

File No. PCAOB-2003-05
Consists of 244 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 19b-4

Proposed Rules

By

Public Company Accounting Oversight Board

In accordance with Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of the Proposed Rules

(a) Pursuant to the provisions of Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") is filing with the Securities and Exchange Commission ("SEC" or "Commission") proposed rules consisting of a rule requiring compliance with applicable auditing and related professional practice standards and a rule providing parameters concerning participation in advisory groups to assist the Board in establishing such standards. The text of the proposed rules is as follows, with underlining indicating additions to the Board's existing rules:

SECTION 1. GENERAL PROVISIONS

Rule 1001. Definitions of Terms Employed in Rules.

.....

(a)(viii) Auditing and Related Professional Practice Standards.

The term "auditing and related professional practice standards" means the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of the Act), and any other professional standards, that are established or adopted by the Board under Section 103 of the Act.

.....

SECTION 7. PROFESSIONAL STANDARDS

Part 1 – General Requirements

Rule 3100. Compliance with Auditing and Related Professional Practice Standards.

A registered public accounting firm and its associated persons shall comply with all applicable auditing and related professional practice standards.

.....

Part 7 – Establishment of Professional Standards

Rule 3700. Advisory Groups.

(a) Formation.

To assist it in carrying out its responsibility to establish auditing and related professional practice standards, the Board will convene one or more advisory groups, in accordance with Section 103(a)(4) of the Act.

(b) Composition.

Advisory groups, in combination or as sub-groups designated by the Board within one advisory group, will contain individuals with expertise in one or more of the following areas –

- (1) accounting;
- (2) auditing;
- (3) corporate finance;
- (4) corporate governance;
- (5) investing in public companies; and
- (6) other areas that the Board deems to be relevant to one or more auditing or related professional practice standards.

(c) Selection of Members of Advisory Groups.

Members of advisory groups will be selected by the Board, in its sole discretion, based upon nominations, including self-nominations, received from any person or organization.

Note: The Board will announce, from time to time, periods during which it will receive nominations to an advisory group. During those periods, nominations may be submitted by any person or organization, including, but not limited to, any investor, any accounting firm, any issuer, and any institution of higher learning.

(d) Personal Membership.

Membership in an advisory group will be personal to the individuals selected to serve on the advisory group. A member's functions and responsibilities, including attendance at meetings, may not be delegated to others.

(e) Ethical Duties of Advisory Group Members.

Members of an advisory group shall comply with EC3, EC8(a), EC9, and, with respect to any private publication or public statement about the Board or any advisory group or any of the activities of the Board or any advisory group, EC10 of the Board's Ethics Code.

(f) Ad Hoc Task Forces.

The Board may, in its discretion, establish ad hoc task forces. The membership of such task forces may include, but is not limited to, advisory group members. To the extent not otherwise required, members of ad hoc task forces shall comply with paragraph (e) of this Rule.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Board

(a) The Board approved the proposed rules, and authorized them for filing with the SEC, at its Open Meeting on June 30, 2003. No other action by the Board is necessary for the filing of these proposed rules.

(b) Questions regarding this rule filing may be directed to Gordon Seymour, Acting General Counsel (202-207-9034; seymourg@pcaobus.org); Thomas Ray, Deputy Chief Auditor (202-207-9112; rayt@pcaobus.org) or Mary Sjoquist, Special Counsel to Board Member Gradison (202-207-9084; sjoquist@pcaobus.org).

3. Board's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rules

(a) Purpose

Section 103(a) of the Act directs the Board, by rule, to establish auditing and related attestation standards, quality control standards, and ethics standards "to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by [the] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." Section 103(b) of the Act also directs the Board to establish independence standards to implement, or as authorized under, Title II of the Act. Rule 1001(a)(viii) defines a term, "Auditing and Related Professional Practice Standards," that encompasses all such standards.

As a corollary to the Board's exclusive, statutory authority to establish and amend standards, all public accounting firms that are registered with the Board must comply with the Board's standards. While this requirement is implicit in the Act, the Board has

codified the obligation of registered firms to comply with the Board's Standards in Rule 3100. Any registered public accounting firm or person associated with such a firm that fails to adhere to applicable Board Standards may be the subject of a Board disciplinary proceeding in accordance with Section 105 of the Act.^{1/} In general, the Board's Standards will apply to registered public accounting firms and their associated persons in connection with their audits of (and related attestations concerning) the financial statements of issuers, as defined in Section 2(a)(7) of the Act, and those firms' auditing and related attestation practices. While the Board will, by rule, establish Standards, it recognizes that the development of such Standards should be an open, public process in which investors, the accounting profession, the preparers of financial statements, and others will have the opportunity to participate. To this end, the Board intends to provide for a public comment process on proposed standards. Moreover, in order to obtain the advice of a broad range of experts, the Board has determined to form an advisory group, the SAG, which may be divided into sub-groups by the Board if the need for specialized advice arises. Finally, the Board may also establish one or more ad hoc task forces to assist the staff with the drafting of technical language, among other things. Rule 3700 provides parameters concerning participation in the SAG or an ad hoc task force.

