**Moody's Investors Service**

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Mr. J. Gordon Seymour
Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

RE: Rulemaking Docket Matter No. 021 – An Audit of Internal Control Over Financial Reporting

Dear Mr. Secretary:

Moody's appreciates this opportunity to comment on the PCAOB's proposed auditing standard on an audit of internal control over financial reporting.

We are writing from our perspective as users of company financial statements and internal control reports in the course of rating the credit risk of debt instruments.

We believe that reporting on internal control has helped restore confidence in U.S. financial reporting which was badly shaken after massive instances of fraudulent reporting. Our discussions with companies suggest that control reporting has promoted investment in the people, policies, processes, and systems necessary to support quality reporting. Further, Moody's has benefited from new information about control problems which has helped us assess the risk of misleading financial reporting, which is one of many elements we consider when assessing credit risk. These benefits have been significant.

By any measure, the costs of implementing reporting on internal control by management and auditors have been high, indeed a multiple of what was projected during the debate over the Sarbanes/Oxley Act. Most commentators have argued that some portion of the cost is unnecessary. Although we have no special insight into costs, we have seen nothing to suggest that concerns about costs are invalid. Accordingly, we support policies that promote efficient control reviews by management and auditors, provided, of course, that this can be done without reducing the benefits of reporting on control.

While much of the commentary about control reporting has been concerned with compliance costs, evidence suggests that important goals of reporting on controls are not being fully achieved:

a) There appears to be insufficient emphasis on controls that prevent senior management from fraudulently manipulating financial reporting (cooking controls).
b) Material weaknesses too often lag rather than precede material errors in financial reporting.

We have discussed these issues with the staff and Board in the past, and appreciate the provisions you have included in the proposed standard to address these issues. In particular:

- To focus on management fraud related controls, the provision that would always require the auditor to evaluate the control environment and controls over the period end financial statement close process and test controls to address the risk of management override.
- To encourage proactive identification of control weaknesses before they result in financial reporting errors, the provision noting that whether a control deficiency is a material weakness does not depend on whether a misstatement has already occurred.

**Controls that Prevent Senior Management from Fraudulent Reporting**

The requirement to report on internal control resulted from one particular type of internal control breakdown: senior management of some major public companies overrode their control systems and intentionally issued misleading financial statements. History has shown that senior management cooking the books has been the most costly of control failures. It has caused billions in investor losses, undermined confidence in reporting affecting the liquidity and cost of capital for many companies, and triggered significant new regulation and requirements, including reporting on controls. Other forms of fraudulent reporting, such as misleading reporting by lower-level employees, have not had the same impact. Neither has control failures resulting in honest errors in financial reporting, regardless of whether they relate to insufficient accounting skills, complex reporting requirements, difficult estimates or judgments or system failures.

Because of its dominant importance, ensuring adequate controls that prevent senior management from cooking the books must be a focus of control assessment. Although other controls are important, companies, auditors and regulators should give first priority to cooking controls.

Yet, despite many hard lessons, control-related literature does not give priority to cooking controls. Control frameworks, auditor guidance on controls, and the SEC's guidance to management each seem to treat fraud-related controls as no more important than a myriad of other control issues.

Internal control reports to date also suggest that audit committees, management and auditors are not giving priority to controls related to senior management fraud. For example, in the latest year of internal control reporting, of the thousands of companies that Moody's rates, only four referred to fraud-related control weaknesses, including tone at the top, and in each case the companies had discovered instances of fraudulent reporting prior to reporting fraud-related control problems.

Why haven't management, auditors, standard setters and regulators given priority to controls related to cooking the books? We speculate reasons possibly include:

- Its difficult for senior management to objectively assess its own tone
- Assessing controls that prevent senior management from cooking the books are often judgmental and its hard to obtain objective compelling evidence absent an instance of senior management fraud
- Controls over senior management are sensitive and uncomfortable for audit committees, management and auditors to address
- Control frameworks don't provide much guidance on cooking controls
- Control-related literature doesn't give priority to cooking controls; risk assessment is left to judgment.

We are pleased that the Board recognizes that a top-down, risk-oriented approach alone is unlikely to ensure adequate focus on fraud-related controls. We suspect that those in senior management who are inclined to cook the books will deem book cooking to be of low risk and direct subordinates to spend time on other controls management deems more important. Similarly, auditors, who decide to accept and retain clients in part based on their assessment of the integrity of senior management, are likely to deem book cooking by management they trust to be of low risk, absent an audit standard that mandates a focus on controls over senior management fraud.

Because senior management fraud has been so costly for investors and difficult to prevent and detect, we suspect there is a lot more to learn about controlling senior management fraud. We suggest that the PCAOB promote research into instances of senior management fraudulent reporting specifically to identify controls that would have prevented the fraud and reasons why auditors failed to identify the material weakness in controls. The insight from this research could help improve controls, improve audit quality and inform future auditing standards.

**Material Weaknesses as Leading Indicators of Reporting Risk**

Few would question that strong controls are essential to quality financial reporting. As users of control reports, we had hoped that material weaknesses flagged would provide insight into the risk of future errors in financial reporting, and provide management time to address control weaknesses before they resulted in reporting failures.

Unfortunately, reports citing material weaknesses appear to be lagging rather than leading indicators of financial reporting problems. Of the companies Moody's rates, during the last year of internal control reporting, 74 companies reported material weaknesses in internal control, but only 4 did not experience prior reporting errors (restatement or material audit adjustment) in the area related to the material weakness.

The data suggest management and auditors require evidence of error or fraud before they are willing to conclude that a control concern is a material weakness. Why are management and auditors so reluctant to cite a material weakness absent evidence of a past error? Concluding that a control issue is a material weakness involves considerable judgment, which is sure to be questioned when it involves controversial and unhappy news. We suspect that management, audit committees and auditors are asking for hard evidence to support a view that control

problems are material weaknesses. We also suspect that the hardest evidence is when control breakdowns result in reporting errors.

Yet, the lagging nature of reported control weaknesses undermines their usefulness to users of financial statements. Further, failing to identify a material weakness may reduce the chance that management will take corrective action in time. Reporting control weaknesses after financial reporting problems have occurred is analogous to a medical doctor reporting high blood pressure only after the patient has suffered a heart attack.

The Board may wish to turn up the noise level on this important problem. It seems that practice is entrenched in the notion that reporting problems must be present to justify a material weakness. A few ideas to do so are:

- Identify in the standard itself the problem of the lagging nature of many control weaknesses to date and call for improvement
- Be clear in the standard that a key goal of reporting on internal control is to identify material weaknesses before related reporting problems occur
- Explain in the standard why the Board concluded that the absence of a reporting problem is irrelevant when judging whether a control deficiency is a material control weakness.

We thank you for considering our comments. Of course, we would be pleased to discuss them with the Board or staff should they desire further information.

Sincerely,

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