American Accounting Association ♦ Auditing Section
Auditing Standards Committee

November 17, 2003

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

RE: Invitation to Comment on PCAOB Rulemaking Docket Matter No. 008

Dear PCAOB:

The Auditing Standards Committee (ASC) of the Auditing Section of the American Accounting Association welcomes the opportunity to comment on the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements*. Overall, we believe that the proposed auditing standard is very clear and quite sound in its logic and requirements. We commend the PCAOB for its thoughtful consideration of the many issues involved in reporting on internal control.

The comments below are organized around the 31 questions posed in Release No. 2003-017. We conclude with other comments that are not directly tied to the questions posed.

We particularly call your attention to the following issues, as they reflect our most substantive suggestions:

- Controls in smaller companies (question 4)
- Reliance on the work of others (question 13)
- Definition of significant deficiency and material weakness (question 17)
- Evaluating the audit committee’s oversight (questions 22-24)
- “Except for” opinions (question 26)
- Controls over quarterly reports (question 31)
- The definition of internal control over financial reporting (other comment #1)
- Heavy focus on control activities (other comment #2).

No.	Question Topic	Response
1	Use of "audit of internal control over financial reporting"	Based on the content of the proposed standard, we believe that this terminology appropriately conveys the nature of the auditor's work. However, we do believe that it is important to prominently highlight that the auditor is attesting to management's assertion about internal control effectiveness. If this notion is not prominently highlighted, we believe that there is the potential for an expectation gap to be created (e.g., some may believe that the auditor is almost solely responsible for statements regarding the company's internal control over financial reporting).
2	Prohibiting internal control audit in absence of financial statement audit	We believe that it is appropriate to require the auditor performing an internal control audit also to perform the financial statement audit. The knowledge gained in the financial statement audit is a key input to the internal control audit.
3	Requiring only work *comparable* to a financial statement audit	We prefer the requirement that the auditor actually perform the financial statement audit, as this will better ensure that the auditor has more complete information about the quality of the company's financial statements and disclosures.
4	Internal control in small companies	We have significant concerns with the discussion of internal control in smaller public companies. Research (see Beasley, Carcello, and Hermanson, *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies*, COSO, 1999) indicates that financial statement fraud among U.S. public companies is concentrated among smaller companies, those with assets and revenues under $100 million. In addition, in over 80% of public company fraud cases, the CEO and/or CFO were implicated in the fraud. However, a pervasive theme of the discussion in the proposed standard is that oversight by ethical top managers may reduce the need for "elaborate internal control systems" in smaller companies. Since small-company accounting fraud typically is perpetrated by CEOs and CFOs, we are concerned that executive-level oversight in such organizations may provide very little protection and may give auditors a false sense of security. In a sense, to prevent fraud, the auditor would be relying on the oversight of the most likely perpetrators. As a result, we question the extent to which executive-level oversight can be an effective substitute for more traditional internal controls. On a related note, if an auditor were to conclude that ethical, executive-level oversight was an appropriate substitute for more extensive internal control systems in a small company, we believe that

		it would be imperative for the auditor to perform significant procedures to assess the ethical orientation of the executives. In the absence of a specific requirement along these lines, we are concerned that many auditors may be inclined to simply state that their small audit clients have effective controls because the CEO and/or CFO are keeping a close eye on the day-to-day operations – without any formal assessment of whether it is reasonable to rely on the oversight of these individuals. We recognize that there are requirements to evaluate the control environment, but we suggest being quite explicit about the auditor's responsibility for assessing top management integrity and values in cases where management oversight is being viewed as an effective form of internal control. Overall, given the concentration of fraud in smaller public companies (and apparently committed largely by CEOs and CFOs), we would strongly prefer to see more focus on formal internal controls in smaller companies. This focus on small company internal controls would be consistent with the SEC's and stock exchanges' decision ultimately to extend recent audit committee reforms to most public companies, rather than exempting those companies with market capitalizations under $200 million.
5	Specifying level of competence and training	We believe that a general statement about the level of competence and training would be appropriate. We recommend including language such as "sufficiently" trained and experienced within the body of the standard. Given that the PCAOB conducts quality reviews of registered firms, we recommend avoiding specific guidelines and instead recommend that the Board focus on competence and training in its quality control efforts.
6	Scope of audit of internal control	We agree with the proposed scope of the audit of internal controls. We believe that it is important for the auditor to obtain direct evidence on the effectiveness of internal controls in addition to evaluating management's assessment method.
7	Criteria for evaluating management documentation	We believe that it is appropriate to provide criteria for evaluating management's internal control documentation. Sound documentation is the first step to understanding controls and ultimately assessing their effectiveness. We do encourage the Board to provide examples that auditors could refer to when evaluating management's documentation.

