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To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008

Comments on PCAOB Rulemaking Docket Matter No. 008; Proposed Auditing Standard

Thank you for your invitation to provide comments on the proposed auditing standard *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* as published by the PCAOB on 7th October 2003.

Control environment:

The Royal Dutch/Shell Group has for many years operated a risk based control environment, which includes controls on financial reporting. One of the key benefits of this is that it helps ensure that control resources are devoted to the right areas. It also supports an environment in which management throughout the organisation is actively responsible for the maintenance and application of controls. The Group has a strong desire that any changes reinforce this environment and that we avoid changes which may erode it, for example through attention being devoted to lower value or lower risk activity.

We have some general observations and some more detailed ones which are in an appendix to this email.

General Observations

A. Role of auditors

We believe that an integrated approach to auditing of financial statements and attestation of management's assessment of the effectiveness of internal control over financial reporting is appropriate.

We are however concerned about the potential for a significant level of duplication of management and external auditor testing. We feel that for efficiency and cost effectiveness and more swiftly to identify those areas of concern to focus on, the external auditor should be able to use their judgment to assess when and where they may rely upon the work of others, by doing sampling of an appropriate nature to verify that reliance may be made. If management's testing is objectively documented and clearly evidenced, and sample testing verifies the results, no further duplication of effort should be required or mandated.

We generally feel that the document seems to be overly limiting the ability of the external auditor to use their judgment to rely on other work. While some comments seem encouraging about less work required for companies that have good controls, other statements seem to substantially negate that.

B. Significance criteria

Equally as important is the significance criteria defined in the Proposed Audit Standard. The Standard defines a stepping down process for setting the scope of the internal controls audit that includes identifying the significant locations, significant accounts, relevant assertions, significant processes, and finally to the controls to test. In paragraph (8) a significant deficiency is defined as one that "results in more than a remote likelihood of a misstatement of the company's annual or interim financial statements that is more than inconsequential in amount". The Appendices show an example of a significant deficiency where the impact is more than inconsequential, but less than material. Taking all this together results in a very detailed scope of assurance and testing, with the result that weaknesses which are non material in any practical sense will need to be attended to with high priority in order to avoid a qualified opinion of the enterprise's control framework, one which would in fact be misleading (a 'false alarm') to users of the accounts.

We believe that this is too broad and we strongly recommend that the more than inconsequential measure be replaced with a higher standard consistent with the notion that these are significant deficiencies (i.e. replace “more than inconsequential” with “significant”). This will not result in material matters going unattended and will release effort to be devoted to preventing or handling material problems.

C. Intended focus on controls on financial reporting

Paragraph (24) directs the external auditor to evaluate all controls specifically intended to address the risks of fraud that are likely to have a material effect, paragraph (43) directs the external auditor to evaluate documentation of controls designed to prevent or detect fraud. Financial controls have their beginnings and basis in the prevention of fraud so this appears to widen the scope to all potentially material controls, not just controls on financial reporting. We propose that the requirement be limited to prevention and detection of fraudulent practices in connection with financial reporting, since that is the matter dealt with by S.404.

We hope that our overall recommendations and our detailed observations are helpful in the development of workable and effective regulations and we appreciate the opportunity you have provided to submit these comments.

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Appendix

Detailed comments

Unless otherwise indicated, the detailed comments are given in response to the questions raised by the PCAOB in the preamble to the Proposed Standard.

1-3 We believe that an integrated approach to auditing of financial statements and attestation of management’s assessment of the effectiveness of internal control over financial reporting is appropriate.

6 It is appropriate for the external auditor to obtain some direct evidence about whether internal control over financial reporting is effective. However, the external auditors should be able to rely upon clear evidence from a viable internal control system that can be verified. They should not be required to do significant repeat testing, thereby duplicating effort, for their test results.

8 We feel that external auditors should be able to use their judgement on whether inadequate documentation is an internal control deficiency. Documentation enables the control(s) to be repeated or audited efficiently (and therefore cost effectively), but the lack of documentation does not in itself mean that the control is not operating effectively.

9 The performance of walkthroughs may assist understanding of the operation of the controls in place, however they should not be mandated since there may be better systemic ways of gaining a similar level of understanding.

10 If the results of management walkthroughs are clearly and objectively documented, we see no reason why external auditors should not be able to rely on management's results, having carried out sample testing to verify reliability.

11 Prior year evidence should be available to management and external auditors to form a conclusion on the scope of the testing to be carried out in the current period. Sufficient sample testing of the prior year evidence to ensure that it remains valid would enable reliance to be placed on that evidence.

12 The judgement of the external auditors should determine the extent to which they are able to rely on the work of management and others. The external auditors should not be duplicating the testing of management or others except on a sample basis to inform that reliance, with sampling done to confirm not recreate evidence of the controls operation.

13 There should be no categories of controls in relation to which the work of management and/or others specifically cannot be relied upon once sample testing by the external auditor has verified the evidence. Individual, and groups of, internal controls do not necessarily fall into single categories of controls. The judgement of the external auditors in making the assessment described in paragraph (103) should determine where reliance may be made.

14 There should be no difference between the approach used to test and place reliance on internal audit work and that of management or others.

15 Re-performance of tests should be left to the judgement of the external auditors, not mandated. Other forms of testing may be more informative and effective than repeating the same tests as carried out by management or others.

16 It is unrealistic and inefficient to require built in duplication of management and external auditor's work. Verification through sample, or other, testing should enable the external auditors to determine the level of reliance that may be placed on the work of management and others.

17 The definitions of significant deficiency and material weakness are too broad to limit the scope of review to those areas that are significant or material in the normal use of those terms (being a small number of 'important or noticeable' items or those 'having a special meaning'). The meaning of 'not inconsequential' is not clear and is not available in other accounting and/or auditing guidance. It sets a very low threshold, which is in conflict with the concept of 'significant' or 'material'. The definitions would be improved by providing a more focussed approach to identify what is significant and material.

19 It is not clear what is meant in paragraph (116) by the necessity for the external 'auditor to evaluate identified control deficiencies'. Reliance should be placed on managements evaluation once confidence in the management and processes has been reached.

20 If management have already identified and communicated internal control deficiencies it is not appropriate for the external auditors to do so again. The external auditor should communicate only those deficiencies identified that have not been identified by management, or that have not been communicated to the Audit Committee.

22-23 Requiring the external auditors to evaluate the effectiveness of the Audit Committee, that appoints them and is responsible for overseeing their activities, seems to put the external auditors in a position with potential for conflict of interest.

25-27 These questions need to be addressed from the standpoint of the user of the accounts. If the rules which determine a material weakness to exist are so tightly drawn as to result in a material weakness being reported, and therefore an adverse report finding, but which is one which does not in fact represent a material threat to the health of the enterprise, then the false alarm does not serve the user well. Somehow a balance needs to be found between a standard which encourages enterprises to ensure their controls are fit for purpose and one which causes warning lights to go on unnecessarily. We do not exclude here material weaknesses which, though currently minor in impact, may nonetheless serve as early warning of problems to come; these should be the subject of disclosure. Because the SEC has eliminated flexibility in how to handle a material finding, the onus is on the PCAOB to define what constitutes material very carefully.

31 Since foreign registrants are not required to certify on a quarterly basis and since in many cases, including that of the Royal Dutch/Shell Group, quarterly releases are unaudited, we assume that the reference to quarterly work is only applicable to companies which certify on a quarterly basis.