^{1/} In addition, the Act provides that any violation of the Board's Rules is to be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq., or the rules and regulations issued thereunder, and any person violating the Board's Rules "shall be subject to the same penalties, and to the same extent, as for a violation of [the Exchange] Act or such rules or regulations." Section 3(b)(1) of the Act.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

4. Board's Statement on Burden on Competition

The Board does not believe that the proposed rules will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. Under the proposed rule concerning compliance with standards, all registered public accounting firms and their associated persons must comply with all applicable auditing and related professional practice standards. The functional equivalent of this requirement is found in the Act, which provides for the Board to impose sanctions on registered firms or associated persons who violate such standards, and the codification of that requirement in the Board's rules does not add to the burden already imposed by the Act. The rules relating to advisory groups do not impose any burden on competition but, rather, provide for public participation, on a voluntary basis, in the process of advising the Board on the establishment of standards.

5. Board's Statement on Comments on the Proposed Rules Received from Members, Participants or Others

The Board released the proposed rules for public comment on April 18, 2003. See Exhibit 2(a)(1). The Board received 22 written comment letters relating to its proposal. See Exhibits 2(a)(2) and 2(a)(3).

The Board has carefully considered all comments it has received. In response to the written comments received, the Board has clarified and modified certain aspects of the proposed rules. The Board's response to the comments it received and the changes made to the rules in response to these comments are summarized in Exhibit 3 to this filing.

6. Extension of Time Period for Commission Action

The Board does not consent to an extension of the time period specified in Section 19(b)(2) of the Securities Exchange Act of 1934.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rules Based on Rules of Another Board or of the Commission

The proposed rules are not based on the rules of another board or of the Commission.

9. Exhibits

Exhibit 1 – Form of Notice of Proposed Rules for Publication in the Federal Register

Exhibit 2(a)(1) – PCAOB Release No. 2003-005 (April 18, 2003)

Exhibit 2(a)(2) – Alphabetical List of Comments

Exhibit 2(a)(3) – Written comments on the rules proposed in PCAOB Release No. 2003-005

Exhibit 3 – PCAOB Release No. 2003-009 (June 30, 2003)

10. Signatures

Pursuant to the requirements of the Act and the Securities Exchange Act of 1934, as amended, the Board has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Public Company Accounting Oversight Board

By:

William J. McDonough
Chairman

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. PCAOB-2003-05)

[Date]

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules
Relating to Compliance with Auditing and Related Professional Practice
Standards and Advisory Groups

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"),
notice is hereby given that on July 11, 2003, the Public Company Accounting
Oversight Board (the "Board" or the "PCAOB") filed with the Securities and
Exchange Commission (the "Commission") the proposed rules described in
Items I, II, and III below, which items have been prepared by the Board. The
Commission is publishing this notice to solicit comments on the proposed rules
from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rules

On June 30, 2003, the Board adopted rules relating to compliance
with auditing and related professional practice standards and relating to advisory
groups. The proposal includes two rules (PCAOB Rules 3100 and 3700) and a
definition that would appear in Rule 1001. The text of the proposed rules is as
follows:

SECTION 1. GENERAL PROVISIONS

Rule 1001. Definitions of Terms Employed in Rules.

.....

(a)(viii) Auditing and Related Professional Practice Standards.

The term "auditing and related professional practice standards" means the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of the Act), and any other professional standards, that are established or adopted by the Board under Section 103 of the Act.

....

SECTION 7. PROFESSIONAL STANDARDS

Part 1 – General Requirements

Rule 3100. Compliance with Auditing and Related Professional Practice Standards.

A registered public accounting firm and its associated persons shall comply with all applicable auditing and related professional practice standards.

....

Part 7 – Establishment of Professional Standards

Rule 3700. Advisory Groups.

(a) Formation.

To assist it in carrying out its responsibility to establish auditing and related professional practice standards, the Board will convene one or more advisory groups, in accordance with Section 103(a)(4) of the Act.

(b) Composition.

