs can be rotated without compromising the efficacy of the audit of internal control. In fact, we believe that permitting rotation would enable the auditors to focus more closely on the walkthroughs it does perform, thus increasing the quality of the audit. We expect that the PCAOB would mandate a minimum frequency for walkthroughs of significant controls (perhaps at least once every three audit cycles).

¹⁶ Proposing Release at p. 4.

¹⁷ See, e.g., Robert C. Pozen, *Why Sweat the Small Stuff?*, THE WALL STREET JOURNAL, Apr. 5, 2006, at A20.

¹⁸ Proposing Release at p. 13; Proposed Standard at Paragraph 14. As support for this statement, footnote 7 of the Proposed Standard cites AU sec. 312, *Audit Risk and Materiality in Conducting and Audit*, which contains multiple references to the relevance of account-balance materiality in audits of financial statements.

9. US GAAP Reconciliations. In a concurrent comment letter that the Committee is submitting to the SEC relating to the proposed interpretation and rules governing management's report on internal control over financial reporting (a copy of which is being provided to the PCAOB), we recommend that the SEC should exempt the reconciliation to US GAAP from the scope of its Section 404 rules. The reconciliation exercise presents specific problems because it is often not integrated with the financial reporting system on which the primary financial statements rely. We similarly recommend that the PCAOB should exempt the US GAAP reconciliation from the audit of internal control. If neither the SEC nor the PCAOB provide exemptions, they should align their final positions on this issue.
10. Using the Work of Others. The Committee supports the PCAOB's proposals to remove barriers that currently limit the ability of auditors to use the work of others. In particular, the Committee strongly supports the elimination of the "principal evidence" provision contained in AS No. 2 and related standards. We suggest that the Proposed Standard as finally adopted, along with the adopting release, affirmatively encourage auditors to so rely, within the bounds of the new standard. On the face of the Proposal, it appears to be permissible for an auditor to elect not to utilize the work of any third party, even though expressly permitted.
11. Oversight by the PCAOB of Implementation of New Auditing Standard. The PCAOB has consistently included in its guidance relating to the audit of internal control statements to the effect that it will focus its inspections of internal control auditing on whether the firms efficiently achieved the objectives of the internal control audit.¹⁹ No such statement is included in the Proposing Release. We believe it will be important for the PCAOB to continue to monitor the implementation of its guidance in this area as part of its inspection authority, and suggest that an explicit statement to that effect in the adopting release relating to the new standard would be useful.²⁰
12. Effective Date. We understand that it will be impractical for companies and their auditors to adjust their existing internal controls and procedures for evaluating and auditing effectiveness in respect of current fiscal years. We therefore suggest that the Proposal take effect for companies' first full fiscal years after adoption. To facilitate advance planning, however, the Committee encourages the PCAOB (and the SEC) to act promptly to complete and adopt final versions of each component of the Proposal. In particular, the Committee urges the PCAOB to

¹⁹ See, e.g., Statement Regarding the Public Company Accounting Oversight Board's Approach to Inspections of Internal Control Audits in the 2006 Inspection Cycle, PCAOB Release No. 104-2006-105 (May 1, 2006); Policy Statement Regarding Implementation of Auditing Standard No. 2, PCAOB Release No. 2005-009 (May 16, 2005) at p. 13 ("we intend to use our upcoming inspections to evaluate how firms have conducted the first round of audits under Auditing Standard No. 2").

²⁰ See also Grundfest & Bochner at p. 56.

request the SEC to adopt the shortest permissible comment period duration following the publication by the SEC of the final version of the Proposal.

Drafting Comments

- Paragraph 6 of the Proposed Standard. The first bullet point should be revised to make clear that knowledge obtained from ongoing, as well as completed, engagements is included.
- Paragraph 17 of the Proposed Standard. This paragraph contains new language to the effect that the auditor must test those company-level controls “that are important to the auditor’s conclusion” regarding the effectiveness of internal control. The quoted language provides little guidance and could result in disagreement between an auditor and its client as to what extent the auditor should test company-level controls. In particular, the use of the word “important” (as opposed to “material” or “essential”) suggests a particularly low standard might be imposed. We believe this ambiguity in relation to such a significant provision could compromise the efficiency of future audits of internal control, and suggest that greater clarity be provided in the Proposed Standard as finally adopted.
- Paragraph 20 of the Proposed Standard. The fifth bullet point presumes that in all cases management will face incentives and pressures to misstate the company’s financial statements. The presumption encourages a pejorative approach to the audit that is inconsistent with the basic concept of “professional skepticism” that is contained in the auditing literature.²¹ It is also important to note that, if this provision of the Proposed Standard is read literally, any incentive-based executive compensation structure could be characterized as presenting such pressures. While excesses have occurred in extreme cases, we do not believe it is appropriate for auditors to view any incentive-based executive compensation system as requiring that affirmative mitigating acts be taken.
- Paragraph 47 of the Proposed Standard. We suggest changing “could” in the third line to “would” to be consistent with the definitions of Material Weakness, Significant Deficiency and the general approach reflected elsewhere in the Proposed Standard.
- Paragraphs 57-59 of the Proposed Standard. The first sentence of Paragraph 59, standing alone, suggests that it is always better to test controls as close as possible to the date of management’s assessment. This could lead auditors to

²¹ AU Section 230, *Due Professional Care in the Performance of Work* at Paragraphs .07-.09 (“the auditor neither assumes that management is dishonest nor assumes unquestioned honesty”). Some observers characterize this standard as constituting a “neutral” concept of professional skepticism. Public Oversight Board, THE PANEL ON AUDIT EFFECTIVENESS - REPORT AND RECOMMENDATIONS (2000) at Section 3.8 and footnote 2 thereto.

unnecessarily compress their audit of internal control into the end of the company's fiscal year, at a time when such compression can compromise management's and the auditor's ability to focus on other matters. Paragraph 59 should be expanded to state that, in balancing the timing of tests, the auditor also could focus on its risk assessment and determine that controls posing lower risk be tested earlier in the year, if doing so would enhance the efficiency of the internal control audit. The Proposed Standard could also permit rotation such that tests performed early in the year are then tested later in the year during the subsequent year's audit, and vice versa.

