

February 26, 2007

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

**RE: PCAOB Rulemaking Docket 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 Sir:

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") proposed auditing standard, *An Audit of Internal Control over Financial Reporting That Is Integrated with An Audit of Financial Statements* (the "standard"). We support the Board's objective to issue a principles-based standard designed to focus the auditor on the matters of highest risk that are most important to evaluating whether internal control over financial reporting is effective. The standard provides the auditor with an increased opportunity to apply appropriate professional judgment which will contribute to a more effective and efficient audit of internal control over financial reporting.

The Sarbanes-Oxley Act of 2002 (the "Act") has been a catalyst for improved financial reporting which has helped to restore investor confidence and increase the transparency and reliability of financial information relied upon by investors and other stakeholders. We believe, if implemented appropriately, the principles in the standard will preserve investor protection while improving the efficiency of implementation of Section 404 of the Act.

PricewaterhouseCoopers is committed to delivering a high-quality and efficient top-down, risk-based audit of internal control over financial reporting that is integrated with an audit of financial statements. The standard, when combined with the proposed Securities and Exchange Commission's ("SEC") interpretive guidance, *Management's Report on Internal Control over Financial Reporting* ("management's guidance"), will contribute to increased efficiency and a reduction in the total costs of compliance with Section 404 of the Act. The degree of benefit will vary significantly from company to company and will be dependent upon many factors, including the extent to which a top-down, risk-based approach was previously implemented.

In the sections below, we include a discussion of some of the more significant matters related to the standard. Observations and recommendations on certain other matters addressed in the Board's invitation to comment are included as an Appendix to this letter.

### **Principles-based Standard**

The standard's focus on principles, rather than prescriptive requirements, will increase appropriately the use of reasonable professional judgment to plan and perform the audit. For example, the standard expands the opportunities to apply professional judgment based on an auditor's assessment of risk when determining the scope of the audit, as well as the sufficiency of evidence needed to determine the effectiveness of internal control.

The application of reasonable professional judgment is an integral part of any audit, including an audit of internal control over financial reporting. The extent to which an auditor applies judgment is influenced in part by the degree of acceptance of those judgments by various parties, including regulators. The PCAOB's actions have had and will continue to have significant impact on an auditor's ability to apply professional judgment. We encourage the inspection process to consider and support the auditor's increased use of professional judgment that will enable the auditor to achieve the desired improvements in the efficiency of audits.

### **Scalability to All Companies**

We support one auditing standard that is scalable to the size and complexity of a company and allows the auditor to align the level of effort with the level of risk and complexity. We believe the standard is appropriately scalable to companies of all sizes and complexity. The standard, along with the COSO guidance for smaller public companies and the forthcoming PCAOB guidance on auditing smaller public companies will contribute positively to the scalability of compliance with Section 404. We believe these combined efforts will result in a reduction of the cost of implementation for non-accelerated filers.

### **Correlation with Management's Assessment**

The most effective and efficient Section 404 process results from a coordinated approach between management's assessment and the audit of internal control over financial reporting. As the ultimate goal of both processes is a conclusion about the effectiveness of internal control over financial reporting, we believe conceptual alignment in the approaches employed by both management and the auditor is an essential element of this cooperative effort. We note that the description of company or (entity) level controls and the list of strong indicators of material weakness are not the same in the standard and management's guidance. Ensuring alignment in these areas will improve efficiency and reduce the confusion that could result from different interpretations of what should be parallel guidance.

### **Use of the Work of Others**

We recognize the increased efficiency that can result from greater reliance on the work of others who have sufficient competence and objectivity. The competence and objectivity model included in the Board's proposed auditing standard, *Considering and Using the Work of Others in an Audit*, will facilitate the auditor's use of judgment in making decisions regarding the extent to which reliance can be placed on the work of others in the integrated audit. We have included recommendations to improve clarity in this area in the Appendix.

### **Company-level Controls**

Strong, comprehensive company-level controls can significantly reduce the risk of material misstatement of the financial statements. The top-down approach appropriately directs the auditor to consider company-level controls when performing an audit of internal control over financial reporting as a means of increasing effectiveness and efficiency. Because of the significant risk for confusion as to how the evaluation of company-level controls can result in increasing or decreasing the testing that the auditor otherwise would perform on controls at the process, transaction or application levels, we believe it is critical that the PCAOB clarify the principle for determining the range of impact that company-level controls can have on the audit of internal control over financial reporting. The principle should include a description of direct and indirect controls and a discussion of the importance of the consideration of the precision at which the company-level controls operate. It should also be aligned with the corresponding discussion in the SEC's guidance for management. We believe it would be useful to include in the standard a principles-based continuum for considering the impact of company-level controls on the auditor's testing of controls at the process, transaction or application levels. We have included our specific recommendations in the Appendix to this letter.

