

April 23, 2004

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

Re: PCAOB Rulemaking Docket Matter No. 014
Proposed Auditing Standard – Conforming Amendments to PCAOB Interim Standards
Resulting From the Adoption of PCAOB Auditing Standard No. 2, An Audit of Internal
Control Over Financial Reporting Performed in Conjunction with an Audit of Financial
Statements

Deloitte & Touche LLP is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the “PCAOB” or the “Board”) on its Proposed Auditing Standard, *Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2* (“PCAOB Auditing Standard No. 2”), *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (the “Proposed Standard”), PCAOB Rulemaking Docket Matter No. 014 (March 9, 2004). We have carefully reviewed the Proposed Standard, and we have several comments organized into three categories as follows: I) Responses to Questions Posed by the Board, II) Other Substantive Comments and III) Editorial Comments.

I) Responses to Questions Posed by the Board

1. Are the references useful in assisting auditors when performing an integrated audit of financial statements and internal control over financial reporting? If not, explain.

Yes. The references are useful and will assist auditors in following the correct guidance. However, we believe that some of the references can be better placed as indicated below.

- Paragraph 4b adds a reference in AU sec. 312.05 to paragraphs 24-26 of PCAOB Auditing Standard No. 2, which describes fraud considerations in an audit of internal control over financial reporting. We believe that a more appropriate place for such a reference is in AU sec. 316, which describes fraud considerations in a

financial statement audit; however, paragraph 6 of the Proposed Standard already includes this reference. Because AU sec. 312 addresses audit risk and materiality in conducting an audit, we recommend that the Board add a comment to AU sec. 312.05 to the effect that in planning an integrated audit, the integrated audit is not designed to detect deficiencies in internal control over financial reporting that, individually or in the aggregate, are less severe than a material weakness (as stated in PCAOB Auditing Standard No. 2, paragraph 27 and paragraph 2d of the Proposed Standard). Deleting the current proposed reference in AU sec. 312.05 and adding the suggested statement would provide a parallel construction in paragraph 4b regarding audit risk and materiality.

- Paragraph 4e adds a note to AU sec. 312.30 referring to paragraphs 147-149 of PCAOB Auditing Standard No. 2, which describe the objective of tests of controls in an audit of internal control over financial reporting. However, the subject matter of AU sec. 312.30 is control risk; accordingly, the reference to paragraphs 147-149 does not appear to be on point.
- Paragraph 7c adds a reference in AU sec. 319 to PCAOB Auditing Standard No. 2, paragraphs 68-70, which discuss relevant assertions. We believe that a more appropriate place for such a reference is in AU sec. 326, which is the section of the interim standards that currently discusses assertions.
- Paragraph 7g adds a reference in AU sec. 319.97 to PCAOB Auditing Standard No. 2, paragraphs 104-105, which discuss “extent of tests of controls.” We believe that this reference would be better placed in the section of AU sec. 319 that discusses “performing tests of controls” (AU sec. 319.75-79).

2. *Have any references been omitted from the proposed auditing standard that commenters believe would be beneficial? If so, explain.*

Yes. We noted that the last sentence of AU sec 319.42 states “ordinarily, audit planning does not require an understanding of the control activities related to each account, balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to them.” We believe this sentence needs to be updated for an integrated audit to conform to or reference PCAOB Auditing Standard No. 2.

3. *Do the proposed amendments clearly describe the new requirements that apply when the auditor is engaged to audit only the financial statements? If not, how can the Board more clearly describe the new requirements?*

No. We believe that a number of new requirements have been obscured behind the label of “conforming changes” and, that as a result, auditors who are engaged to audit only the financial statements will fail to notice such new requirements and, therefore, fail to

appropriately modify the financial statement audit process. Accordingly, we recommend that the PCAOB appropriately highlight each new requirement for such audits to ensure that practitioners are aware of and fully understand the ramifications of each new requirement. Please refer to our comments in Section II relating to paragraphs 7b and 7h and paragraph 13a-c.

As we have previously expressed to the Board, it is extremely important to clearly communicate changes to interim standards resulting from proposed standards. We fully agree that it is necessary to make specific changes to the Board's interim standards in order to conform such standards to PCAOB Auditing Standard No. 2. However, until such time as a full codification of both current text and proposed amended text can be produced, the ability of auditors to follow the correct guidance will be greatly hampered, increasing the likelihood of auditors failing to effectively implement new requirements adopted by the Board. Accordingly, we strongly urge the PCAOB to come to a resolution over the codification issue with the American Institute of Certified Public Accountants (the "AICPA") as quickly as possible.

