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Office of the Secretary
Public Company Accounting Oversight Board
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Subject: PCAOB Rulemaking Docket Matter No. 008

We are pleased to comment on the proposed Auditing Standard, "An Audit of Internal Control Over Financial Statement Reporting Performed in Conjunction with an Audit of Financial Statements." We understand the need to quickly prepare guidance for the numerous audits of internal control required by the Sarbanes-Oxley Act of 2002. Following are changes we suggest to improve the guidance in the proposed Standard and the resulting reports that will be issued.

1. The report on internal control over financial reporting that is included in the proposed Standard should be significantly revised. The proposed report is based on criteria that will be obscure to most users, and the report is not sufficiently descriptive or informative for most users.

First, the criteria referred to in the proposed report are not widely-known. Users now have a general understanding of "generally accepted accounting principles" and thus can absorb what that reference means when they read it in an auditors' report. Their understanding is assisted by the footnote disclosures of the accounting principles used. In the proposed report on internal control over financial reporting, however, the "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission" does not provide this understanding to users. Quickly, what are these criteria? How does "Internal Control—Integrated Framework" relate to "internal control over financial reporting"? Who are the Sponsoring Organizations and what is their authority to specify something? Who or what is the Treadway Commission? Why should this Framework be used as a basis for reporting? What does this Framework say? Is the Treadway Commission still active and updating its work as needed? How can someone get a copy of what the Treadway Commission issued? Why does the auditor's report on financial statements refer to PCAOB standards while the report on internal control over financial reporting refers to Treadway Commission standards?

In short, users will not adequately understand the basis used to evaluate internal control over financial reporting, and thus are likely to not understand, or to misunderstand, the report. More discussion in the management report and the auditor report of the criteria used is needed.

Second, the sample report gives a conclusion that the company's assessment about internal control over financial reporting is fairly stated, in accordance with some criteria (see prior paragraphs.) This report, however, gives the user no further information about the controls. There is no discussion of what the internal controls are over financial reporting, whether they are centralized or decentralized, whether there is an internal audit department, whether there is an audit committee, and so on. To illustrate our concern with the sparse information provided in this report about internal controls, imagine if the presentation of financial position and results of operations, and the auditor's report thereon, were to be similar to this proposal. There wouldn't be any financial statements or disclosures or other details. Instead there would be a statement by management that "we had a good year on revenue and income and have a strong balance sheet" with the auditor saying "we agree with their evaluation." Or perhaps, this report might say we had a "tough year" or that the balance sheet is "weak". This would be a very limited and poor degree of communication with users about financial position and results of operations. What is the user to make out of a brief report such as this? However, this is the level of information that will be provided by the proposed reports on internal control. Nothing about internal control over financial reporting is described or communicated, nothing is disclosed, nothing is discussed. The user is just given a conclusion that internal control over financial reporting is effective, but is not given a description of the internal control system over financial reporting, of what these internal controls are, of how they operate, of what they encompass. Further, the user has to guess what the criteria are that this report is based on--yes, the source of the criteria is mentioned, but what ARE the criteria? Nor does the auditor's report give a description of what was tested or of the various components of controls or the details of the criteria used.

Also, the presence of a fraud at a company may mean that the detection function of internal controls worked as intended and the fraud was brought to light—but the users may be confused and wonder how there could be a fraud when internal controls were reported as being effective and thus the fraud wasn't prevented from occurring in the first case. A better discussion of both the preventive and the detective nature of internal control over financial reporting in the proposed report might alleviate this possible confusion.

We suggest that both management's report and the auditor's report include significant additional information about both management's assessment of internal controls over financial reporting and the auditor's separate evaluation thereof. One section of these expanded reports should discuss design of internal controls over financial reporting and provide information about the areas where design was assessed, and how it was assessed. Another section of these expanded reports should discuss operating effectiveness of internal controls over financial reporting and how the operating effectiveness was assessed and tested. These additional sections should provide details for the user in the several areas that are evaluated: operating environment, tone at the top, risk management, control procedures, internal audit, monitoring, audit committee, revenue recognition, asset safeguarding, approval of expenditures, and so on.

Otherwise, the user will have limited knowledge of what was done by the auditor or of what assurance they should take from the auditor's report. These revisions are needed to improve communication with users and to avoid creating an "expectation gap" with users, who might come to expect that the report on internal control covers everything and that there is no cost-benefit consideration used in designing controls or in testing them.