### **Interim Materiality**

Although we believe that reliable interim financial information is critically important to the capital markets, we recommend that the Board eliminate the requirement to evaluate the significance of all control deficiencies against interim results. While the standard directs the auditor to plan and scope the audit of internal control over financial reporting using the same materiality considerations he or she would use in planning the audit of the company's annual financial statements, the references to interim financial statements in the definitions of material weakness and significant deficiency has in some cases resulted in the perception that the audit scope should consider interim results. We believe the elimination of the references to interim financial statements in the definitions may enhance understanding of the symmetry between the scope of the audit and the evaluation of deficiencies and therefore improve efficiency. Furthermore, we believe it is equally important that the approach to and definition of materiality be consistently applied

throughout the audit of internal control over financial reporting and the audit of the annual financial statements.

**Effective Date**

Minimizing the disruption from implementation of the standard is important to all constituents. Toward that end, we encourage the Board's expedient consideration of these proposals and others received in the comment period to allow for the release of the standard as soon in 2007 as possible. A timely release of the standard will allow for maximum efficiency to be achieved for years ending in 2007, when practical, even if the standard was to be required for years beginning after December 15, 2007.

**Conclusion**

We support the effort by the PCAOB to issue a principles-based standard that relies on a top-down, risk-based approach, and the resulting expansion of the opportunities to apply well-reasoned professional judgment. We believe that the expanded use of appropriate judgment will have a meaningful impact on improving the efficiency and effectiveness of the integrated audit.

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We would be pleased to discuss our comments and to answer any questions that the PCAOB staff or the Board may have. Please do not hesitate to contact Vincent Colman (973-236-5390) or Jim Lee (973-236-4478) regarding our submission.

Sincerely,

*PriceWaterhouseCoopers LLP*

**Proposed Auditing Standard – An Audit of Internal Control over  
Financial Reporting That Is Integrated with  
An Audit of Financial Statements and Related Other Proposals**

In the text that follows we offer our responses to the Board's invitation to comment, grouped by category, and in some cases expanding upon our observations and recommendations highlighted in the comment letter.

**Top-down, Risk-based Approach**

A top-down, risk-based approach is an efficient and effective means to auditing internal control over financial reporting by focusing the auditor's attention on those controls that are most important to the auditor's conclusion about whether the company's controls sufficiently address the risk of material misstatement. The standard not only clearly describes how to use such an approach but we also believe that the structure of the standard facilitates the auditor's execution of a top-down, risk-based approach. The assessment of risk underlies the entire audit process and has a pervasive impact on the audit. The standard appropriately focuses on the direct correlation between the level of risk and the level of evidence necessary to conclude that a control is operating effectively.

While the identification of the most important controls requires considerable judgment, the principles outlined in the standard provide the auditor sufficient flexibility to vary the scope, nature, timing, and extent of procedures in order to eliminate unnecessary procedures as appropriate. The top-down, risk-based approach also facilitates scaling the audit to the size and complexity of each company by focusing on the company-specific risks of material misstatement. The standard enhances the auditor's ability to tailor the audit to a company's specific facts and circumstances, including its complexity, size, risk assessment, company-level controls, results of management's testing, and experience from prior year audits.

In addition, the application of the standard's top-down, risk-based approach to multi-location audits will improve the efficiency of such audits by permitting the auditor to exercise judgment to select locations based on the assessed risk of material misstatement to the financial statements.

### Company-level Controls

As mentioned in our comment letter, we believe it is important to clarify the description and range of impact of company-level controls and align it with the corresponding description in the SEC's guidance for management. Toward that end, we believe it would be useful to include in the standard a principles-based continuum for considering the impact of company-level controls on the nature, timing and extent of the auditor's testing of controls at the process, transaction or application levels. The continuum should consider whether a company-level control is directly or indirectly related to a relevant assertion for a significant account as well as the precision at which the company-level control operates. We believe that the concept of a continuum best describes the relationship between the consideration of the precision of company-level controls and the extent of testing, if any, necessary for lower-level controls.

