February 16, 2007

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

RE: PCAOB Rulemaking Docket Matter No. 21 – *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals*, PCAOB Release No. 2006-007

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is a newly formed group created by the public company auditing profession to help foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. The CAQ consists of approximately 800 member firms that audit or are interested in auditing public companies. We welcome the opportunity to share our views on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals* (December 19, 2006).

The CAQ supports the PCAOB's proposed auditing standard on internal control over financial reporting and the related proposals. Overall, we believe that these proposals will facilitate continued progress in upholding the investor protections that are so fundamental to the success of the Sarbanes-Oxley Act (the Act) and the market vitality that has been the result of its passage in a manner that better balances costs with benefits. These changes also will serve to improve the effectiveness and efficiency of the processes related to the internal control reporting provisions of the Act.

Since its passage, the Act has served to enhance the integrity of our capital markets and restore investor confidence. It has done so in part by recognizing that effective internal controls are the bedrock of reliable financial reporting. As the PCAOB contemplates issuance of the new standards and related proposals, we strongly believe that change should flow primarily from the desire to reinforce the significant benefits of Section 404 of the Act and the audit of internal control over financial reporting rather than a drive to cut costs.

Investors are the lifeblood of our capital markets system, and that system can not thrive without investors' steady, unwavering belief that legislative and regulatory safeguards are designed for their protection. We believe that the PCAOB's proposals support our mutual and deep commitment to investors and the markets.

We expect the proposed changes, along with the proposals by the Securities and Exchange Commission (SEC), will result in a reduction of total Section 404 efforts, due to various specific, positive changes in the proposals. These would include the ability of an auditor to (a) determine audit coverage based upon risk, without any pre-established quantitative coverage requirement, relative to an issuer's operations; (b) adjust, under certain conditions, the nature, timing and extent of testing of particular controls, based in part on cumulative experience gained in prior audits; and (c) increase the use of the work of others, if certain conditions are met.

We believe that the scope of these reductions in effort, and their relative balance between management effort and auditor effort, will likely vary significantly based on facts and circumstances for each particular company. Factors that will impact these reductions include: (a) the degree to which management undertakes a thoughtful, comprehensive effort to rationalize the controls that it includes in its assessment; (b) the state and quality of an issuer's control structure, as well as the degree of centralization and complexity of its operations, and the risks inherent in its business model; and (c) the quality and commitment management demonstrates in its assessment process, including the quality of its documentation, its tone at the top, and the consideration it gives to various activities it performs, in order to maximize the degree to which these could be used by the auditor.

Because of these and other factors, it is not possible to set the expectation of a specific or across-the-board reduction that the proposals by the PCAOB and the SEC will cause in Section 404-related costs for all companies. Although the effect of the new guidance will vary from company to company, the maximum opportunities for efficiencies and cost-effectiveness in Section 404 implementation can be obtained when management and auditors work together to conduct their assessments in a complementary manner, and when the auditor can make effective use of other's work. We also believe that the benefits from the SEC and PCAOB proposals will be greatest to companies that have not yet initially implemented the requirements of Section 404, such as non-accelerated filers and new public companies. We also expect that the cost of complying with Section 404 can decline as companies and members of the auditing profession become more familiar with the legal and regulatory requirements.

We support the PCAOB's increased emphasis and flexibility on the auditor's use of professional judgment, and its decision to apply a single model of auditor reporting on internal control over financial reporting, that is scalable to companies of varying size *and* complexity.

We also applaud the PCAOB's project to develop guidance and education for auditors of smaller public companies that is supported by many of the member firms of the CAQ. This project will facilitate scalability of the proposed standard in an effective and efficient manner for audits of these smaller public companies.

The CAQ also supports the PCAOB's plan to require that auditors obtain evidence regarding the operating effectiveness of controls to determine whether the controls in place actually work as intended. Requiring auditors to apply a risk-based approach to testing controls and annual tests of key controls supports the reliability of the audit.

The CAQ appreciates the PCAOB's emphasis on more flexibility in determining the extent to which the work of others may be used by the auditor. However, we believe that changes in the proposed standard on internal control over financial reporting in this area, coupled with the existing standard *"The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"* (AU sec. 322), can achieve the Board's objective of effective and efficient implementation of Section 404. Accordingly, we do not support the Board's proposed standard that would supersede AU sec. 322, as it is unnecessary to achieve the Board's objectives in this area, and may reduce audit effectiveness through the inappropriate use of the work of others.

