CFA INSTITUTE
Centre for Financial Market Integrity

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Nancy M. Morris
Secretary, Securities and Exchange Commission
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Washington, DC 20549-1090

E-mail: rule-comments@sec.gov

Subject: File Number PCAOB2007-02.

Dear Ms. Morris:

The CFA Institute Centre for Financial Market Integrity (the Centre)[1] appreciates the opportunity to comment on Auditing Standard No. 5—*An Audit of Internal Control over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS5).

The Centre represents the views of investment professionals, including portfolio managers, investment analysts, and advisors, located in 132 countries worldwide. A long-standing goal of the Centre is to promote fair and transparent global capital markets and investor protection. An integral part of the goal is ensuring the quality of corporate financial reporting and disclosures provided to investors and other end users of this information. The Centre also develops, promulgates, and maintains the highest ethical standards for the global investment community through such standards as the CFA Institute *Code of Ethics* and *Standards of Professional Conduct.*

General Comments

We commend the Board and staff of the Public Company Accounting Oversight Board (PCAOB) and the Securities and Exchange Commission (SEC) and staff for their diligent efforts over the last several years to restore the trust and confidence of investors worldwide in the effectiveness of audits of companies that choose to raise capital in U.S. markets.[2] External financial reporting serves the needs of those capital providers who cannot otherwise command the information they require to

[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong and London, CFA Institute, formerly the Association for Investment Management and Research®, is a global, not-for-profit professional association of more than 93,000 financial analysts, portfolio managers, and other investment professionals, of whom more than 79,100 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 134 Member Societies in 55 countries and territories.

[2] We use the term "investor" to include all of those who supply capital to companies, including creditors, employees, pension beneficiaries, vendors, suppliers and other third-party capital providers.

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make decisions. Thus, effective audits of listed companies are critical to ensure that the information used by investors in financial decision-making is accurate, complete, and timely.

An auditor's objective in an audit of internal control over financial reporting is "…to express an opinion on the *effectiveness* of the company's internal control over financial reporting."[3] AS5 states

> *Effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.* ***If one or more material weaknesses exist, the company's internal control over financial reporting cannot be considered effective.***"[4] [Emphasis added]

A material weakness is defined as

> *…a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is* ***a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis***.[5]

Experience provides ample and compelling evidence of the importance of audits of internal controls. In the last few years, due in large part to Section 404 of the Sarbanes-Oxley Act (SOX 404), hundreds of listed companies have reported material misstatements accompanied by material weaknesses in their internal controls. Indeed, some 1,538 misstatements and weaknesses were reported in 2006 alone.[6] It is notable that deficiencies reported by relatively large registrants have declined over what are now three annual SOX 404 cycles. In the first year of audits, 16% reported material misstatements and deficiencies.

However, such reports have declined as companies have moved swiftly to correct problems. The decrease was 14% in 2006 alone. Meanwhile the trend for restatements and deficiencies among those going through SOX 404 for the first time, primarily smaller registrants emerging from the non-accelerated filer status, continues to reflect an initial upward spike. SOX 404 has been an effective investor protection in this regard.[7] Moreover, it further reflects the wisdom of the SEC's determination to keep SOX 404 for all filers, regardless of size.

Academic research has clearly demonstrated that investors respond to auditors' and managers' reports regarding the effectiveness of a company's internal controls.[8] When company managers and their auditors report internal control deficiencies, the cost of capital rises for their companies

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[3] PCAOB Release 2007-005, Standard. May 24, 2007. p. A1-4, para. 3.
[4] Ibid, para. 2.
[5] Ibid, p. A1-43, para. A7.
[6] Glass Lewis & Co. *The Errors of Their Way*. 2007.
[7] Ibid.
[8] See, for example, Ashbaugh-Skaife, Collins, Kinney and LaFond, *The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital.* April 2006, revised February 2007.

reflecting the increased risk of material misstatements. When such companies correct those deficiencies and report that their internal control systems are effective, their cost of capital declines on average by 150 basis points.[9] This growing body of research clearly demonstrates the importance that investors and the financial markets place on auditing internal controls as well as their response to the auditors' reports.