We envision the continuum to extend between (1) a direct company-level control that is designed to operate at a degree of precision that would, by itself, prevent or detect on a timely basis material misstatements to one or more relevant assertions, and (2) an indirect company-level control (e.g., the control environment) that is not directly related to any relevant assertion for any specific significant account and, therefore, would not by itself prevent or detect on a timely basis material misstatements to one or more relevant assertions. In our experience, indirect controls are significantly more prevalent than direct company-level controls.

The standard should acknowledge that it would be sufficient to only test a company-level control when the company-level control operates effectively at a degree of precision that would, by itself, prevent or detect on a timely basis material misstatements to one or more relevant assertions. When the direct company-level control does not operate at that appropriate degree of precision, it would be necessary for the auditor to test process, transaction or application level controls. The standard should acknowledge that the consideration of controls that are not at the appropriate level of precision (i.e. indirect company-level controls) factor into the determination of the nature and extent of testing. Examples may be an effective way to illustrate these important concepts.

In addition, we recommend that the Board include in paragraphs 17 and 18 of the standard (i.e., the point at which identification of company-level controls is initially discussed) the emphasis on the precision of company-level controls included in paragraph 43 of the standard.

### Walkthroughs

We concur with the Board that walkthroughs are an effective means for the auditor to evaluate the design of controls surrounding a significant process, as well as to identify significant changes from the prior year. We support the increased opportunities to use the

work of others and believe it is appropriate for the auditor to use the direct assistance of others in performing certain walkthroughs.

The auditor's assessment of risk and consideration of knowledge gained in prior years' audits are important considerations in determining the extent to which walkthroughs alone can provide sufficient evidence of operating effectiveness of certain controls. For example, we believe that when a company has a strong control environment, it may be appropriate for the auditor to rely upon walkthrough procedures as sufficient evidence of operating effectiveness for lower risk automated application controls and routine, lower risk manual controls.

We agree that aligning the level of effort with the level of risk is essential to performing an effective and efficient audit. We believe that the standard's modifications to the walkthrough requirements will help to improve this alignment.

### **Evaluation of Deficiencies / Strong Indicators**

The evaluation of deficiencies identified in an audit of internal control over financial reporting is a subjective assessment which requires considerable judgment. The revised definitions of material weakness and significant deficiency provide additional clarity and will improve application of the terms, which may help to reduce unnecessary effort in testing and in evaluating certain deficiencies. The focus on testing only the most important controls may reduce the effort spent analyzing deficiencies that could not rise to the level of a material weakness.

The strong indicators of a material weakness are important considerations in determining whether a material weakness in internal control over financial reporting exists. We agree that the standard will allow greater judgment in evaluating whether or not a deficiency exists even though a strong indicator of a material weakness (e.g., restatement of previously issued financial statements) is present.

The challenge in allowing greater judgment is addressing the range of acceptable conclusions when subjective decisions are made by different individuals. We believe, however, that applying professional judgment to specific facts and circumstances when a strong indicator is present will result in improved reporting of deficiencies in that it will support the reporting of only those deficiencies that truly represent a risk of material misstatement.

### **Evaluation of Management's Process**

An understanding of management's assessment process is inherent in the audit of internal control over financial reporting. Since the auditor must understand management's assessment in order to properly plan and perform the audit of internal control over financial reporting, including determining the extent to which he or she will rely on the work of

others, we support the elimination of the requirement to perform a separate evaluation of management's process.

### **Use of the Work of Others**

We recognize the efficiency improvements that can result from increasing reliance on the work of others who have sufficient competence and objectivity. The proposed competence and objectivity model provides the auditor with appropriate factors to consider in determining the appropriateness and extent of relying on the work of others.

To further clarify the auditor's opportunity to rely on the work of others, we recommend that the proposed standard incorporate the concepts found currently in paragraphs 21 and 22 of AU Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, regarding the consideration of materiality and the extent of reliance on the work of others in high risk areas or areas where the evaluation of audit evidence is highly subjective.

We also believe that it is inefficient to consider relevant activities performed by others, as contemplated in paragraphs 3 to 6 of the standard, prior to the determination of whether there are sufficiently objective, competent personnel on whose work the auditor can rely. Obtaining an understanding of all relevant activities only to subsequently find that those activities cannot be considered in determining the nature, timing and extent of the auditor's own procedures because of a lack of sufficient objectivity or competence, will not promote efficiency. As a result, we recommend that these paragraphs be moved to follow the auditor's assessment of objectivity and competence.