4. *Are there any additional requirements that are applicable in an integrated audit of financial statements and internal control over financial reporting that also should be applicable when the auditor is engaged to audit only the financial statements?*

No. We do not believe there are any other additional requirements that are applicable in an integrated audit that should also be applied when the auditor is engaged to audit only the financial statements. With respect to the two examples provided by the PCAOB:

- We believe that the auditor should be able to apply judgment in determining whether to communicate internal control deficiencies that are less severe than significant deficiencies in a financial statement only audit.
- Although the Proposed Standard states that the auditor in a financial statement only audit does not have an explicit requirement to evaluate the effectiveness of the audit committee, we understood that to mean that the Board intends for the auditor to perform some basic level of procedures to consider whether the audit committee appeared to be effective for purposes of gaining an understanding of internal control in order to plan the audit but not necessarily sufficient to form an opinion on the effectiveness of the audit committee. If the Board did not intend for the auditor to perform procedures as described above, further clarification of such statement is necessary.

5. *Are there any circumstances in which the proposed amendments in an audit of financial statements are not appropriate or should not be made? If so, what are those circumstances, and why do they indicate that the proposed amendment is not appropriate? Recognizing that the requirements in the proposed amendments are*

required in an integrated audit, describe the circumstances that are different in an audit of financial statements from those in an integrated audit of financial statements and internal control over financial reporting.

Yes. As discussed in Section II below relating to the proposed amendments to AU sec. 325 (paragraph 10 of the Proposed Standard), we do not believe that the report examples contained in AU sec. 325 should be deleted. Rather we recommend that they be conformed for the definitions in PCAOB Auditing Standard No. 2. Additionally, we do not believe it is sufficient to say in paragraph 11 of the Proposed Standard that in an audit of financial statements only, that the auditor may continue to apply Auditing Interpretation No. 1 to AU sec. 325 without the PCAOB also conforming all relevant terminology, including the definition of a material weakness, contained in the illustration of a report in paragraph .04 of such interpretation.

6. Are there any circumstances in which issuers would want or need to file an AT sec. 501 report with the Commission? If so, explain.

Yes. We are aware that some asset-backed securitization issuers have been filing AT sec. 501 reports to comply with their filing requirements with the Commission. In lieu of obtaining an audit of the financial statements of the trust, asset-backed securitization issuers may obtain an attest report on their processing activities. A variety of different attest reports from compliance with minimum servicing requirements under the Mortgage Bankers Association's Uniform Standard Audit Program or other compliance criteria to an examination of the effectiveness of internal control over financial reporting of the trust have been used to satisfy these requirements.

Although some issuers who do file audited financial statements with the Commission might want to obtain an AT sec. 501 report for filing with the Commission for other reasons, we do not believe that such approach would be appropriate under the premise that an audit of financial statements and of internal control over financial reporting is an integrated audit. We expect that auditors will receive questions from issuers regarding the following types of scenarios:

- If the issuer has a material weakness at year end, can the auditor perform an audit of internal control as of a subsequent interim date under either PCAOB Auditing Standard No. 2 or AT sec. 501 to issue a report to be filed in a Form 10-Q or Form 8-K without performing a subsequent audit of financial statements?
- Can an issuer file an AT sec. 501 report of a nonpublic entity that the issuer is proposing to acquire or has acquired (e.g., when such report is included in the annual report of the nonpublic entity)?

We recommend that the Board consider addressing such scenarios in any interpretive guidance that the PCAOB develops.

7. *Should AT sec. 501 be amended rather than superseded? If amended, what types of changes should be made to AT sec. 501?*

The answer to this question depends on whether the PCAOB wants to change practice for asset-backed securitization issuers. If those issuers that used an AT sec. 501 report in the past are prohibited from doing so once the PCAOB supersedes AT sec. 501, such issuers could follow the approach that other issuers use of reporting on compliance (based on AT sec. 601) or on the effectiveness of the operational aspect of processing (based on AT sec. 101, with the AICPA AT sec. 501 standards providing useful information).

8. *Is there a need for an auditor's report on internal control in addition to the auditor's report on the integrated audit of financial statements and internal control over financial reporting? If so, what information should the report include? In which circumstances would the report be issued? Who would use the report?*

It is unclear whether the PCAOB is questioning (a) whether a stand-alone audit of internal control would be necessary in any circumstances for an issuer or (b) whether there is a need for an issuer to provide the internal control report issued under the integrated audit approach without the accompanying report on the financial statements. Accordingly, we have provided responses to both.