The PCAOB recognized the importance to investors and the financial markets of the prevention of material weaknesses, the detection of them if they should occur, and the PCAOB's role in this process in 2004 when developing the predecessor rule to AS5:

> ***To achieve reliable financial statements, internal controls must be in place to see that records accurately and fairly reflect transactions in and dispositions of a company's assets; to provide assurance that the records of transactions are sufficient to prepare financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are made only as authorized by management and directors; and to make sure that steps are in place to prevent or detect theft, unauthorized use or disposition of the company's assets of a value that could have a material effect on the financial statements.***[10] [Emphasis added]
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> ***In the simplest terms, investors can have much more confidence in the reliability of a corporate financial statement if corporate management demonstrates that it exercises adequate internal control over bookkeeping, the sufficiency of books and records for the preparation of accurate financial statements, adherence to rules about the use of company assets and the possibility of misappropriation of company assets.***[11] [Emphasis added]

We believe that the words of the PCAOB are quite clear that the first, and most compelling, criterion for evaluating an integrated audit of internal controls and financial reporting must be whether the audit has been **effective.** Such effectiveness would entail providing reasonable assurance that the controls are free of material weaknesses that could lead to material misstatements. Put slightly differently, the relative **efficiency** with which an audit is conducted is of no relevance unless the audit has been effective in achieving its fundamental objective. [12]

Therefore, it follows naturally that the quality of any internal control audit standard, such as AS5, must be evaluated on the basis of whether the direction contained therein is sufficient to achieve the audit objective of providing reasonable assurance that the controls are free of material weaknesses.

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[9] Ibid.
[10] Ibid.
[11] Ibid, p. 3.
[12] See also the remarks of Professor Joe Carcello as reported in the Unofficial Transcript of the PCAOB's Standing Advisory Group meeting on February 22, 2007.

Our general conclusion is that AS5 contains the necessary core elements and principles required to achieve this objective. The focus must now be on proper implementation of the standard.

Commentary on the Objectives

The public Release which accompanied the final issuance of AS5 states that the revised standard is designed to achieve four objectives[13]:

- *Focus the audit of internal control on the most important matters*.
- *Include only the requirements necessary for an effective audit*.
- *Make the audit scalable to fit the size and the complexity of any company*.
- *Simplify the text of the standard*.

We will briefly consider each of these objectives before specifically addressing the questions raised in the SEC's request for comment.

***1. Focus the audit of internal control on the most important matters*.**

The discussion provided by the PCAOB on this point states

> *Auditing Standard No. 5 clarifies how auditors should assess risk to focus on the areas that have a reasonable possibility of containing a material misstatement, and to calibrate the amount of testing necessary based on the degree of risk. The standard emphasizes the significance of fraud risk and anti-fraud controls, and explains what impact entity-level controls might have on the tests of other controls.*

<u>We raise the following issues and potential concerns regarding this objective:</u>

- Effective risk assessments require sound audit procedures, but most importantly, audit staff with adequate business knowledge, experience, and skill to properly gauge the risks and assess the effectiveness of attendant risk control design and function. These assessments can be very complex determinations. This is increasingly so in an environment where the complexity of business operations and their financial transactions will only grow. The direct implication is that if auditors are to perform effective risk-based audits, substantial expertise must be devoted to the design of the audit and attention applied to staff qualifications and training

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- Consideration should be given to needed revisions in both the entry-level educational requirements for auditors, including the CPA examination requirements, as well as enhancements to firms' ongoing internal professional training.

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[13] *Board Approves New Audit Standard for Internal Control over Financial Reporting and, Separately, Recommendations on Inspection Frequency Rule.*
http://www.pcaob.org/News_and_Events/News?2007?05-24.aspx.

- A key concern is the degree of skill and ability required to deal with high-risk transactions involving related parties, including senior managers or directors. These skills include the ability to render informed and healthy skepticism.

- Another important skill is early detection, finding and correcting material weaknesses *before* they result in material misstatements in the financial statements. Moody's has presented troubling evidence indicating that the audit community needs to do more in this area.[14]

2. *Include only the requirements necessary for an effective audit*.

The Board has re-evaluated every area of the internal control audit to determine whether Auditing Standard No. 2 encouraged auditors to perform procedures that are not necessary to achieve the intended benefits of the audit. Auditing Standard No. 5 focuses the multi-location direction on risk rather than coverage; requires the auditor to assess risk at the assertion rather than control level; and removes barriers to using the work of others. In addition, Auditing Standard No. 5 does not require the auditor to evaluate management's evaluation process.

<u>We raise the following issues and potential concerns regarding this objective:</u>

- Auditors must fully engage in a scaled, risk-based approach that focuses on what is necessary for both an effective as well as efficient audit of internal controls.

- Auditors and companies must not lapse into the same neglect experienced under the Foreign Corrupt Practices Act of 1977 (FCPA) which required similar attention to effective and efficient audits over internal controls.

- PCAOB oversight must exercise continued vigilance and focus on these areas to deter the lax behavior seen pre-Sarbanes-Oxley and the excesses that occurred with initial SOX 404 implementation.

3. *Make the audit scalable to fit the size and the complexity of any company*.

