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24 November 2003

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

Email: **comments@pcaobus.org**

File Reference: **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 Ms. Primus:

The Association for Investment Management and Research® (AIMR) is pleased to comment on the Public Company Accounting Oversight Board's (PCAOB) Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.* With headquarters in Charlottesville, VA, and regional offices in Hong Kong and London, AIMR is a non-profit professional organization of 67,000 financial analysts, portfolio managers, and other investment professionals in 115 countries of which 55,800 are holders of the Chartered Financial Analyst® (CFA®) designation. AIMR's membership also includes 127 affiliated societies and chapters in 46 countries. AIMR is internationally renowned for its rigorous CFA curriculum and examination program. More than 102,000 candidates worldwide enrolled for the June 2003 CFA Examination.

General Comments

We commend the efforts of the Public Company Accounting Oversight Board (PCAOB) to strengthen the financial reporting system for companies that are publicly traded in the United States, increase the reliability and validity of financial reports, and provide greater oversight and transparency of both the attest function and the evaluation of systems of internal controls. Reliable financial information is the life blood of the financial markets. Participants in these markets must have complete, reliable, and transparent information in order to make appropriate financial decisions, including valuation and investment decisions, and to properly allocate capital.

In recent years, when it became apparent to investors and other users of financial statements that they might no longer be able to rely upon the reliability of companies' financial disclosures, their trust and confidence in the markets collapsed. The loss of investor confidence has harmed everyone who participates in the financial markets, including the issuers of securities themselves. Consequently, we support strongly the PCAOB's initiatives which we believe will contribute in a fundamental way to restoring the essential trust and confidence of investors and other users of financial statements.

In particular, we support the Board's proposal to:

1. Require auditors to evaluate management's process for determining whether its standards are effective; and

2. Require auditors to gather evidence through testing to determine whether the

    a. Controls are effective, and

    b. Management's assertion to that effect is fairly stated.

The critical core of any audit of financial statements is the evaluation of the effectiveness of the company's system of internal controls. If material failures occur in the internal control systems, as we have seen in a number of the recent corporate collapses, then the reporting system cannot be relied upon to produce reliable financial statements. It is not sufficient that auditors merely review internal control system documentation and management's assertions as to the effectiveness of the system. Attestation as to the effectiveness of the system requires direct tests to evaluate the:

- Control environment;
- Control and other business and operational risks;
- Control activities;
- Information and communication system; and
- Monitoring of the control and reporting systems.

Auditors must test each of the critical components of internal control systems, and provide sufficient independent and competent evidence to be able to provide an opinion that can be relied upon by investors and other users of the statements. In the absence of such tests and evidence, there is no basis for reliance on the system, or for auditors to formulate an opinion on the financial statements, or for users (whether they are internal or external to the company) to rely on system outputs. Consequently, the risk premium that investors and other providers of capital will demand if they are to provide their capital to issuers of such financial statements will place a great burden on the operations of companies. We believe that failure to ensure the reliability of these systems will ultimately be more costly for everyone.

We realize and expect that the costs of audits will likely increase with the increased audit activities and that these costs will ultimately be borne by shareholders. We would observe, however, as been widely reported, that the average cost of audits has been artificially low in the past because of the effective subsidization of audit fees by revenues generated from additional services auditors provided to their audit clients. Indeed, one of the chief objections raised by the audit profession to the prohibition under the Sarbanes-Oxley Act of 2002 of auditors' providing non-audit consulting services to their audit clients was that without those services, the audit firms would have to increase their audit fees significantly. Shareholders were already bearing the costs of *both* the audits and the additional consulting services.

There is a clear economic tradeoff between the cost of audits and the cost of capital. That is, if, in order to reduce or contain audit costs, the scope of audit activities is restricted, then the resulting decrease in the confidence that users have in audited financial reports will be reflected directly in higher costs of capital demanded by investors. Moreover, because of the greater uncertainty resulting from reduced reliability, we believe the increased risk premium is likely to be greater than the cost savings realized by the reduced audit activities. Such a circumstance would ill-serve issuers and their existing shareholders as well as other investors.

We also concur with the Board's proposal that auditors should identify circumstances that constitute a significant deficiency and which are a strong indicator of material weakness. In particular, the proposal states that the auditor should evaluate the effectiveness of the audit committee's oversight of the company's internal control and external financial reporting systems. A cornerstone of effective as well as efficient internal control systems is a strong and continuous internal monitoring and audit function.

The Sarbanes-Oxley Act mandated that US registrants must have an effective and independent audit subcommittee within their boards of directors. This committee would serve as the apex of the internal audit and financial reporting functions. However, it is not sufficient that such a committee be formed. Rather, in order to fulfill the intent of the Sarbanes-Oxley legislation, the effectiveness with which the committee performs its fiduciary responsibilities to oversee the internal control system and financial reporting process must be assessed as well. Again, in a number of the recent corporate collapses, it was clear that the directors failed in their responsibility to monitor and evaluate such systems, and, in some cases, had even acquiesced in management's overriding of the control systems.

Consequently, we concur with the provision to expand the auditor's current responsibilities to evaluate the effectiveness of the oversight function, particularly with regard to the audit committee's responsibilities. We do not believe that this will involve a significant increase in the costs of audits because auditors are currently required to communicate with the audit committee and discuss with them both the results of their audits and any concerns or material deficiencies revealed by their tests. Indeed, this increased responsibility could lead to greater cooperation between auditors and the committee. We believe that improving this relationship could make a very constructive contribution to both the auditor's work and the audit committee's efforts and effectiveness.

Concluding Remarks

In conclusion we support the Board's efforts to improve the quality and effectiveness of audits of companies that are publicly traded in the United States and believe these proposals will lead to greater reliability and transparency of the financial reports that are essential to investors and other participants in the financial markets. We strongly encourage the Board to continue with such improvements.

AIMR appreciates the opportunity to express its views on the Proposed Auditing Standard, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. If the Board or staff have questions or seek amplification of our views, please contact Rebecca McEnally at 1-434-951-5319 or at rebecca.mcenally@aimr.org. We would be pleased to answer any questions or provide additional information you might request.

Respectfully yours,

/s/ Patricia Doran Walters

Patricia Doran Walters, Ph.D., CFA
Senior Vice President, Professional Standards
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/s/ Rebecca Todd McEnally

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Vice-President, Advocacy, AIMR

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