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Office of the Secretary  
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Re: PCAOB Rulemaking Docket Matter No. 021

The Procter & Gamble Company appreciates the opportunity to provide their views on the Public Company Accounting Oversight Board ("PCAOB") proposed 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* ("proposed standards").

We agree that the proposed standards have the potential to assist auditors in making their audit process more efficient and cost-effective, as the PCAOB intended. We appreciate the thought and effort put into developing the standards. We also appreciate the fact that the PCAOB has listened to comments expressed at the two Roundtables and in other forums about the balance between costs and benefits of Sarbanes-Oxley compliance. The proposed standards open the door for productive dialogue with our external auditors about how to make our assessments and their audits much more efficient.

We especially appreciate that the proposed guidance has moved to a more principles-based approach that will allow companies to apply the principles in assessing individual company situations. We support the top-down, risk-based approach and encourage the clear communication of the expectation that the guidance provides flexibility to support other approaches that companies may have chosen to adopt.

In addition to our support for the proposed guidance, we have concerns surrounding the alignment between management guidance and external audit standards. We believe that the proposed PCAOB standards, although improved from the existing PCAOB Audit Standard No. 2 ("AS2"), are still more detailed and prescriptive than the proposed SEC guidance. These differences are likely to result in external audits that are more conservative than management assessments and are likely to perpetuate inefficient audits by creating two distinct evaluation approaches.

Related to the ability for companies to implement the proposed guidance successfully in alignment with their external auditors, the auditors must be assured that the inspection practices of the PCAOB will align with the proposed auditing standards. If the auditors do not receive that assurance, they will be reluctant to change their approach until after an inspection cycle, which can be more than a year from the time of the audit. If auditors do not change their approach, companies will continue to incur additional costs and fail to achieve the objective of more efficient and effective assessments. We discuss alternatives in the appendix that may help achieve this objective.

We believe that the PCAOB needs to be proactive in encouraging external auditors to embrace the level of significant change that the companies expect to make in their assessments.

We also have several suggestions for clarifications or enhancements to the proposed guidance itself. All suggestions are described more fully below, but the top priority items in terms of improving efficiency and effectiveness are:

- Focus on change in controls for testing, allowing for rotation testing of controls that have operated effectively in the past and have not changed;
- Increased reliance on entity-level controls to reduce process-level testing;
- Focus on the evaluation of control deficiency against an annual materiality definition and not an interim threshold. The complete controls evaluation is performed and reported annually; the evaluation of whether a control deficiency could result in an error to future interim or annual statements should be evaluated against an annual materiality definition.

We believe these suggestions are critically important to have a meaningful impact in striking the right balance between costs and benefits of internal controls assessments.

## **ALIGNMENT BETWEEN MANAGEMENT AND EXTERNAL AUDITORS**

Management guidance and external audit standards must be aligned. We believe that the proposed PCAOB standards, although improved from the existing PCAOB Audit Standard No. 2 (“AS2”), are still more detailed and prescriptive than the proposed SEC guidance. In the absence of management guidance, companies have had to adhere to some rules under AS2 to satisfy the requirements of the external auditors.

We expect that to change, but it will require a principles-based approach to the requirements. With the flexibility to focus on a top-down, risk-based approach to detect only material weaknesses, we anticipate that companies may be able to drive to a more cost-effective approach that focuses on high risk areas. However, there may be other more detailed approaches that are adopted to meet the internal objectives of maintaining and monitoring a company’s control environment. Having the flexibility to implement the most cost effective approach to balancing internal and external objectives can be achieved by being clear on the minimum objectives of the regulatory requirements and allowing flexibility in meeting those. This will result in a better tradeoff between the quality of controls assurance and the cost of compliance. Companies are certainly motivated to become more efficient in their compliance processes. It stands to reason that the external auditors, under the proposed standards, would be able to mirror management’s efficiencies.

We want to emphasize how critical it is that the audit standards are aligned with management guidance. The external auditors must be comfortable with management’s assessment approach to optimize reliance and achieve overall cost savings. Although the requirement for an opinion on management’s assessment process has been eliminated, the opinion on the controls themselves remains. A more detailed or conservative approach on the part of the auditors will drive companies to continue to document and assess lower-risk controls, thereby continuing to incur unnecessary costs and failing to achieve the objective of more effective and efficient assessments.