8	Inadequate documentation as deficiency, significant deficiency, or material weakness	We appreciate the need for auditor judgment in this area and do not believe that inadequate documentation should automatically rise to the level of a significant deficiency or material weakness. Inadequate documentation, and the deficiencies associated with it, should be assessed on a case-by-case basis by the auditor. As a practical matter, we believe that inadequate documentation, in many cases, will rise to at least the level of a significant deficiency. If the controls are not properly documented (i.e., not properly understood by management), then it seems there would be at least "more than a remote likelihood that a misstatement of the annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected."
9	Requiring walkthroughs	We strongly agree with the requirement regarding walkthroughs. However, it would be helpful to provide more guidance about the extent of walkthroughs. For example, is one walkthrough for each significant process sufficient (see paragraphs 79-83)? Also, additional guidance on how to perform walkthroughs for control environment issues would be helpful. Finally, we suggest including more explicit language regarding where walkthroughs should begin. Because many information systems at public companies are interconnected and driven by relational databases, identifying the starting point might be difficult. We are concerned that auditors will start the walkthrough at the point where traditional accounting transactions begin, without moving backwards in the process to where the transaction is first initiated. As an example of the complexities involved, under many of the strategic alliance agreements that exist, companies interface their information systems such that transactions initiate at another entity. In such cases, we suggest requiring auditors to begin walkthroughs at alliance partner locations when necessary to understand relevant controls that impact financial reporting.
10	Requiring walkthroughs to be performed by auditor himself or herself	We agree with requiring the auditor to perform the walkthrough himself or herself.

11	Obtaining evidence of control effectiveness each year versus using prior year evidence to support current year conclusion	We agree that "each year's audit must stand on its own." Information from prior-year audits (particularly related to control design) may be an important input into the current year audit, but we do not believe that it can provide the basis for the current year opinion. The same is true for financial statement audits – last year's substantive testing of Accounts Receivable does not allow the auditor to skip Accounts Receivable this year. However, the extent of evidence needed should be reduced if the auditor is comfortable that no significant changes occurred in the design or implementation of a control from a prior year. Finally, we are unclear about the substance of the change to "relevant assertions" from "significant controls" and how this resolves the "so-called 'rotating tests of controls' issue." We suggest that the Board more clearly explain this issue.
12	Using the work of management or others	We do not believe that the auditor ever should be required to use the work of others, and we believe that reliance on such work should always be permitted (although the extent of reliance may be required to vary – see question 13 below). We encourage the Board to consider more carefully defining what constitutes the work of management and others, including a listing of "other" parties who may be considered appropriate.
13	Appropriateness of three categories of controls and extent of auditor reliance on others	The three-tiered approach described in the standard (i.e., controls for which auditor cannot rely, controls for which auditor's reliance is limited, and controls for which auditors can rely) generally seems appropriate. However, we are not fully supportive of having a no reliance category. We understand that some controls (like those in the control environment) are critical. However, even for these critical controls, we believe that the auditor should be able to gain some assurance from work performed by management/internal audit. Granted, the external auditor would need to carefully limit reliance in these areas, but should not be completely prohibited from some degree of reliance. Further, we wonder whether it makes sense to discuss the reliance issue from the perspective of the work performed at interim vs. the "as of" date. For example, to what extent can an auditor rely on interim work by others that is supplemented with the auditor's own work at year-end?
14	Appropriateness of recognition of internal audit work	We believe that the recognition of internal audit is adequate. However, as indicated above, we do not believe it is appropriate to completely prohibit reliance on internal audit's work in some areas, if in fact they have met the quality standards put forth in SAS No. 65.

