NASBA

National Association of State Boards of Accountancy

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

Re: PCAOB Rulemaking Docket Matter No. 008: Proposed Auditing Standard -- An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit Of Financial Statements

Dear Board Members:

The National Association of State Boards of Accountancy (NASBA) appreciates the opportunity to offer comments to the Public Company Accounting Oversight Board (the Board) concerning the proposed "Auditing Standard -- An Audit of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements."

NASBA is the national organization of state accountancy regulators. As the only authorities empowered to grant or revoke licenses of certified public accountants (CPAs), the State Boards are interested in the effect that the Board's proposed rules and auditing standards may have upon state public protection programs. We believe that close cooperation and a working partnership of the PCAOB and the SEC with NASBA and the State Boards will result in more effective regulatory efforts than otherwise would be achieved.

Our Professional & Regulatory Response Committee offers the following comments on selected questions posed in Release No. 2003-017:

<u>Question 2</u>. Should the auditor be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements?

<u>Comment</u>. Yes, we agree with the Board's integrated approach to the audit of the financial statements and internal controls. The audit of internal controls over financial reporting is complementary to the audit of the financial statements and should be performed by the same firm.

<u>Question 4</u>. Does the Board's proposed standard give appropriate consideration to how internal control is implemented in, and how the audit of internal control over financial reporting should be conducted at, small and medium-sized issuers?

<u>Comment</u>. We agree with your comment that, "For a smaller, less complex company, the Board expects that the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control." We are concerned that auditors will feel compelled to perform "one-size-fits all testing" resulting in increased costs without increasing the effectiveness of the audit. We believe the standard should provide greater clarity on the importance of the control environment and its potential impact on the level of control testing that should be done. To do this, we suggest that the standard would be enhanced by adding the points enumerated in Appendix E Section E1 to the body of the standard.

Question 5. Should the Board, generally or in this proposed standard, specify the level of competence and training of the audit personnel that is necessary to perform specified auditing procedures effectively? For example, it would be inappropriate for a new, inexperienced auditor to have primary responsibility for conducting interviews of a company's senior management about possible fraud.

Comment. We believe that general guidance would be helpful to auditing firms without mandating specific training requirements. Further, we believe that the facts and circumstances of each engagement will dictate the amount of training that a particular team should have. The use of professional judgment by the firm to meet the circumstances of the engagement should be emphasized. We believe this is in harmony with the Uniform Accountancy Act.

Question 8. Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?

Comment. We agree that the auditor should be allowed to evaluate the severity of the lack of documentation and its effect on internal control. While proper documentation is an important part of the control environment, the existence or lack of internal controls, not the lack of proper documentation, should ultimately form the basis for the auditor's report on internal controls.

Question 10. Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors or others?

Comment. We believe that the cost and benefit of any regulation must be carefully evaluated. We believe that any perceived benefit of allowing only the auditor to perform the walkthroughs is outweighed by the cost. When the internal audit function is properly structured as a quasi-independent organization within the company, reporting through appropriate channels, it can be a powerful tool in the control environment. To prohibit the use of internal auditors in performing or assisting with walkthroughs when properly supervised and retested by the external auditor is inefficient. It may also force the external auditor to deploy resources on more mundane areas to the detriment of the audit of riskier areas, thus decreasing the overall effectiveness of the auditor.

Again, we believe that the standard should allow for professional judgment in determining reliance upon the work of others. We believe that the standard should encourage the use of internal auditors and the use of internal audit in public companies.

A substantial percentage of accountancy boards' licensees are employed by corporations and are bound by the same code of professional conduct as the licensees in public practice. In fact, many are hired because they are CPAs.

Question 11. Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

Comment. As previously indicated, we believe the audit of internal controls should be thorough and complete but should also be efficient and cost effective. In many organizations, especially those that are well-controlled, the control environment may change little from year to year. In those environments, the auditor should be able to use his or her professional judgment and audit knowledge gained from prior years to determine the scope of the work to be performed. We are not suggesting that significant areas be skipped or rotated from year to year, but the level of audit testing may be varied from year-to-year to allow emphasis or focus on a variety of areas.

Question 12 . To what extent should the auditor be permitted or required to use the work of management and others?
Question 13. Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?
Question 14. Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

Comment. As indicated in our response to Question 10, we believe that the work of internal auditors should be permitted subject to the external auditor's evaluation that the work of the internal auditors can be relied upon. Similarly, we believe that work performed by management can be used when properly tested by the external auditor and under the appropriate circumstances, for example, in routine processing areas.

Further we believe the three categories specified are appropriate. However, we believe that the prohibitions outlined in the last two bullet points in paragraph 104 do not give due consideration to the use of the results of testing performed by others. Using professional judgment and appropriate retesting, the external auditor should be allowed to use the work of management and others in these areas subject to independence considerations. For example, IT experts may enhance the audit by providing very valuable assistance in testing information technology controls.

Question 17. Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

Comment. We are concerned that the use in paragraph 8 of the term "remote" coupled with a new term "inconsequential" could result in too broad a definition of significant deficiency. Using this broad definition could result in somewhat trivial items being reported to the audit committee, thus diverting the audit committee from evaluating truly important items. We believe that the auditor should exercise professional judgment, focusing on items that could result in significant misstatements if not corrected.

Question 20. Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?

Comment. Auditor judgment should be allowed to determine which deficiencies need to be reported in writing. The auditor should not be required to report insignificant items. This will help management focus their corrective efforts on significant areas.

Question 22. Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

Comment. The auditor should not be required to evaluate the audit committee. This creates an unworkable conflict-of-interest as the audit committee is charged with engaging the outside auditor and approval of additional services. We believe that the company's board of directors has the responsibility to evaluate the effectiveness of the audit committee. In making that evaluation they can solicit factual information from the auditors to help them in that assessment. However, if the auditors, in the course of their dealings with the audit committee, become aware of problems in the operation of the audit committee that are significant to the internal control structure of the company, they should be reported to the board of directors.

Question 25. Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?

Comment. We believe that a material weakness that is identified and then corrected in sufficient time before the date of the auditor's report on internal controls to allow additional testing to make sure it is operating effectively, should not result in an adverse report on internal control.

Question 26. Are there circumstances where a qualified "except for" conclusion would be appropriate?

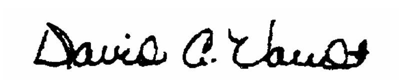
Comment. We believe that an "except for" opinion may be appropriate in limited circumstances, for example, a recent acquisition. If the Board determines that an "except for" opinion may be appropriate, we suggest that examples be given to clarify under what circumstances it may be used.

Question 29. Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client?

Comment. Consistent with the philosophy that the auditor should not audit his or her own work, we believe that the auditor should not develop the internal control structure and then perform an audit of internal controls. Another firm should be engaged to help management design and implement internal controls.

NASBA is pleased to provide these comments and would be happy to answer any specific questions you might have.

Sincerely,



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Chair

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