In coordination with the Board's ongoing project to develop guidance for auditors of ***smaller*** *companies, Auditing Standard No. 5 explains how to tailor the audit of internal control to fit the size and complexity of any public company.*

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[14]See Moody's letter to the SEC regarding File Number S7-24-06 – *Management's Report on Internal Control Over Financial Reporting*: http://sec.gov/comments/s7-24-06/s72406-178.pdf. See also the "Remarks of Charles D. Niemeier on the Proposed Auditing Standard on an Audit of Internal Control over Financial Reporting," PCAOB Open Meeting. December 19, 2006. p. 4.

<u>We raise the following issues and potential concerns regarding this objective:</u>

- We agree with other experts that the most important driver of risk, appropriate internal control structures, audit procedures, and the resulting costs is the *complexity* of a company's operations.[15]

- Using size alone as a determinant of the need for properly designed, implemented and audited internal controls of a public company was properly rejected by the Commission and should be resisted in the future.

- The role of PCAOB reviews will be key in sending the message to both companies and audit firms that efficiency at the cost of effectiveness is not acceptable nor is the performance of audits in a one-size-fits-all fashion.

- The complexity of the determinations mentioned above will require additional consultation between auditors and the PCAOB, and possibly additional guidance.

***4. Simplify the text of the standard*.**

> *The text of Auditing Standard No. 5 is simpler and easier to use than that of Auditing Standard No. 2. It focuses more on general principles than on detailed requirements and uses plain English to define key terms and describe important concepts.*

<u>We raise the following issues and potential concerns regarding this objective:</u>

- We have long endorsed the use of "plain English" and strongly support principles-based standard setting. The challenge remains to provide sufficiently clear and unambiguous guidance, applied consistently across all companies and situations.

- The PCAOB must have the resources and capacity to provide the needed explanation and interpretation to guard against variability in implementation leading to diminished audit quality.

- There will be a cost challenge to both ensuring adequate guidance from the PCAOB and direction to audit staff and preparers in this principles-based approach. The oversight body and industry should expect that cost savings in the SOX 404 process may not be immediate in this regard.

This concludes our remarks on the overall AS5 objectives. Given all of the issues and concerns identified, we believe that the PCAOB will have an even greater responsibility in its compliance oversight role over audits. In particular, the PCAOB will need to evaluate the extent to which

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[15] See also the remarks of Robert Kueppers as reported in the Unofficial Transcript of the PCAOB's Standing Advisory Group meeting on February 22, 2007.

auditors have observed risk-based audit principles, conducted appropriate analyses to evaluate risks, designed effective tests and procedures to assess the controls related to the risks, including those to prevent or detect fraud, acted on the information to require corrections where they are needed, and reported on their findings to statement users. We believe that this role is entirely appropriate for the PCAOB but it will present the PCAOB with additional challenges.

SEC Questions

1. Is the standard of materiality appropriately defined throughout AS5 to provide sufficient guidance to auditors? For example, is materiality appropriately incorporated into the guidance regarding the matters to be considered in planning an audit and the identification of significant accounts?

4. Please comment on whether the definition of "material weakness" in Paragraph A7 (which is consistent with the definition that the SEC adopted) appropriately describes the deficiencies that should prevent the auditor from finding that ICFR is effective.

We will address these two questions together.

The standard of materiality in AS5, "…a reasonable possibility that a material misstatement…will not be prevented or detected…" has been revised from that used previously, "…more than a remote likelihood that a material misstatement…will not be prevented or detected". These two definitions are consistent with the thresholds specified in FAS 5: *Accounting for Contingencies*. The documentation indicates that the objective behind revising the materiality criterion was to achieve greater consistency with the SEC's standard. It also addresses anecdotal evidence that the more than remote likelihood standard was being interpreted by audit firms in the post-Arthur Andersen environment in a hyper risk-averse manner, even on highly immaterial items, causing significant additional costs and demands on company resources. We trust that the reasonable possibility standard will help address this problem.

In any event, we believe these two FAS 5 concepts are outdated, inconsistent with the requirements of many important financial reporting standards, and much in need of replacement. For instance, it is not clear how preparers and auditors currently apply the FAS 5 thresholds in practice, nor is it apparent what degree of consistency may or may not exist in the application of either concept. Thus, it is difficult to fully assess whether the "standard…[can] provide sufficient guidance to auditors."

We conclude that the PCAOB will have greater responsibilities and challenges in determining whether the spirit and objectives of SOX 404 are being met. Clearly, the ultimate test of such fundamental provisions as the materiality threshold for internal control weaknesses will occur in their application. That is, if we continue to have cases such as we saw in 2001-2002 where companies collapsed without prior warning of difficulties or of reporting and internal control deficiencies, or where we learn after the fact that large amounts of assets were transferred fraudulently to insiders as recently revealed in the option-backdating situation, or in other unreported related party transactions, then we will have to call into question not only the quality of the guidance provided, but the application as well.