15	Appropriateness of flexibility in determining reperformance of others' testing	Overall, allowing flexibility in determining the extent of reperformance seems appropriate. Using professional judgment, auditors should be able to decide how much work to reperform, and the conditions under which they should reperform the work. Further, this flexibility should be helpful in terms of concerns about fraud detection – if reperformance is "random" or based on auditors' perceptions about client risk or internal control weaknesses, then there is more of a "surprise" element to the internal control audit, which we believe is appropriate. Having said this, we note that an earlier report by the POB suggested that the level of testing of internal auditors' work when relied upon in a financial statement audit was inadequate in many of the audits they reviewed. Without being specific as to testing requirements (e.g., reperform some tests of all significant accounts) we have some concern that reperformance levels may be too low. We encourage the Board to rely on its quality reviews of registered firms to assess the sufficiency of reperformance and to provide more specific guidance if needed.
16	Auditor obtaining the principle evidence	We agree that the auditor should obtain the principle evidence, but we encourage the Board to more carefully define the concept of principle evidence.
17	Definitions of significant deficiency and material weakness	We have some concerns related to these definitions. First, we anticipate uneven application/interpretation of these definitions. Perhaps moving to a model using terms such as "low, medium, or high" risk of misstatement would result in more consistent application, given that these are commonly-used terms. Second, we are concerned that negotiations between auditors and clients will result in some weaknesses being "bargained down" to significant deficiencies so they will not be publicly disclosed. As a result, we wonder whether there would be merit to requiring public disclosure of both significant deficiencies and material weaknesses.
18	Examples in Appendix D	We found these examples to be helpful. However, we would like to see some discussion about the example of a material misstatement in the financial statements not being initially identified by the company's internal controls. Often, material misstatements identified by the external auditor are in the accounts which are estimates (e.g., allowance for doubtful accounts). Would misstatements identified by the auditor for these accounts be considered significant deficiencies (and possibly material weaknesses)? Or would it depend on whether the process management used to come up with the estimate was reasonable? Providing more discussion on this topic would be useful.

19	Necessity of evaluating all internal control deficiencies	We agree that all internal control deficiencies need to be evaluated. In addition, we recommend that the Board consider utilizing the risk management literature (as COSO has done for its Enterprise Risk Management Framework) to help in making these assessments. Auditors can assess the probability and magnitude of the risk of material misstatement given the control weakness as inputs into determining the severity of the control deficiency. Auditors can base their evaluation of the deficiency on measures such as the expected impact of the deficiency (computed as probability of misstatement times the impact). The assessments of severity ultimately should be based on professional judgment, but utilizing a framework to help in making that judgment helps to improve consistency.
20	Communicating all internal control deficiencies to management in writing	We agree that all internal control deficiencies need to be reported to management in writing.
21	Strong indicators of material weakness	We agree that these factors all reflect likely material weaknesses. However, we are concerned that the list of circumstances in paragraph 126 of the standard might lead to auditors not considering other circumstances. We recommend that the Board include language at the beginning of the paragraph very clearly stating that other circumstances may exist that should lead auditors to the same conclusion.
22	Appropriateness of auditor evaluation of audit committee oversight	We believe that it is appropriate for the auditor to evaluate the effectiveness of audit committee oversight – as part of both the internal control audit and the financial statement audit. Research clearly indicates that stronger audit committees are associated with reduced financial reporting risk. In addition, the literature (e.g., Beasley 1996 and others) also draws a strong linkage between overall board quality, particularly independence, and the risk of financial reporting problems. As a result, we encourage consideration of whether the auditor also should be specifically required to evaluate the overall board's oversight effectiveness when performing internal control or financial statement audits. Having said this, we do appreciate the practical and other concerns (see question 23 below) related to this requirement. In light of these concerns, one radical and perhaps cost-prohibitive suggestion is to require a second audit firm to perform the audit committee assessment on a less frequent basis (e.g., every 3 – 5 years).