2. The proposed report on internal control over financial reporting is an "on-off" switch. If there is one material weakness, the internal control system IN TOTAL is described as not

providing “effective internal control over financial reporting.” It’s as if there is NO internal control system at all, not one that happens to have one problem somewhere. See the sample report on page A-69 in the proposal, which indicates that because there is a material weakness, the achievement of the objectives of internal control over financial reporting has not occurred. However, paragraphs 8 through 11 of this proposed Standard appear to indicate that the objective of internal control over financial reporting is to prevent and detect misstatements.

The expanded report on internal control over financial reporting we suggest above should be able to provide a better balance, by not sounding that because there is ONE material weakness, the whole system is worthless. The more detailed report we discussed above will better enable preparers and auditors to convey the gradations of various control situations that will exist in entities due to size of company, risk, costs, and other factors, as well as to allow discussion of the presence of a weakness or two, and even cost-benefit decisions made regarding controls.

3. Continuing the topic just discussed in #2, if a material weakness exists, there still may be no misstatement that occurred. It is possible, among other reasons, that a suitable “tone at the top” provides such a sufficient preventive control that a weakness elsewhere was mitigated and a misstatement was prevented. The ultimate objective, for users, is the presence of proper financial reporting. Thus, the criteria used for deciding when a material weakness occurred might need to consider whether the material weakness “meant” anything or led to any problems in financial reporting.

4. This proposal is lengthy and complex. We believe working groups should be formed to help the Board’s staff provide continuing and timely implementation guidance on questions that will undoubtedly arise in practice. These questions are likely to arise from preparers, who will be asked to prepare the needed documentation of internal controls and assessments under the rules prescribed in this proposal, and from auditors, who will face numerous issues as to extent of testing, extent of documentation, reporting, independence, and so on.

5. Throughout the sample reports, we suggest that every mention of “internal control” be revised to refer instead to “internal control over financial reporting.” The scope of the auditor’s evaluation and assessment is limited to the latter term, not to the broader concept of “internal control,” and we suggest avoiding a possible area of confusion of users who might believe they are reading a report on all aspects of internal control.

6. In smaller entities, controls may be more informal than in larger entities. The proposed Standard in Appendix E takes notes of this. We suggest that, as part of the expanded reporting on internal control we earlier suggest, that the reports discuss some of the more informal ways in which internal control over financial reporting is maintained. A user should not see the same form of report for a small entity as for a larger entity and believe that their internal control systems thus have identical complexity and features.

7. Entities may have recently acquired another company just before year-end and be in the process of absorbing the acquisition, including making changes to conform the acquired entity’s controls with the acquirer. An entity with a recent acquisition may find itself unable to determine whether internal controls are sufficient in the acquired entity, or unable to support its assessment with suitable documentation, or unable to apply its control structure to the acquisition, simply because there has not been enough time to do so. We suggest that special consideration be given in the report on internal control (already, as we suggested earlier, expanded in scope and content) so that the evaluation of the reporting entity can acknowledge

that a recently-acquired entity has controls that have not yet been evaluated by management. Users would be expected to understand and accept this situation because it is a logical feature of any significant acquisition and the resulting integration.

8. The various requirements for communications of material weaknesses by the auditor should discuss that these communications do not form the basis for management's conclusion about the absence of material weaknesses. It should be made clear, in every instance where the communication requirements are prescribed, that management cannot rely on the fact the auditor hasn't communicated a material weakness in forming management's conclusions about material weaknesses. It should be clear that the auditor's communications about material weaknesses can't be used as a basis for management's assessment.

9. The guidance for making significance decisions for testing (paragraph 60) refers to significant accounts "at both the financial statement level and then at the account or disclosure component level." We agree with "the financial statement level" and disagree with the "account" level. Going beyond the line items in the financial statements may mean, in smaller entities, going to hundreds or thousands of general ledger accounts, while larger entities could have hundreds of thousands of "accounts". Our concern about this point is heightened by paragraph 63, which states: "In some cases, separate components of an account may also need to be considered a significant account...". Does this mean that an entity with thousands of general ledger accounts might have yet even many, many more items to consider, considerably in excess of the number of accounts, as to components of these general ledger accounts? We suggest the guidance in this proposal remain consistently at the financial statement level. In fact, even at the financial statement line item level, some smaller balance items still may be too small a level at which to make significance decisions.