Advisory groups, in combination or as sub-groups designated by the Board within one advisory group, will contain individuals with expertise in one or more of the following areas –

- (1) accounting;
- (2) auditing;
- (3) corporate finance;
- (4) corporate governance;
- (5) investing in public companies; and
- (6) other areas that the Board deems to be relevant to one or more auditing or related professional practice standards.

(c) Selection of Members of Advisory Groups.

Members of advisory groups will be selected by the Board, in its sole discretion, based upon nominations, including self-nominations, received from any person or organization.

Note: The Board will announce, from time to time, periods during which it will receive nominations to an advisory group. During those periods, nominations may be submitted by any person or organization, including, but not limited to, any investor, any accounting firm, any issuer, and any institution of higher learning.

(d) Personal Membership.

Membership in an advisory group will be personal to the individuals selected to serve on the advisory group. A member's functions and

responsibilities, including attendance at meetings, may not be delegated to others.

(e) Ethical Duties of Advisory Group Members.

Members of an advisory group shall comply with EC3, EC8(a), EC9, and, with respect to any private publication or public statement about the Board or any advisory group or any of the activities of the Board or any advisory group, EC10 of the Board's Ethics Code.

(f) Ad Hoc Task Forces.

The Board may, in its discretion, establish ad hoc task forces. The membership of such task forces may include, but is not limited to, advisory group members. To the extent not otherwise required, members of ad hoc task forces shall comply with paragraph (e) of this Rule.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B and C below, of the most significant aspects of such statements.

A. Board's Statement of the Purpose Of, and Statutory Basis for, the Proposed Rules

(a) Purpose

(i) Rules 1001(a)(viii) and 3100

Rule 1001(a)(viii) defines "auditing and related professional practice standards" as the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of the Act), and any other professional standards, that are established or adopted by the Board under Section 103 of the Act (hereafter referred to in this Section A. as "Standards").

Section 103(a) of the Act directs the Board, by rule, to establish auditing and related attestation standards, quality control standards, and ethics standards "to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by [the] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." Section 103(b) of the Act also directs the Board to establish independence standards to implement, or as authorized under, Title II of the Act.^{1/}

As a corollary to the Board's exclusive, statutory authority to establish and amend Standards, all public accounting firms that are registered with the Board

^{1/} See also Report of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, on S. 2673, S. Rep. No. 107-205 (July 26, 2002) ("The Committee has concluded that the Board's plenary authority in this area is essential for the Board's effective operation, a position taken during the hearings by a number of witnesses..."). Board Rules adopting or modifying auditing and related professional practice standards require approval by the Commission. In addition, the Board recognizes that the Commission may also establish professional standards applicable to accountants that practice before it and audit reports filed with it and that the Commission has the authority to institute proceedings to amend the Board's Rules, including those that establish auditing and related professional practice standards. See Sections 2(a)(10), 3(c)(2), and 107(b)(5) of the Act.

must comply with the Board's Standards. While this requirement is implicit in the Act, the Board has codified the obligation of registered firms to comply with the Board's Standards in Rule 3100. Any registered public accounting firm or person associated with such a firm that fails to adhere to applicable Board Standards may be the subject of a Board disciplinary proceeding in accordance with Section 105 of the Act.^{2/} In general, the Board's Standards will apply to registered public accounting firms and their associated persons in connection with their audits of (and related attestations concerning) the financial statements of issuers, as defined in Section 2(a)(7) of the Act, and those firms' auditing and related attestation practices.

(ii) Rule 3700

While the Board will, by rule, establish Standards, it recognizes that the development of such Standards should be an open, public process in which investors, the accounting profession, the preparers of financial statements, and others will have the opportunity to participate. To this end, as discussed in PCAOB Release No. 2003-005 (April 18, 2003), the Board intends to provide for a public comment process on proposed standards.^{3/} The Board's staff will, of

^{2/} In addition, the Act provides that any violation of the Board's Rules is to be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq., or the rules and regulations issued thereunder, and any person violating the Board's Rules "shall be subject to the same penalties, and to the same extent, as for a violation of [the Exchange] Act or such rules or regulations." Section 3(b)(1) of the Act.

^{3/} In response to PCAOB Release No. 2003-005, the Board received several comments relating to the process by which the Board will establish standards. While this release is intended to address only the adoption of Rules

course, be actively involved in the standards-setting process, but the Board also encourages proposals and recommendations on its standards-setting agenda and standards development projects from the public. Moreover, in order to obtain the advice of a broad range of experts, the Board has determined to form an advisory group, the SAG, which may be divided into sub-groups by the Board if the need for specialized advice arises. Finally, the Board may also establish one or more ad hoc task forces to assist the staff with the drafting of technical language, among other things.