23	Ability of auditors to effectively carry out responsibility to evaluate audit committee	We anticipate that this requirement could raise some significant issues in practice. The audit committee will both hire and be evaluated by the auditor. It certainly would be awkward in situations where the auditor concludes that the audit committee's oversight is ineffective, especially since this would be a specific criticism of the three or four members of the audit committee. In the past, investors were concerned that the auditor was hired by management and audited management's books. In a sense, that has been replaced by the auditor being hired by the audit committee and auditing the audit committee's oversight. In both instances, there is a conflict of interest for the auditor that must be recognized and managed. In today's environment, many investors may not believe that auditors can effectively carry out this responsibility from an appearance standpoint, if not from a fact standpoint. We call the Board's attention to press reports associated with the release of this proposed standard. Articles in major publications quickly noted that auditors would be evaluating those who hire and fire them. Going beyond the human/perception issues, we wonder whether there are liability concerns that may substantially limit the instances where an auditor cites ineffective audit committee oversight as a material weakness. For example, would an adverse internal control opinion citing inadequate audit committee oversight trigger shareholder suits against the directors? We encourage careful consideration of such issues.
24	Implications of audit committee representing material weakness	Given the concerns expressed in question 23 above, as a practical matter, we believe that the most likely outcome is that auditors simply will not accept/continue serving audit clients whose audit committees are ineffective. We would expect to see very few internal control opinions that cite inadequate audit committee oversight. Also, we question how requiring an auditor who has knowledge of a material weakness (sufficient to issue an adverse opinion) to withdraw from an engagement serves the public interest. Under the general standard of due professional care, we argue that an auditor with knowledge of ineffective audit committee oversight should issue an adverse opinion rather than be required to withdraw.
25	Material weakness requiring adverse opinion from auditor	We strongly agree that the presence of a material weakness must result in an adverse internal control opinion. In addition, we recommend that the Board discuss more explicitly in the standard the extent to which companies can fix controls that have been identified as significantly deficient in order to avoid an adverse opinion. For audits of financial statements, the threat of an adverse opinion

		traditionally has served as an important control to ensure that financial statements are corrected prior to being issued to the public. Based on our reading of the exposure draft, we are unclear on precisely to what extent this process is possible when auditing management's assessment of internal control.
26	Appropriateness of qualified "except for" auditor opinion	We do not believe that qualified "except for" opinions should be allowed in the presence of material weaknesses because the definition of material weakness states that there is "more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected." In such a case, we believe that internal control is, by definition, not effective – the company would not have "reasonable assurance regarding the reliability of financial reporting." In addition, we are not convinced that internal control can be compartmentalized very well. If there is a material weakness with one aspect of internal control, it is possible that the effects of this issue could permeate other areas. Again, overall internal control would not be effective. Given the above concerns, our view is that the presence of a material weakness should automatically result in an adverse internal control opinion. Finally, based on the spirit of the Sarbanes-Oxley Act in requiring adverse opinions for any material weakness, it might be most consistent to require disclaimers of opinion in any condition in which a material scope limitation exists. Under this line of reasoning, there would be no circumstances under which a qualified "except for" opinion should be allowed.
27	Auditor speaking directly to internal control effectiveness for non-standard opinions	We believe that requiring the auditor to speak directly to internal control effectiveness in such situations provides the most informative, least confusing reporting.