- Paragraph 76 of the Proposed Standard. As drafted, this paragraph suggests that a control can only be considered compensating if it would, with certainty, prevent or detect the misstatement. We believe this is an unworkable standard and suggest adding the phrase "be reasonably likely to" immediately preceding the words "prevent or detect" in the fourth line of this paragraph.
- Paragraph 79 of the Proposed Standard; first bullet point on page A1-32. The reference in the first bullet point on page A1-32 to the "risk assessment function" is unclear. We believe the PCAOB intends to refer to the risk assessment function within the company's financial reporting structure, but this reference could be read to refer to the company's overall business risk management function.
- Paragraph 84.f. of the Proposed Standard. This paragraph involves a formulation of relevant management that is broader than the formulation used in Paragraph 79, where the term "senior management" is defined. We recommend that this paragraph utilize that defined term (modified as suggested in this comment letter).
- Paragraph 90 of the Proposed Standard. As drafted, this paragraph could be read to prohibit the company from disclosing any of the written communications referred to in this portion of the Proposed Standard to third parties that may have a need to know and to whom the company would like to make disclosure (such as investment banks, potential counterparties or their counsel performing due diligence in connection with capital markets or M&A transactions). We believe that access on the part of relevant transaction participants to correspondence with the Audit Committee regarding the audit of internal control could prove to be useful to investor protection. We also note that Paragraph 90 could be read to include the written materials required to be provided to the Audit Committee by the auditors pursuant to Section 10A(k)(3) of the Securities Exchange Act of 1934. We do not believe auditors can condition the delivery of these statutorily-required communications upon a confidentiality obligation. We thus suggest that Paragraph 90 be deleted.
- Paragraph 96 of the Proposed Standard. The PCAOB proposes to change the content of the auditor's report on internal control to eliminate the requirement to evaluate management's evaluation process. As noted above, the Committee

supports this proposal. We note that the first paragraph of the model text of an unqualified opinion in Paragraph 96 of the Proposed Standard includes a reference to the audit of management's assessment, as included in an accompanying report. We suggest that this formulation be conformed to the other references in the model text, which correctly state that the auditor has audited the effectiveness of internal control.

- Paragraphs 106-08 of the Proposed Standard. These paragraphs provide that an auditor must take into account in his or her opinion any subsequent adverse events occurring between period end-date and the date of the auditor's opinion. The inverse situation is not addressed. The Committee believes that the occurrence of a positive event after period end-date and prior to delivery of the opinion is equally relevant to investors. AS No. 4 (Reporting on Whether a Previously Reported Material Weakness Continues to Exist) provides for reporting on remediation of a Material Weakness after a period-end date but before the relevant opinion is delivered. We recommend that the PCAOB clarify that AS No. 4 continues to be applicable.
- Paragraphs A10 and A11 of Appendix A to the Proposed Standard. The references to "financial statements" in the second and third lines of Paragraph A10 and the third line of Paragraph A11 should both be modified by the phrase "taken as a whole." This will clarify that the respective defined terms are calibrated to the overall financial statements and not to account-balance entries.
- Paragraph B18 of Appendix B to the Proposed Standard. The word "may" at the end of the second line should be changed to "must" (or "should" if language is added to the Proposal to make clear that the normative standard "should" is to be interpreted as mandatory, not optional).
- Paragraph C14 of Appendix C to the Proposed Standard. This paragraph should be revised to permit the auditor to consult with the Audit Committee, not just management, prior to formally notifying the Audit Committee of the remaining material misstatement. This is consistent with the provisions of the Sarbanes-Oxley Act, now part of §10A of the Securities Exchange Act of 1934, providing that the auditors report to, and their work is overseen by, the Audit Committee.
- Appendix 3 - Proposed Rule 3525: Audit Committee Pre-approval of Services Related to Internal Control Over Financial Reporting. The Committee is concerned that item (c) (requiring the auditor to document the substance of its discussion with the Audit Committee) will unnecessarily create a potentially adverse litigation record. The auditor could, of course, document the fact that the discussion occurred and confirm that the Audit Committee will prepare minutes reflecting the substance of the discussion.


Conclusion

The Committee believes that the Proposal constitutes a significant improvement to AS No. 2. We commend the PCAOB and its staff for their efforts to improve both the efficiency and efficacy of this process. As discussed above, we believe that there are aspects of the Proposed Standard and the Proposal that merit further consideration by the PCAOB.

The implementation of Section 404 has become a hot-button issue, both politically and competitively. We share the PCAOB's and the SEC's desire to produce rules and standards that are readily understood by auditors, management and investors and that consistently result in efficient and effective audits on internal control and related disclosures. We believe that this can be achieved by significant, rather than incremental, change to AS No. 2 and related standards. We hope our comments are of use to the PCAOB and its staff in this process.

Members of the Committee would be pleased to answer any questions you might have regarding our comments.

Respectfully submitted,



Norman D. Slonaker
Chair of the Committee on Financial
Reporting

cc: Securities and Exchange Commission
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Hon. Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner
Hon. Kathleen L. Casey, Commissioner
Hon. Annette L. Nazareth, Commissioner

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Securities and Exchange Commission – Division of Corporation Finance
Mr. John W. White
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