2. Please comment on the requirement in Paragraph 80 that the auditor consider whether there are any deficiencies or combinations of deficiencies that are significant deficiencies and, if so, communicate those to the audit committee. Specifically, will the communication requirement regarding significant deficiencies divert auditors' attention away from material weaknesses?

The Sarbanes-Oxley Act recognized the critical role that the directors of a company, in particular the audit committee, have in protecting the interests of the capital providers to the company, and especially those of the shareowners, the residual claimants to the net assets of the company. Among the most important changes brought by the Sarbanes-Oxley Act were the requirements that the auditors communicate to the committee any matters of concern that they've discovered during the course of the audit, and be prepared to respond to any questions that the committee members might have. This mandate would include material weaknesses as well as any other serious matters of a worrisome nature, including significant deficiencies.

Thus, it would seem obvious that both significant deficiencies and more serious material weaknesses in internal control discovered by the auditors must, as a matter of course, be communicated to the audit committee members for their consideration. We do not see any inherent distraction in this regard.

3. Is AS5 sufficiently clear that for purposes of evaluating identified deficiencies, multiple control deficiencies should only be looked at in combination if they are related to one another?

Paragraph 65 states

> *Multiple control deficiencies that affect the* ***same financial statement account balance or disclosure*** *increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies that affect the* ***same significant account or disclosure, relevant assertion, or component of internal control*** *collectively result in a material weakness.* [Emphasis added]

This guidance would appear to be clear and unambiguous on its face, so it is difficult to understand the concern expressed in the question. Above all, however, we believe that auditors should have the flexibility to evaluate particular assertions and circumstances and determine those cases in which multiple control deficiencies could lead to a conclusion that a reasonable possibility exists that a material misstatement will not be prevented or detected.

5. Is AS5 sufficiently clear about the extent to which auditors can use the work of others?

Paragraph 17 states

> *For purposes of the audit of internal control, however, the auditor may use the work performed by, or receive direct assistance from, internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of*

internal control over financial reporting. In an integrated audit of internal control over financial reporting and the financial statements, the auditor also may use this work to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of the financial statements.

The provisions regarding the ability of auditors to use the work of others have attracted much attention. The general concern is whether this will negatively impact the reliability and quality of the audit. Typically in the past the work performed by *internal auditors* has not been an issue. Such work usually includes tests and similar procedures where the auditors have satisfied themselves as to the competence and objectivity (independence) of the internal auditors, who frequently meet high certification standards. The overall objective of an audit is seemingly met in this regard.

Conversely, many question the extent to which work performed by "…company personnel (in addition to internal auditors), and third parties working under the direction of management…" could contribute properly to obtaining objective and independent evidence. That is, the auditor is placed in the position of using work performed under the direction of managers to support the same managers' assertions. We think this provision should be carefully reconsidered, limiting auditor reliance on staff and others controlled by management to very limited, nonmaterial situations, if at all.

6. ***Will AS5 reduce expected audit costs under Section 404, particularly for smaller public companies, to result in cost-effective, integrated audits?***

We have discussed this topic at length above and believe cost savings can be realized with appropriate implementation of Commission guidance to preparers on proper internal control design and structure, followed by application of an audit of internal controls in accord with AS5 provisions. It must be understood and accepted that the cost of proper internal controls will never revert to pre-Sarbanes-Oxley days. The goal is to limit the additional cost burden on companies by having the most efficient implementation possible. However, we feel that first and foremost, the audit of any company must be *effective* in detecting material weaknesses in internal controls that could result in material misstatements or fraud.
We must never sacrifice effectiveness for efficiency and the role of the audit and the auditor is to provide reasonable assurance that the financial statements meet these standards.

7. ***Does AS5 inappropriately discourage or restrict auditors from scaling audits, particularly for smaller public companies?***

We do not believe that AS5 discourages or restricts auditors from scaling audits appropriately. We believe that audits for *all* companies should be specifically designed and scaled taking into account the complexity, size, and scope of operations. AS5 allows and encourages auditors to do this for all companies.

Conclusion

We appreciate the opportunity to respond to the SEC's invitation to comment on File Number PCAOB2007-02, Auditing Standard No. 5—*An Audit of Internal Control over Financial Reporting That Is Integrated with An Audit of Financial Statements* Should the Commission or staff have further questions, or desire additional clarification of our views, we will be pleased to respond.

Respectfully,

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