28	Providing specific guidance on independence and internal control-related non-audit services	If possible, it would be useful to add such guidance. For example, could the audit firm help in documenting the client's internal controls? Could the audit firm provide guidance on the internal control assessment process that management employs? We believe that many companies are hoping to be able to look to their external auditors for guidance on this whole process (including documentation requirements, number of items to test, etc.). If there are activities that the Board believes should not be performed, they should be specified in the standard. Without specific guidance, some firms, offices, or individuals may find themselves stepping over the line. Having said this, if this suggestion would result in significant delays in issuing the standard, then this issue could be addressed in subsequent standards.
29	Specific internal control-related non-audit services to prohibit	Please refer to question 28 above for some of the services that may be prohibited.
30	Auditor responsibilities for quarterly certifications – 4th quarter versus other quarters	Please refer to question 31 below regarding concerns over quarterly controls. In addition, we encourage the Board to work with the SEC to reconsider the decision to shorten the period for when the quarterly reports are due. Accounting firms were severely challenged when trying to meet the shorter deadlines for one review. It seems quite burdensome to potentially double the requirements on a quarterly basis without enabling a sufficient amount of time to effectively conduct both reviews.
31	Auditor responsibilities for quarterly certifications – appropriateness of scope	We have a significant concern related to internal controls over quarterly reporting, and we recognize that our concern actually ties back to the wording in the Sarbanes-Oxley Act and related SEC rules. Research (see Beasley, Carcello, and Hermanson, *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies*, COSO, 1999) indicates that financial statement fraud among U.S. public companies often begins in quarterly financial statements. A common pattern among the approximately 200 frauds studied was a fraud beginning in the first quarter of year 1, growing through the second, third, and fourth quarters of year 1, and then progressing through the first three quarters of year 2 (the typical fraud length was approximately two years, and a few frauds only involved interim periods). Our concern is that the 21-month fraud above would involve the misstatement of seven periods' financial statements (six quarters and one annual period), but only one of these seven periods (the annual

		period) is directly covered by the internal control reporting requirements (i.e., as of the end of the fiscal year). In other words, if management and the auditor have an obligation only to assess internal control effectiveness as of the end of the fiscal year, has the door been left somewhat open to allow fraud to occur during the first three quarters of the year? This may be the case if the controls over preparation of the quarterly financial statements are not as extensive or effective as the controls over annual financial statement preparation. While the definitions of "significant deficiency" and "material weakness" both refer to interim and annual misstatements, we are unclear how interim reporting risks can be evaluated effectively if controls over interim reporting are not extensively tested. In light of these concerns, we encourage more consideration of how to address internal control effectiveness in the first three quarters of the year. Again, we do recognize the constraints of the Act and the related SEC rules.

Other comments:

1. Definition of internal control – This comment also is offered recognizing that the Board is operating within the constraints of the Sarbanes-Oxley Act and related SEC rules on internal control reporting. The use of "internal control over financial reporting" seems to imply that there are different controls over operations and financial reporting. Under many of the information systems being utilized by publicly-traded companies, a common information system is utilized for operations and financial reporting. We suggest that the Board consider wording along the lines that the assurance is over any controls at the organization that can reasonably be expected to impact financial reporting. While this language change may appear subtle, we recommend avoiding any language that suggests there are multiple types of internal control. Rather, internal controls at an organization help to manage various risks at the organization, some of which have a direct impact on financial reporting. Other controls might only have an indirect impact on financial reporting (e.g., a lagged impact or an impact on another part of the organization that directly impacts financial reporting). While the standard provides the definition of internal control over financial reporting in paragraph 6, we are concerned that many controls related to key risks at the organization might not be investigated. The source of this concern is deciding when an internal control over financial reporting is *initiated*. For example, ineffective controls related to the customer service business process might impact the estimation process for warranties or recalls. However, under the proposed standard, it is not clear whether this control would fall under the proposed definition. This same problem is contained in the COSO (1992) framework that is used as background for this standard in paragraphs 13-14.