Section 103(a)(4) of the Act provides that the Board shall "convene, or authorize its staff to convene, such expert advisory groups as may be appropriate... to make recommendations concerning the content (including proposed drafts) of auditing, quality control, ethics, independence, or other standards required to be established under this section." The Board has decided initially that it is likely to exercise this authority by convening the SAG to participate in the standards-setting process. Rule 3700 addresses the formation, composition, and other basic matters concerning advisory groups, including the SAG.

(1) Role, Size and Composition

The role of the SAG will be to assist the Board in *reviewing* existing Standards, in *evaluating* proposed Standards recommended by Board staff, Board-formed technical task forces or others and *recommending* to the Board new or amended Standards. The role of the SAG will not ordinarily include

3100 and 3700, the Board will nevertheless take these comments into consideration in its standards-setting work.

technical drafting (which will be performed by the Board's staff, with the assistance of ad hoc task forces, when necessary). Instead, the Board will look to the SAG to provide advice and insight as to the need to formulate new Standards or change existing Standards and opinions on the impact of proposed new or changed Standards.

The Board contemplates that the SAG initially will have approximately 25 members. As noted above, the Board may, based on the circumstances of particular projects, prior to or after the formation of the SAG, form ad hoc task forces of specially qualified persons selected by the Board to assist it with specific projects. Members of any appointed ad hoc task force may or may not be members of the SAG.

The SAG will be composed of individuals with a variety of backgrounds, including practicing auditors, preparers of financial statements, investors (both individual and institutional), and others.^{4/} In order to achieve this diversity, the Board expects that no one field of expertise will predominate among the SAG membership. Although SAG members may be employed or otherwise affiliated with particular organizations, the Board expects SAG members to serve in their individual capacities and not to serve as representatives of particular interests, groups or employers.

(2) Nominations of SAG Members

In determining appointments to the SAG, the Board intends to solicit nominations, including self-nominations. Interested parties will have 45 days

^{4/} The Board also anticipates appointing individuals from academia and state accounting regulators, among others, to the SAG.

from the date of the Board's Notice ("Notice") to the public to submit nominations on a form which will be provided in the Notice. Interested parties who have submitted nominations prior to the publication of the Notice, will be sent nomination forms for completion at the time of publication of the Notice.

(3) Qualifications

In evaluating nominations for the SAG, the Board will seek individuals with an interest in the quality of the audits of public companies. The Board may also consider certain factors in determining SAG appointments including but not limited to the following –

- (a) SAG members will be individuals of integrity, with an understanding of the responsibilities for and the nature of financial disclosure required under the securities laws and the obligations of accountants with respect to the preparation of and issuance of audit reports with respect to such disclosures; and
- (b) SAG members will have a working knowledge of one or more of the following subjects and a general understanding of the remaining subjects –
 - generally accepted auditing standards (as developed by previous auditing standards setting bodies and adopted by the Board as Standards and, in the future, as set from time to time by the Board);
 - generally accepted accounting principles;
 - the creation, audit or analysis of public financial statements;

- public company corporate governance; and
- other fields that the Board deems to be relevant.

(4) Term

Unless the appointment is revoked for cause, as determined by the Board, or unless the SAG member voluntarily resigns from the SAG, membership on the SAG will be for a term of two years; provided, however, that approximately 50 percent of the initial members will be appointed for a three-year term to assure continuity. Members will not be limited in the number of terms that they may serve.

(5) Conditions of Membership

Rule 3700(d) specifically states that members of the SAG will serve in their individual capacities and therefore may not delegate their duties, including attendance at meetings, as SAG members. In addition, each appointee to the SAG shall agree in writing to the following "conditions of membership" in order to avoid potential conflicts of interest and to assure that the Board's standards-setting agenda is met –

- (a) to serve on a voluntary basis without compensation from the Board;^{5/}
- (b) to seek constructive resolutions to issues raised by the Board for the SAG;

^{5/} SAG members shall be entitled to reimbursement for documented reasonable travel expenses relating to participation in official SAG meetings or other SAG activities.