In addition, in the release accompanying the standard, the Board noted that it has received comment letters indicating that some believe that the "principal evidence" provision included in AS 2 may have impacted the understanding of the amount of reliance that could be placed on the work others. The elimination of this phrase, as proposed by the Board, is appropriately responsive to those comments and yet will not have an adverse impact on the quality of the audit of internal control over financial reporting provided sufficient competent evidence is obtained by the auditor as required by paragraph 9, and the considerations in paragraphs 21 and 22 of AU Section 322 are included in the final standard as recommended above.

### **Documentation**

Audit documentation facilitates the planning, performance, and supervision of the audit in addition to providing a written record of the basis for the auditor's conclusions. The requirement for adequate documentation is already a significant component of the cost of an audit. The Board's Auditing Standard No. 3, *Audit Documentation* ("AS 3"), provides general requirements for the nature and extent of documentation the auditor should prepare in connection with an audit. We are concerned that the standard's pervasive use of "should" statements may unintentionally increase the documentation burden on the auditor



by requiring the documentation of individual, specific scoping or testing matters already effectively addressed in the auditor's overall documentation of the top-down, risk-based approach. For example, although a risk assessment is a fundamental part of the overall audit planning process, paragraph 51 implies that the risk of a control's failure resulting in a material weakness needs to be assessed and documented for each individual control. We recommend that the Board reconsider how its use of "should" statements in the standard may create undue documentation burdens because of the documentation requirements under AS 3.

### **Communicating Certain Matters**

We recognize the value and importance of communicating, in writing, to management and the audit committee significant deficiencies and material weaknesses identified during the audit. We believe, however, that the requirement to communicate, in writing, to management *all* deficiencies in internal control over financial reporting identified during the audit represents an unnecessary administrative burden. It is common practice for the auditor to verbally communicate all deficiencies identified during the course of the audit to management, regardless of magnitude. While the standard is clear that material weaknesses and significant deficiencies must be communicated in writing to management and the audit committee before the issuance of the auditor's report, the written communication of deficiencies that are neither significant deficiencies nor material weaknesses typically occurs after the auditor's report is issued. As a result, this represents a requirement with little, if any, incremental value given the insignificance of many control deficiencies. We believe the requirement to communicate such matters in writing is inconsistent with the Board's objective to focus the audit on the matters most important or of greatest risk to internal control. Accordingly, we recommend the Board limit the required communication to only those matters deemed to be significant deficiencies or material weaknesses. This change would also be consistent with the PCAOB's interim standard AU sec. 325, paragraph 7, for an audit of financial statements only, which makes the communication of these matters subject to the judgment of the auditor, and does not include a requirement that the communication be in writing.

### **Procedures in the Roll-forward Period**

We recognize the importance of applying professional judgment in all aspects of the audit, including when determining the roll-forward procedures necessary when the auditor obtains evidence of the operating effectiveness of controls at an interim date. Paragraph 64 of the standard describes appropriate factors the auditor should consider in determining the extent of such procedures, and includes consideration of the length of the remaining period. When the assessed risk of controls is higher or the remaining period is significant, it is likely that additional procedures will be necessary to obtain evidence of the effectiveness of controls closer to the as of date when the initial testing was performed at an interim date. We are concerned that the use of the words "if any" in paragraph 63 (and the note to paragraph 63) of the standard as it relates to the need to conduct roll-forward

procedures, may be misunderstood to imply that roll-forward procedures are to be performed on an exception basis when evidence about the operating effectiveness of controls is obtained at an interim date. Accordingly, we believe the elimination of the words "if any" would clarify the Board's intent that the auditor fully consider the paragraph 64 factors when determining the nature, timing and extent of roll-forward procedures required.

#### **Pre-approval of Services Related to Internal Control Over Financial Reporting**

The principles described in the Note included in the proposed Rule 3525 text are also included as part of the SEC's Preliminary Note to Reg. S-X, Section 210.2-01 ("Rule 2-01"). We encourage the PCAOB to mirror the SEC's treatment of these principles by describing them in the adopting release or preamble to the ethics and independence rules rather than in the text of Rule 3525. We addressed the value of including this type of discussion of overriding principles outside of the rule text in our September 25, 2000 response to the SEC's draft amendments to Rule 2-01, File No. S7-13-00.