10. We suggest that the various discussions of what must be done in an audit of the financial statements be removed from this guidance on auditing internal control over financial statements. A specific example is the discussion in paragraph 141 that the substantive procedures must include "examining material adjustments made during the course of preparing the financial statements." "Material adjustments made during the course of preparing the financial statements" could include reclassifications to comply with GAAP, closing net income to retained earnings, and a host of other normal entries made to record December's sales, calculate income taxes, and so on. Whatever the merits of requiring testing of material adjustments in the financial statements, we suggest all such guidance be handled instead in auditing standards that focus specifically on auditing financial statements, and not in a statement with the different objective of auditing internal control over financial reporting. In that way, all the standard-setting on auditing financial statements can be evaluated on its merits instead of being decided now as an "aside" in this proposal on internal control.

11. There may be significant independence implications in the variety of tasks that an auditor, especially an auditor of a smaller entity, could be called upon to assist management with. Tasks could range from education for the audit committee to performing tests that management could rely on. Some of this assistance would be allowed, some would not. We suggest the Board give consideration now to the areas in which an auditor could assist management with in internal control analysis, especially on a smaller entity, and provide guidance now, as the initial phases of implementing this new standard will be crucial. The guidance is needed in the areas between the clear calls as to what is allowable versus what is not. To avoid unneeded problems with independence, and to allow providing smaller entities with much-needed assistance, we suggest the Board provide more robust guidance on the independence rules to allow audit

committees and auditors to make proper decisions about the scope of assistance that may be obtained.

12. This proposed Standard will lead to a significant increase in the amount of work needed from an auditor, at the same time that there will be a shortening by one-third of the time available to complete the year-end audit and perform the needed procedures for filing of Form 10-K, for accelerated filers. Accordingly, we suggest the Board revisit the scope of the procedures in this proposal that are stated as those that must be performed after year-end, to ensure that there remains enough time to perform the procedures actually needed within the deadlines provided.

13. Paragraph 101 prescribes that the work performed on each audit of internal control “each year” should provide “sufficient evidence about whether the company’s internal control over financial reporting, including the controls for ALL internal control components, is operating effectively.” (emphasis added). We suggest this be revised to allow the use of prior information obtained.

An analogy to an audit of financial statements may provide a useful illustration. In 2002, an entity may have added a fixed asset, which the auditor audited. For the audit for 2004, would the auditor need to obtain evidence about the fixed asset addition from 2002, which remains on the financial statements of the entity at year-end 2004, or would the Board allow the auditor to rely on the evidence obtained in the 2002 audit. If the Board will allow reliance on prior evidence for financial statement presentation, which we think makes all the sense in the world, why must instead, for the audit of internal control over financial reporting, involving the numerous systems and accounts and assertions that make up the matter to be audited, why should the auditor be required to ignore all the testing done by the auditor in prior years? We suggest this proposed Standard take a revised position on this cost-benefit issue to allow the use of prior, valid evidence.

14. Appendix E may provide smaller companies with an ability to provide less documentation of their internal control system. We suggest that Appendix E balance its discussions of the matters discussed in, for example, paragraph E3 (“written policies.... often less complete or less formal”), and similar wording elsewhere, with guidance that written documentation is required of management nevertheless.

15. We note the requirement to assess the effectiveness of the audit committee, as part of the auditor’s reporting on internal control over financial reporting. At first look, this appears problematic, as the audit committee is the one that hires the auditor, is the one that approves the scope of the auditor’s work, and is the one to whom the auditor reports various matters. Thus, it might seem that the auditor is reporting on the effectiveness of those that hired the auditor. However, the audit committee is indisputably part of the internal control system, and the Sarbanes-Oxley Act of 2002 does require a report by management and by the auditor on internal control over financial reporting, so we concur that the scope of the auditor’s work must include assessments of the role and effectiveness of the audit committee. We do suggest the Board take especial note of the sensitivity of this relationship and provide extensive guidance on how the auditor is to assess, and report on, their assessment of the role of the audit committee, those that hire the auditor.

If you have any questions or would like further discussion, please contact Jim Brown.

Very truly yours,

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