However, if the Board determines that it is necessary to have a separate standard for considering and using the work of others in an audit that supersedes AU sec. 322, we believe that the Board should incorporate the paragraphs of AU sec. 322 identified in the appendix to this letter, which are missing from the proposed standard, as we consider these to be fundamental to reliance on the work of others, to help ensure both effective and efficient use of the work of others in execution of all aspects of an integrated audit.

A more detailed discussion of our perspective is included in the appendix to this letter, and many of the public company auditing firms that are members of the CAQ will submit their own comment letters.

We appreciate the PCAOB's efforts to improve integrated audits and implementation of the provisions of Section 404, and look forward to working with all market constituents to identify enhancements that improve efficiency without diluting investor protections. We believe that these changes should be implemented as soon as practicable in 2007, allowing for sufficient time for auditors to conduct training and develop methodologies for complying with the final standard and guidance. In this regard, we encourage the Board's accelerated consideration of these proposals, so that the revisions can impact audits for the current year ending December 31, 2007.

We appreciate the opportunity to comment on the PCAOB's proposals and would welcome the opportunity to meet with you to clarify any of our comments.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc: PCAOB
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Commissioner Kathleen L. Casey
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Appendix

The Center for Audit Quality recognizes that there were various requests for comments within the PCAOB's Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals.* However, we would like to state that we have limited our comments to the significant matters noted below on behalf of our member firms. Please refer to the individual public company auditing firm letters for additional comments.

We are very supportive of the direction of the proposed standards, particularly their increased emphasis on appropriate exercise of auditor judgment. However, we offer the following comments intended to improve them to meet the overall goal of making implementation of Section 404 more effective and efficient.

Considering and Using the Work of Others in an Audit

We believe that the changes in the proposed standard on internal control over financial reporting (ICFR) coupled with the existing standard *"The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"* (AU sec. 322) can achieve the Board's objective of effective and efficient implementation of Section 404. Accordingly, we do not support the Board's proposed standard that would supersede AU sec. 322, as it is unnecessary to achieve the Board's objectives in this area, and may reduce audit effectiveness through the inappropriate use of the work of others.

Conversely, if the Board concludes that a new standard is necessary, one very important principle in AU sec. 322 that has not been included in the proposed standard relates to the auditor's ability to use the work of others, where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, and the notion that in these circumstances, the auditor's evidence should not be derived solely from the work of others. We have noted the relevant specific paragraphs from AU sec. 322 below and recommend that the Board add this very important concept to the proposed standard.

> **.21** For assertions related to material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, the auditor should perform sufficient procedures to fulfill the responsibilities described in paragraphs .18 and .19. In determining these procedures, the auditor gives consideration to the results of work (either tests of controls or substantive tests) performed by internal auditors on those particular assertions. However, for such assertions, the consideration of internal auditors' work cannot alone reduce audit risk to an acceptable level to eliminate the necessity to perform tests of those assertions directly by the auditor. Assertions about the

> valuation of assets and liabilities involving significant accounting estimates, and about the existence and disclosure of related-party transactions, contingencies, uncertainties, and subsequent events, are examples of assertions that might have a high risk of material misstatement or involve a high degree of subjectivity in the evaluation of audit evidence.
>
> **.22** On the other hand, for certain assertions related to less material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is low, the auditor may decide, after considering the circumstances and the results of work (either tests of controls or substantive tests) performed by internal auditors on those particular assertions, that audit risk has been reduced to an acceptable level and that testing of the assertions directly by the auditor may not be necessary. Assertions about the existence of cash, prepaid assets, and fixed-asset additions are examples of assertions that might have a low risk of material misstatement or involve a low degree of subjectivity in the evaluation of audit evidence.

In addition, recognizing that the "principal evidence" concept previously included in *PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements"* has been eliminated, the auditor still must be in a position to positively state in the opinion that he or she has audited the financial statements and management's assessment of ICFR. The ability of the auditor to state such an opinion implies that he or she has obtained principal evidence. As noted in paragraph 9 in the proposed standard on considering and using the work of others in an audit, judgments about the sufficiency of evidence obtained, assessments of risk, the materiality of misstatements, and evaluations of test results must be those of the auditor. We believe that replacing AU sec. 322 with the proposed standard likely will lead to confusion regarding the auditor's implied obligation to obtain principal evidence in support of his or her opinion.