- (c) to act in the public interest in his or her individual capacity and not as a representative of any constituency;
- (d) to attend at least 75 percent of all SAG meetings;^{6/}
- (e) to agree to spend, at an expected minimum, between 50 and 100 hours per year on SAG matters or such reasonably greater amount of time as may be necessary to achieve the goals of the SAG and the Board;^{7/}
- (f) to refrain from using his or her position on the SAG to influence Board members or Board staff on matters directly affecting that SAG member or his or her employer, business partners or clients;^{8/}
- (g) to recuse himself or herself, or otherwise withdraw from, consideration of any matter before the SAG or the Board directly affecting such SAG member, his or her employer, business partners or clients. If recusal or withdrawal is not practical in either

^{6/} Attendance may be in person or by telephone or teleconference. SAG members who fail to participate in the minimum number of meetings shall be subject to removal by the Board unless excused from attendance by the Chair of the SAG for good reason.

^{7/} During the first year of the SAG, members may expect to spend more than the minimum number of hours on SAG matters.

^{8/} SAG members are not precluded from appearing or practicing before the Board regarding matters generally affecting all issuers or registered public accounting firms, including, indirectly, the member, his or her employer, business partners or clients. Accordingly, a SAG member who is employed by a registered public accounting firm would be permitted to be involved in preparing a comment on a Board rule proposal that generally affects all issuers or registered public accounting firms.

such member's or the Board's opinion, such SAG member shall resign from the SAG;^{9/}

- (h) to be bound by EC3, EC8(a), EC9, and, with respect to any private publication or public statement regarding the Board or the SAG or any of the activities of the Board or the SAG, EC10 of the Board's Ethics code;^{10/}
- (i) to annually certify his or her continuing compliance with "the conditions of membership;" and
- (j) to agree to any such other provisions that the Board may deem necessary to avoid even the appearance of a conflict of interest.

(6) Meetings and Board Relations

The Board has determined that the first Chair of the SAG will be the Board's Chief Auditor and Director of Professional Standards who will be a non-voting member of the SAG. The Board will approve the agenda for all annual, semi-annual or quarterly SAG meetings as set forth below. Agenda items may

^{9/} Matters generally affecting issuers or registered public accounting firms, even though affecting the SAG member, his or her employer, business partners or clients, shall not require the member to recuse or withdraw him or herself from consideration of the matter or to resign from SAG. The Board expects that most standards-setting projects will affect issuers (or categories of issuers) and registered public accounting firms and their associated persons in a generally similar manner; however, if a standard would have a unique or disproportionate effect on a particular issuer or firm, a SAG member employed by that issuer or firm would be required under Rule 3700 to recuse himself or herself.

^{10/} In PCAOB Release No. 2003-008 (June 30, 2003), the Board clarified that for purposes of applying EC8(a) to SAG members, the SAG members shall not be considered to lack independence or objectivity with regard to SAG matters merely because they (or their employer, business partners or clients) are subject to the direct or indirect oversight of the Board.

also be added where the Board determines that the assistance of the SAG is required in response to emerging issues or problems. The Chair will be responsible for preparing the meeting agenda, organizing and overseeing meetings, conference calls and related activities, acting as the general liaison to the Board and finalizing all submissions to the Board based on the SAG recommendations.

The SAG will hold an annual meeting to discuss the agenda presented to the SAG on the annual standards-setting process and related matters. The SAG will also hold a semi-annual meeting. Both the annual and the semi-annual meetings will be open to the public. Meetings of the SAG may also be held, at the direction of the Board or the Chair, during the intervening quarters. In addition, at the direction of the Chair, monthly meetings of the SAG may be held, by video or teleconference, for the Board's staff to report on new issues raised by the Board for the SAG's consideration and to discuss the status of pending issues. Final decisions on recommendations to the Board and related activities will be conducted at the annual, semi-annual, or other open meeting of the SAG.^{11/} The meetings held in the quarters between the annual and semi-annual meeting, if any, and the monthly meetings will not generally be open to the public.

^{11/} The Board expects the SAG to make decisions in an efficient and speedy manner. To this end, the SAG need not defer decisions on recommendations for the annual or semi-annual open meetings. Rather, at the direction of the Chair, the SAG may make decisions on recommendations at any meeting, so long as it is open to the public in some manner, including, at the direction of the Chair, telephonically.

If so directed by the Chair of the SAG, the SAG may convene hearings, roundtable discussions or other fact-finding activities designed to assist the SAG in the development of recommendations on new or amended Standards or other recommendations to the Board.