Further, we do not believe that additional, prescriptive guidance over management's evaluation approach is required, rather the guidance that allows judgment and principle to be used in achieving stated minimum objectives.

## **CLARIFICATIONS AND ENHANCEMENTS**

### **Focus on changes in controls**

The proposed guidance encourages the use of prior knowledge and assessment results to guide the risk assessment and testing approach. After the initial assessment, subsequent reviews of risk and design can be focused on changes in risks and controls. Prior testing results can be used to guide the risk assessment of both the significant accounts and the controls.

We support the focus on changes in controls and believe that it could lead to the logical conclusion that a control would not need to be tested or assessed each year. In spite of the discussion about incorporating prior year information and results to guide the extent of testing, the proposed guidance does not address the current practice of "each year standing on its own," requiring some type of assessment of each control each year. By contrast the PCAOB proposed standards specifically provide for benchmarking of automated controls. We suggest that the SEC consider where and how management might be encouraged to benchmark or rotate testing of controls in all areas. If management could confirm that the control design had not changed and that the control had been operating effectively in prior assessments, we should have the freedom to forego annual testing of that control, particularly for lower risk controls, in favor of a rotational testing plan.

### **Company-level controls**

Companies have put much thought and effort into identifying and enhancing company-level controls. Although we are confident that company-level controls are the key to preventing material future financial reporting failures, in some cases it remains unclear as to how these controls can be leveraged to reduce testing of transaction level controls, particularly indirect company-level controls such as ethics programs and Board of Director oversight. Paragraphs 16 and 17 of the proposed standard indicate that a top-down approach begins with company-level controls, that those controls must be tested, and that the evaluation could result in increasing or decreasing other auditor testing. This language does not express a strong conviction that company-level controls can have a significant effect on the extent of other testing. We ask that the PCAOB reconsider whether the language could be enhanced to more strongly support giving credit for strong company-level controls.

Leveraging company-level controls to reduce other testing has been more successful in the case of direct company-level controls, such as analytic reviews and budget-to-actual comparisons. One issue here has been establishing the precision at which these controls operate. With the new focus on detecting material misstatements, the precision should be less of an issue. In paragraph 43 the proposed standard states that some company-level controls might adequately prevent or detect misstatements to one or more relevant assertions. We would like to see the word "material" inserted before "misstatements" twice in this paragraph to emphasize that the acceptable level of precision is higher than in the past.

### **Annual vs. interim financial statements considered in evaluating deficiencies**

The definition of "material weakness" in the proposed guidance (page 13) includes a misstatement of the company's "annual or interim financial statements." Management's assessment and evaluation for deficiency is an annual assessment of the operating effectiveness as of the end of the fiscal year. We believe that reporting at fiscal year end is pragmatic...being forced to evaluate and report on an interim basis, however, leaves no room for remediation. We believe that the evaluation of whether the control deficiency could result in an error to future interim or annual statements should be evaluated against an annual materiality definition. Said another way, companies should not be held to a more demanding threshold on our interim reporting simply because our earnings (which drive materiality determination) during interim periods are a fraction of the annual amount). We believe that the deficiency evaluation should only consider the impact on annual financial statements. Basing materiality upon impact to the annual financial statements is also believed to be most consistent with the proposed guidance that also states that, "As part of the evaluation of ICFR, management considers whether the deficiencies, individually or in combination, are material weaknesses as of the end of the fiscal year." For all of these reasons, we suggest that the reference to interim financial statements should be removed from the definition in the proposed guidance.

### **Definition of "significant" deficiency**

We believe that the phrase "less than material yet important enough to merit attention" will raise the threshold of magnitude above the current level of "more than inconsequential."

Another observation is that the "prudent official" language in paragraph 77 does not include any qualifier based upon magnitude of deficiency. Reading this paragraph as currently stated would imply that any error in transactions not in conformity with GAAP could result in a significant deficiency. In addition, the language in paragraph A12 has changed to define a "significant deficiency" as a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting. We believe that the premise of the standard is the assessment of the control environment as measured against an investor mindset (preventing errors that could be material to an investor). Prudent internal officials likely have a much different view of potential control issues than an investor would for any number of reasons. Thus, introducing an internal view is inconsistent and could lead to a much broader and more detailed executional expectation.

### **Auditor judgment**

We support the changes in the proposed standards to remove much of the detailed or prescriptive guidance that was included in Audit Standard No. 2. We believe that leaving more decisions in the hands of the individual audit engagement teams can improve efficiency and quality by tailoring the approach to the specific company circumstances.