Paragraphs 3 through 6 of the proposed standard describe the auditor's responsibility to determine whether there are activities performed by others that can be used in connection with the audit. We believe that these paragraphs likely will lead to unnecessary effort expended searching for activities significantly removed from those of internal auditors and similar groups described in AU sec. 322 that, upon consideration, will not be useable because of issues related to competence and objectivity or are not tests that provide audit evidence as described in the proposed standard. Accordingly, we see no benefit to adding these paragraphs. If the Board decides to adopt the proposed standard, then we recommend that the discussion of competence and objectivity precede the consideration of relevant activities in order to more appropriately reflect the thought process of the auditor in considering the work of others. In addition, the Board should describe the extent of documentation it would consider appropriate when conducting the activities required in paragraphs 3 through 6.

Consideration of Fraud and Company-Level Controls

We believe it is important that when an auditor assesses risk when planning the audit, the interaction between the assessed risk of fraud for certain assertions be addressed when scoping the audit of ICFR. We recommend that this notion be clearly articulated in the proposed standard. For example, we believe the Board should better articulate this notion in the interaction between the risk that the control might not be effective as described in paragraph 51 and whether the control is intended to address significant fraud risk.

Another example is that the Board's proposed standard lacks clarity with regard to the consideration of the precision of company-level controls as it relates to the risk of fraud. In other words, we believe that the concept regarding company-level controls cited in paragraph 43 of the proposed standard should be reiterated earlier in the standard – around paragraph 17, the section on Identifying Company-Level Controls – to better address the auditors' consideration of fraud and to better integrate fraud considerations consistent with the concepts in AU sec. 316 "*Consideration of Fraud in a Financial Statement Audit*."

Considering the Effect of Company-Level Controls

The evaluation of company-level controls is an important part of a top-down, risk-based approach and should occur early in the audit. However, we are concerned that, at times, such controls may not operate in a manner that would identify possible breakdowns in lower-level controls. For example, company-level controls may not be designed at a level of precision that would sufficiently address the risk that material misstatements to a relevant financial statement assertion will be prevented or detected.

We believe that the final standard should acknowledge that in many circumstances company-level controls only indirectly relate to relevant assertions (e.g., those controls that primarily operate within the control environment) and do not operate in a manner that would be sufficient to address the risk of material misstatement to specific accounts and disclosures in the financial statements. In addition, we would welcome examples that illustrate the linkage between company-level controls and relevant assertions and the benefit that could be derived from them in determining the nature, timing, and extent of testing of lower-level controls.

Multi-location Scoping Decisions

We are supportive of the Board's refocus of the multi-location testing requirements on risk rather than coverage and likewise are supportive of the deletion of "large portion" from the proposed standard on ICFR. However, we believe that the auditor should not lose sight of the need to obtain sufficient audit evidence to support the auditor's opinion. Accordingly, we suggest that guidance be added to paragraph B13 acknowledging that the responsibility for the opinion expressed in the auditor's report rests solely with the auditor.

Strong Indicators of Material Weaknesses

We have observed that the description of strong indicators of material weaknesses in the Board's proposed standard on ICFR differs from the SEC's proposed management guidance. As indicated in our letter to the SEC on its proposed management guidance, we believe that the SEC should conform its description to the PCAOB's description of such factors. Conforming the two documents will help to reduce potential confusion, inconsistencies, and possible inefficiencies that may occur as a result of differing evaluations by management and auditors of the same control deficiency. Please refer to our comment letter to the SEC on the proposed management guidance on ICFR.

Documentation

We note that there may be possible unintended consequences relative to the interaction between the requirements of the proposed standard on ICFR and the Board's Auditing Standard No. 3 "*Audit Documentation,"* as a result of the use of the words "should" and "must" throughout the proposed standard. For example, paragraph 51 of the proposed standard under the *Relationship of Risk to the Evidence to be Obtained* includes a requirement that "[f]or each control selected for testing, the auditor **should** [emphasis added] assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result." Compliance with this requirement could generate a level of documentation relating to the auditor's assessment of risk as it pertains to documentation required, that may not necessarily add to the level of effectiveness of the audit. Therefore, we recommend that the Board reconsider the use of the words "should" and "must" throughout the proposed standard to ensure that disproportionate auditor effort is not unnecessarily devoted to documenting consideration of items that ordinarily would be incorporated into the auditor's overall methodology.

Precedent of Mandatory Efficiency Requirements

We support the objective of conducting an efficient as well as effective audit, but we are concerned about the precedent established with the inclusion in an auditing standard of presumptively mandatory performance requirements relating to efficiencies. We are concerned that this is inconsistent with the nature of professional standards, and that it may detract from the overarching objective of performing high quality audits – audits that ultimately help protect investors.