Decisions on whether a recommendation should be made to the Board will be by a majority of the SAG members present in person or by video or teleconference. Recommendations from the SAG will be presented to the Board at an open meeting of the Board. Such recommendations will be provided in writing, including dissenting opinions, if any, by SAG members. The Board retains the exclusive authority to adopt, modify, or reject any SAG recommendation, in its sole discretion, in order to protect investors by improving the fairness and reliability of corporate disclosures as set forth in the Act.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rules will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. Under the proposed rule concerning compliance with standards, all registered public accounting firms and their associated persons must comply with all applicable auditing and related professional practice standards. The functional equivalent of this requirement is found in the Act, which provides for the Board to impose sanctions on registered firms or associated persons who violate such standards, and the codification of that

requirement in the Board's rules does not add to the burden already imposed by the Act. The rules relating to advisory groups do not impose any burden on competition but, rather, provide for public participation, on a voluntary basis, in the process of advising the Board on the establishment of standards.

C. Board's Statement on Comments on the Proposed Rules Received from Members, Participants or Others

The Board released the proposed rules for public comment in PCAOB Release No. 2003-005 (April 18, 2003). A copy of PCAOB Release No. 2003-005 and the comment letters received in response to the PCAOB's request for comment are available on the PCAOB's web site at pcaobus.org. The Board received 22 written comments. The Board has clarified and modified certain aspects of the proposed rules in response to comments it received, as discussed below.

The Board had proposed to use "professional auditing standards" as the term defined in Rule 1001(a)(viii). Several commenters expressed concern that characterizing attestation, quality control, ethical, and independence standards as "professional auditing standards" would confuse people as to the defined term's meaning. To address these concerns, the Board has chosen to use the term "auditing and related professional practice standards" as the defined term for the standards established or adopted by the Board under Section 103 of the Act. The Board has used the longer term "auditing and related professional practice standards," rather than the shorter "professional standards," because the term "professional standards" is defined otherwise in Section 2(a)(10) of the Act. The term "auditing and related professional practice standards" is similar to that portion of the definition of the term "professional standards" that appears in

Section 2(a)(10)(B) of the Act. (Hereafter in this section C., the term "Standards" shall be used to refer to the standards encompassed by the defined term "auditing and related professional practice standards.")

In addition, the Board's proposed definition was based on a portion of the definition of "professional standards" in Section 2(a)(10)(B) of the Act. For purposes of clarity, the Board has modified this definition slightly to track more closely the description of the standards the Board will set in Section 103(a)(1) of the Act. The definition still includes any other type of standard provided for in the definition of "professional standards" in Section 2(a)(10)(B) of the Act that the Board establishes or adopts under Section 103 of the Act. Accordingly, the definition, as revised, covers the same scope of standards as the Board's proposed rule.

A number of commenters suggested that proposed Rule 3100 was either beyond the Board's authority or would create the impression that the Rule applied to areas outside the Board's authority. To address these concerns, commenters suggested adding language about the scope of the Board's authority to Rule 3100. After considering these comments, the Board decided to adopt the Rule as proposed.

The Board recognizes its responsibility to oversee the audits of issuers, as that term is defined in the Act, and does not intend to suggest that registered public accounting firms and their associated persons must comply with the Board's Standards in auditing non-issuers. Rule 3100, however, requires registered public accounting firms and their associated persons to comply with all

applicable Standards. Accordingly, if the Board's Standards do not apply to an engagement or other activity of the firm, Rule 3100, by its own terms, does not apply to that engagement or activity.^{12/}

Finally, one commenter suggested that Rule 3100 also require registered public accounting firms and their associated person to be duly licensed, registered or permitted or otherwise to hold valid practice privileges and be in good standing under the laws of each applicable state. Registration with the Board does not supersede state registration or licensing requirements and the Board expects registered public accounting firms and their associated persons to comply with state and other applicable legal requirements. Rule 3100, however, is merely intended to codify the obligation of registered public accounting firms and their associated persons to comply with Board Standards and to ensure that the Board's Standards are enforceable. Accordingly, the Board decided not to

^{12/} For example, the Board's Interim Auditing Standards provide that, "[i]n connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003 (Codification of Statements on Auditing Standards, AU § 150 (AICPA 2002))." See Rule 3200T. The term "audit report" is defined in the Act and the Board's Rules to mean the audit of an issuer. See Rule 1001(a)(vi), adopted by the Board in PCAOB Release. No. 2003-007. Moreover, the Board notes that it would not be a correct description of its authority to say, as one commenter suggested Rule 3100 provide, that "A registered public accounting firm and its associated persons shall comply with all applicable professional auditing standards *in performing an audit of an issuer.*" Particularly with respect to the quality control standards the Board is authorized to establish, the Board may adopt standards that, while related to registered public accounting firms' audit practices, must be complied with other than in the course of performing an audit. Cf. Section 103(a)(2)(B) of the Act (requiring the Board to include, among the "quality control standards that it adopts with respect to the issuance of audit reports, requirements... relating to... hiring, professional development, and advancement of personnel").

amend the Rule as proposed to reflect this suggestion. Authorities other than the Board may nevertheless require that accounting firms or individual auditors comply with the Board's Standards in the conduct of audits of (or attestations concerning) the financial statements of non-issuers.^{13/} In that event, those authorities may enforce the Board's Standards pursuant to their own processes.