As discussed above in our responses to questions 7 and 8, the current need for a report on the effectiveness of internal control for a situation other than an integrated audit relates to asset-backed securitization issuers. However, we believe it would be confusing to users if such engagements and related reports were to follow PCAOB Auditing Standard No. 2 when an integrated audit is not performed.

We believe that subsidiaries of issuers who have needs, other than for purposes of the needs of the parent company issuer, to provide a report on the effectiveness of internal control over financial reporting would be able to obtain such a report under either PCAOB Auditing Standard No. 2 (if it relates to the entity's year-end in an integrated audit), or under the existing AICPA standards (if required by a particular regulator or for a date other than the subsidiary's year-end).

We believe that an issuer should be able to provide their assertion regarding the effectiveness of internal control over financial reporting together with the auditor's report thereon without the related financial statements and auditor's report for purposes other than complying with Section 404. In such situation, we do not believe that any additional language should be included in the auditor's report; however, we would recommend removing any reference to the audited financial statements and related auditor's report when such documents are not included.

II) Other Substantive Comments

Paragraphs 7b and 7h

The Proposed Standard would add the following to AU sec 319.02 “the auditor should perform substantive procedures for ***all relevant assertions*** related to all significant accounts and disclosures in the financial statements.” Additionally, the Proposed Standard would amend the last sentence of AU sec 319.107 to state that the “auditor should perform substantive procedures for ***all relevant assertions*** related to all significant accounts and disclosures in the financial statements.” However, current guidance contained in AU sec. 319.81 and AU sec. 322.16, and elsewhere throughout the interim standards, requires that substantive procedures be performed at “***the account balance or class of transaction level.***”

The proposed amended language represents a significant change in current auditing standards and significantly impacts the audit process and the fundamental performance of substantive audit procedures. Accordingly, as discussed in our response to Question 3 above, the Board needs to better publicize the importance of this change and the Board’s plans to conform the remainder of the interim standards to adopt this change in order to ensure that practitioners are aware of and fully understand the ramifications of the new requirements.

Paragraph 10

The Proposed Standard would supersede AU sec. 325 in two different manners—first, AU sec. 325 would be superceded in its entirety for an integrated audit by paragraphs 207-214 of PCAOB Auditing Standard No. 2 and second, AU sec. 325 would be superceded for a financial statement audit by the new text in the Proposed Standard (subparagraphs 1-10 of paragraph 10). We believe that a clearer approach to communicating new requirements would be to amend AU sec. 325 to specifically state that it does not apply to an integrated audit, provide a cross-reference to the appropriate paragraphs in PCAOB Auditing Standard No. 2 for guidance related to communicating internal control related matters in an integrated audit, and then revise AU sec. 325 as the PCOAB determines appropriate for the financial statement audit only situation.

Additionally, we believe that there is still a need for the PCAOB to provide more meaningful guidance, including an illustrative form of report for purposes of communicating control deficiencies (including significant deficiencies and material weaknesses) in the standards for both an integrated audit and a financial statement audit. The Proposed Standard, as currently framed, would supercede the existing illustrative language for a financial statement audit and the PCAOB standards would be left without any illustrative form of report for either an integrated audit or a financial statement only audit. Accordingly, we recommended in our response to Question 5 above that the PCAOB retain a report example in AU sec. 325 with conforming language to PCAOB Auditing Standard No. 2. Additionally, we recommend that the PCAOB, through amendment to its Auditing Standard No. 2 or otherwise, provide an illustrative report for the communication resulting from an integrated audit described in paragraphs .207-.214 of such standard.

Subparagraph 4—We are concerned that the written communication for a financial statement only audit would *always* be required to be made *prior* to the issuance of the auditor’s report. Where significant deficiencies are noted at the very end of the audit, it would seem appropriate to issue the written communication *concurrent* with the auditor’s report on the financial statements to make it clear that it covers matters through completion of the audit, and to make reference to the issued auditor’s report in the communication. This would be particularly true for situations in which a written communication under AU sec. 325 was issued following interim audit work and the auditor had additional matters to report at year end.

Subparagraph 6—Proposed paragraph 6 of amended AU sec. 325 lists the required elements of a written communication about control deficiencies in an audit of financial statements, including a statement about intended use of the written communication in paragraph 6c. Such statement, however, is inconsistent with AU sec. 532, which would also require that a statement be included in the written communication that the report is not intended to be and should not be used by anyone other than the specified parties. We recommend that the statement in paragraph 6c be modified to be consistent with AU sec. 532. However, if the Board fully intends to modify current practice, this should be clearly identified and publicized as a significant change and the Board should describe its plans to conform the interim standards.