2. Heavy focus on control activities – The proposed standard seems to be focused more on the control activities component of COSO than on the other components. Our concern with this focus is that auditors are likely most familiar with the control activities component of COSO and would probably benefit from more direction, guidance, and examples related to the other four components of internal control (especially those that focus on entity-wide controls, rather than those that focus on initiating, recording, processing, and reporting transactions). For example, in the paragraphs discussing documentation (beginning with paragraph 43), there is not a lot of guidance as to what would be included in the documentation of the elements of the control environment (e.g., what should be documented about integrity of management, management's operating philosophy, etc.?). Similarly, in Appendix B, all of the examples related to extent of testing seem to focus on control activities. It would be helpful to have some examples for control environment controls, and others. The same applies to the examples provided in Appendix D.

3. Issues related to testing control effectiveness

    a. The discussion in paragraph 85 mentions that procedures used to test design effectiveness include inquiries, observations, and walkthroughs. Should review of documentation be added to this list of procedures?

    b. The tests discussed in the standard include inquiries of the client (see paragraph 90). Based on our understanding of the approaches being used by some client firms, some of the inquiry data are being obtained via structured surveys. We believe that the readers of the standard could benefit from some discussion about ensuring the validity of survey data, designing appropriate survey instruments/questions, etc.

    c. Paragraph 112 – Would it be useful to have some discussion as to the appropriateness of describing an identified exception as an "isolated instance?" We are concerned that some auditors may be too quick to consider an item isolated.

4. Other minor/editorial comments:

    a. Paragraph 22, 2nd bullet – We encourage additional explanation of this point. Our concern is that practitioners will not understand what types of qualitative factors to consider.

    b. Paragraph 24 – This paragraph relates to the control environment. However, one of the bullet points indicates "company's risk assessment process." Under COSO, the risk assessment process is not part of the control environment, but is a separate component of internal control. In addition, we wonder whether internal audit activity typically is identified as part of the control environment.

    c. Paragraph 50, 3rd bullet – It might be useful to elaborate on the last sentence. Could examples be provided?

    d. Paragraphs 85 and 87 – We encourage more specific guidance on testing design effectiveness. We are concerned that auditors will not have a good

basis for performing such tests. Available guidance typically has discussions on assessing design effectiveness and then assessing and testing operational effectiveness. We are not familiar with much guidance on testing design effectiveness.

e. Paragraph 126 – This paragraph should specifically refer to paragraph 180. When reading paragraph 126 we had questions about the issues subsequently discussed in paragraph 180.

f. Paragraph 140 – We found the last sentence of paragraph 140 to be surprising. Research indicates that analytical procedures can be quite helpful in fraud detection, and SAS No. 99 specifically calls for auditors to perform analytical procedures to assist in fraud detection.

g. Paragraph 145 – The first bullet calls for the auditor to document "the evaluation of the design of each of the five components of the company's internal control over financial reporting." Does the Board truly intend for the auditor to document separate conclusions about each of the five components, given that only one overall opinion on internal control will be provided?

h. Paragraph 191 states that the auditor is not required to perform procedures sufficient to identify all internal control deficiencies. However, is the auditor required to perform procedures necessary to identify all significant deficiencies and/or all material weaknesses? A clarifying comment on this issue would be useful.

We hope that our suggestions are helpful and will assist in finalizing the auditing standard. Please feel free to contact our committee Chair for elaboration on or clarification of any comment.

Respectfully Submitted,

Auditing Standards Committee
Auditing Section, American Accounting Association

Committee Members:
Dana R. Hermanson, Kennesaw State University (Chair)
770.423.6077, Dana_Hermanson@coles2.kennesaw.edu
Audrey Gramling, Georgia State University (Vice Chair)
Brian Ballou, University of Illinois (Past Chair)
Karla Johnstone, University of Wisconsin-Madison
Roger Martin, University of Virginia
Stephen Asare, University of Florida
Stuart Turley, University of Manchester

The Auditing Standards Committee wishes to acknowledge the helpful insights of Heather Hermanson, Mark Peecher, and Ira Solomon.