In addressing proposed Rule 3700, commenters suggested that it might be appropriate to establish more than one advisory group since expertise is likely to be required in more than one specialized area. The Board is aware that it may need advice in one or more specialized areas. However, the Board has determined to form only one standing advisory group (the "SAG"). This group, however, may, at the Board's direction, form specialized sub-groups as needed. In addition, the Board may form ad hoc task forces to work with Board staff in formulating Standards in specialized areas which may then, in the Board's discretion, be added to the SAG's agenda for discussion at SAG meetings.

In addition, Commenters recommended adding other specific groups from which nominations could be received to the groups identified in Rule 3700(c) as proposed. After careful consideration of these comments, the Board determined that Rule 3700(c) should reflect the Board's intention to accept nominations from all sources. Accordingly, Rule 3700(c) was revised to state that the Board will accept nominations from any person or organization, including self-nominations.

^{13/} Cf. Section 209 of the Act (stating that "[i]n supervising nonregistered public accounting firms and their associated persons, appropriate State regulatory authorities should make an independent determination of the proper standards applicable...").

A note to this part of Rule 3700 provides that the Board will announce, from time to time, periods during which it will receive nominations for an advisory group.

With respect to qualifications of the advisory group members, one commenter suggested that all members have qualifications similar to those "requirements set forth for audit committee members in recently issued stock exchange and SEC" rules or proposed rules. The New York Stock Exchange ("NYSE") proposed listing requirements require that all members of audit committees of listed companies be financially literate. In addition, at least one member of the audit committee must meet the definition of an "audit committee financial expert."^{14/} The NASDAQ Stock Market ("NASDAQ") proposed rules regarding qualifications for service on audit committees require that all audit committee members must be able to read and understand financial statements including a company's balance sheet, income statement, and cash flow statement and that the audit committee have at least one member who meets the definition of an "audit committee financial expert."^{15/} After considering this comment, the Board decided to adopt the Rule as proposed by the Board. While Rule 3700 does not specifically state the qualifications each member must have, the Rule does set forth the types of expertise that the Board will look for in advisory group members. In addition, as noted in Section C.4. of this Release, the Board may also consider certain specific qualifications in selecting nominees

^{14/} See SEC Release No. 34-47672; File No. SR-NYSE-2002-33 (April 11, 2003).

^{15/} See SEC Release No. 34-47516; File No. SR-NASD-2002-141 (March 17, 2003).

to the SAG. The Board believes that it will likely select members who, at a minimum, would meet the general qualifications set forth for "all" audit committee members in the proposed Rules of the NYSE and NASDAQ while providing the Board with the flexibility to select members from a broad spectrum of backgrounds to assist it in meeting the requirements of the Act. SAG members will be selected based upon qualifications which will be elicited from them on a nomination form and through the evaluative process.

Furthermore, commenters suggested that the composition of the SAG be flexible because the Board may find that it is unable to attract a sufficient number of qualified members from fields such as finance and investment. In response to this concern, it should be noted that, the Board expects that the SAG will be broadly representative and that no one field of expertise will predominate among the SAG membership. Other concerns regarding composition related to assuring that the SAG have a sufficient number of members with technical expertise including requiring a majority of members to be practicing auditors. Although the Board certainly intends that the SAG have practicing auditors among its members, the Board believes that it is important that the SAG be able to provide advice in a broad range of areas, including technical auditing expertise, and that technical expertise in particular areas may be obtained by forming ad hoc task forces, as needed and as appropriate for particular standards-setting projects. Other commenters recommended that –

- (a) the four largest auditing firms be represented on the SAG;
- (b) non-U.S. auditors be represented;

- (c) the number of members associated with a single firm, company or association be limited;
- (d) membership be dispersed among those affiliated with firms, companies and associations of various sizes; and
- (e) there be a balance between financial information suppliers (representatives of public companies and auditors) and financial information users (equity and debt investors).

As noted above, the Board recognizes the need to have diversity on the SAG and in selecting members will keep diversity in mind while assuring that no one expertise will predominate among the SAG membership.