We do want to comment on instances where the guidance remains detailed and/or prescriptive and recommend that the language be modified:

- The requirement for the auditor to perform walkthroughs remains in the proposed standards, although it is modified to require walkthroughs of only significant processes rather than each major class of transactions within each significant process. We believe that while the walkthrough can be an effective means for gathering evidence regarding the

design and even operating effectiveness of controls, it should not be required, but rather left to the auditor's judgment.

- Paragraph 70 requires that the auditor evaluate the severity of each control deficiency that comes to his or her attention, even though he/she is not required to search for deficiencies that are less severe than a material weakness. We believe that this is not necessary, and that an acceptable alternative would be for the auditor to verify that management has evaluated all deficiencies.

### **Reliance by auditors on the work of others**

The second proposed standard expands the potential for auditor reliance on the work of others, which should further reduce the costs of external audits and better align the audit and the management assessment. The proposed standard defines guidelines for competence and objectivity that could expand reliance on work by company employees and contractors other than internal audit. It removes the "principal evidence" requirement and also removes the requirement for original work in testing of controls in the control environment. We believe that these changes will be effective in facilitating greater reliance and lower costs.

The proposed standard includes factors to consider in the external auditor's evaluation of competence and objectivity to determine the appropriate level of reliance on the work of others. The criteria seem comprehensive, but we have concerns about how the auditors will obtain and document their satisfaction with competence and objectivity based on these somewhat detailed criteria. If the auditor felt compelled to satisfy several of the criteria listed, gathering and reviewing documentation of competence and objectivity could be onerous. We also believe that the focus on organizational status could be interpreted quite restrictively to direct the auditor to rely only on the work of Internal Audit. Many companies have established successful programs of using line testers who have deep knowledge of the processes and controls. In many cases, they are equally or more competent and objective than Internal Audit.

We believe that competence and objectivity can be appropriately judged by the external auditors in individual company situations without being constrained by factors specified in the proposed standard. Therefore, we would like to see paragraphs 14 and 15 removed from the proposed standard and let the auditor apply his/her judgment in evaluating competence and objectivity.

### **Detection of Fraud**

The proposed guidance states on paragraph 23 that, along with other factors, management should consider the risk of material misstatement due to fraud in its risk assessment. This clarification is helpful as it has been unclear whether companies should be identifying and assessing controls that would detect ANY fraud committed by a senior executive.

Contradicting that point, however, is the language on page 45 which says that fraud of any magnitude on the part of senior management is an indicator of a material weakness. It may be appropriate to define the specific types of fraud that should be considered to be an indicator of a material weakness (e.g., intentional manipulation of financial statements, versus misappropriation of assets).

### **Removal of opinion on management's assessment**

We support the elimination of the opinion on management's assessment process. Although we do not expect to see substantial efficiencies result from the change, we believe that the opinion on the management assessment is superfluous and should be eliminated. If companies want to optimize auditor reliance on management testing, they will still need to mirror the external auditors' standards of testing and documentation. However, the elimination of the opinion will give companies the flexibility to make that decision without being compelled to conform their assessments to AS2 standards.

### **Deficiency evaluation**

The change in the likelihood component of the material weakness definition from "more than remote" to "reasonable possibility" should reduce the time spent on evaluating deficiencies. Although the proposed guidance includes indicators of material weaknesses and a description of typical significant deficiencies (footnote 74), it does not address quantitative guidelines for determining materiality thresholds. The guidance could be clarified by specifying that materiality for deficiency evaluation should be aligned with financial statement materiality.

The proposed guidance includes factors to consider in evaluating the likelihood and magnitude of a control deficiency or combination of deficiencies. Many companies have been using a deficiency evaluation framework that was created by the larger audit firms. This framework focuses on a quantitative and mechanical approach that is counter to the concept of a risk-based evaluation approach. We believe that the factors in the proposed guidance can be used in lieu of the framework and recommend that the guidance include a statement that allows flexibility in using a deficiency evaluation framework and encourages judgment of factors provided in the proposed guidance.

### **Effective date**

We hope that we have clearly communicated our support for the proposed guidance. To allow companies to realize the expected benefits in the near future, we suggest that the proposed guidance and the proposed standards should be implemented as soon as possible.

Thank you for considering our views. We would be happy to discuss our comments and recommendations at your convenience.

Sincerely,

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