Paragraph 13a

Paragraph 13a proposes amending AU sec. 329.09 to include a statement that “For significant risks of material misstatement, it is unlikely that audit evidence obtained from *substantive* analytical procedures alone will be sufficient” [emphasis added]. It is not clear from this language how the auditor is required to respond or what would be considered sufficient evidence. We believe clearer wording would be as follows: “Often the auditor will need to obtain evidence from test of details or from a combination of tests of details and substantive analytical procedures for significant risks of material misstatement.”

Paragraph 13c

Paragraph 13c states “before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information”; however, it is unclear what is meant by the phrase “before using the results obtained from substantive analytical procedures.” Perhaps the following would more clearly articulate the PCAOB’s intent: “If the auditor plans on performing substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information to be used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information.” However, if this suggested language is adopted, the PCAOB would then need to determine how to apply such guidance in situations in which prior-year information is used by the auditor to develop expectations and one or more of such prior years were audited by a predecessor auditor. Would it be acceptable for the successor auditor to merely tie out the prior-year information to

the audited prior-year financial statements or would the successor auditor be required to perform other procedures? The Proposed Standard should clearly set forth the intended requirements.

Paragraphs 18 and 19

Paragraphs 18 and 19 provide guidance on the dating of reports and state that the reports on the audits of the financial statements and internal control over financial reporting should be dated the same. In the course of developing interpretive guidance, we recommend that the PCAOB address various dating scenarios that auditors traditionally have been faced with, including dual-dating of reports for subsequent events and restatements for corrections of an error.

III) Editorial Comments:

In addition to the comments below, we would caution the Board against repeating portions of new standards within other standards, as doing so will make it more difficult and challenging for the Board to ensure on a go-forward basis that all relevant guidance has been appropriately updated when and if the Board subsequently modifies its standards. In the text of the Proposed Standard, portions of PCAOB Auditing Standard No. 2 have been repeated in several places including in paragraphs 2, 14, and 17. We believe a cleaner approach is to include cross-references only rather than repeating actual text.

Paragraph 2a-e

We believe the suggested amendments to AU sec. 310.06 are extremely confusing and will be difficult for auditors to follow because, as proposed, each bullet point bounces back and forth between an integrated audit and a financial statement audit. We believe that a much clearer approach to providing the guidance would be to have two categories of bulleted items within AU sec. 310.06—one complete set related to a financial statement audit and another complete set related to an integrated audit. Alternatively, a grid might be created that clearly sets out the elements that need to be understood by the client, including the responsibilities of management and the auditors, with one column for a financial statement audit only and another column for an integrated audit.

Additionally, as PCAOB Auditing Standard No. 2 requires an opinion both on management's assertion and on the effectiveness of internal control, the conforming amendments should be consistent. Accordingly, paragraphs 2b (first bullet) and 2d (first bullet) should be revised to refer to the opinion on the effectiveness of internal control over financial reporting.

Paragraph 2e requires communications to be made to management and, depending on whether they constitute significant deficiencies, to the board of directors. A cross-reference should be added to direct the auditor to the specific guidance.

Paragraph 14

We recommend that the last sentence of the proposed note to paragraph 11 of SAS 92 be revised to recognize the fundamental risk of misstatement with respect to derivative

transactions arising from one of the essential characteristics of a derivative, as defined in paragraph 6 b. of Financial Accounting Standards Board Statement No. 133, namely that “it represents no initial net investment or an initial net investment that is smaller than would be required for other types of contracts....” Accordingly, we propose revising the proposed note to read as follows [with inserted text shown in bold italics and deleted text shown in strike-through]:

“Therefore, in an integrated audit ... if a company’s investment in ~~derivatives and securities~~ represents a significant account ***or if its derivative activities represent a significant class of transactions***, the auditor’s understanding of controls should include controls over ~~derivatives and securities~~ ***such*** transactions...”

Paragraph 15

As PCAOB No. 2 includes only the written representations that should be obtained in connection with the audit of internal control, we believe that the note in paragraph 15 should read “refer to paragraphs 142-144 of PCAOB Auditing Standard No. 2 for ***additional*** required written representations...” [inserted text is shown in bold italics].

Paragraph 17

We believe that the phrase “should necessarily inform the auditor’s decisions” included in the note to be added to AU sec. 342.10 should read “should necessarily influence [or impact] the auditor’s decisions,” to more clearly articulate the action required as clearly work cannot “inform” someone’s decisions.

We appreciate the opportunity to comment, and would be pleased to discuss these issues with you further. If you have any questions or would like to discuss these issues further, please contact Robert J. Kueppers at (203) 761-3579 or John A. Fogarty at (203) 761-3227.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: William J. McDonough, Chairman of the PCAOB
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