With respect to the actual functions of the SAG, one commenter, suggested that the SAG be involved in all standards-setting proposals while another commenter recommended that the actual drafting of the Standards fall within the SAG's authority. In order to maintain flexibility in the rulemaking process, the Board determined not to revise the proposed Rule to reflect these comments. Although the SAG is likely to be involved in the Board's standards-setting process as discussed in the Release, the Board does not intend to make SAG involvement mandatory to every standards-setting project. In addition, the actual drafting of the Standards is likely to be done by the Board's staff assisted by ad hoc task forces where necessary.

Another comment related to recommending that the SAG work toward "harmonizing" international standards. Neither Rule 3100 nor 3700 is intended to address substantive standards-setting issues. Rather the Board intends to

address such issues, including cooperation with standards-setters in other jurisdictions, in the future.

Commenters also made recommendations regarding SAG procedural matters. These commenters suggested that the Board address –

- (a) the process for making recommendations on Standards for consideration by the Board;
- (b) whether or not SAG meetings would be open to the public;
- (c) the format and the frequency of the meetings;
- (d) the process by which the Board will set the SAG's agenda;
- (e) the appointment of a Chair for the SAG;
- (f) whether the Board will provide all resources for drafting, editing, monitoring comments and publishing new and amended Standards;
- (g) the term of appointment to the SAG; and
- (h) an avenue for minority viewpoints to be expressed in any report or recommendation to the Board.

With the exception of the comment on resources for drafting and publishing new Standards, the Board has addressed all of these comments in Section B.7. of the Release. In summary, the SAG will hold an annual meeting and a semi-annual meeting. Additional meetings may be held in the intervening quarters. Monthly telephonic meetings are also expected to be held at the discretion of the Chair. The annual and semi-annual meetings, and any meeting at which the SAG makes a final decision on a recommendation to the Board, will be open to the public. Agenda items for the SAG will be driven in part by the

schedule to be set by the Board for the review of the Interim Auditing Standards. Other agenda items will be added by the Board where the Board determines that a response to emerging issues or problems connected with audits needs to be addressed. The Board determined that the first Chair of the SAG will be the Board's Chief Auditor and Director of Professional Standards. All SAG members will be appointed for two-year terms except that approximately one-half of the appointees initially appointed to the SAG will be appointed for a three-year term to assure continuity. There will be no limits on the terms that a member of the SAG may serve. The Board anticipates that drafting, editing, monitoring comments and publishing, will be conducted by the Board and its staff. To the extent that the SAG is specifically authorized by the Board to undertake any of these functions and the expenses have been preapproved by the Board or a staff member delegated by the Board, the Board will cover the SAG's costs.

In response to the issue of whether the SAG's meetings will be open to the public and in order to assure that the public is informed of the SAG's operations, the Board determined that the annual and semi-annual meetings of the SAG will be open. In addition, decisions on making recommendations to the Board will only be made at an open meeting of the SAG. All recommendations to the Board by the SAG will be presented to the Board in open public meetings of the Board and such presentations will include the presentation of minority views of the SAG members. Finally, it should be noted that Board standards-setting proposals will be subject to the public comment process before being adopted by the Board.

With respect to Rule 3700(e) relating to the ethical duties of the SAG members, one commenter recommended that the SAG members be subject to Section EC14, the certification requirements, of the Ethics Code. In response to this comment, the Board added to its "conditions of membership" described in Section C of the Release, a requirement that members of the SAG shall annually certify their continuing compliance with the "conditions of membership." A second commenter recommended that both Rule 3700(e) and EC8(a) of the Ethics Code be clarified to confirm that being a practicing auditor does not, in and of itself, constitute a financial interest requiring recusal. Section EC8(a) of the Ethics Code was revised to add an explanatory note that clarifies this issue.^{16/} A third commenter recommended that members of the SAG be prohibited from "unauthorized" speaking for the Board. In response to this comment, the Board revised Rule 3700(e) to make EC10 of the Board's Ethics Code applicable to any private publication or public statement by an advisory group member with regard to the Board or the advisory group or any of the activities of the Board or the advisory group. Finally, a fourth commenter recommended that a member of the SAG be permitted to share SAG material with support personnel within the member's home organization who are assigned to assist the member in his or her duties. The Board did not add a provision to address this concern. The Board believes that SAG members will normally be able to perform their responsibilities without needing access to non-public Board information. To the extent that it may be appropriate, from time to time, to permit non-public

^{16/} See PCAOB Release No. 2003-008 (June 30, 2003).

standards-setting information to be shared with individuals outside the SAG, including to permit SAG members to consult technical experts who are not employees or staff of the Board, the Board may require that such individuals agree to the confidentiality provisions under Section EC9 of the Ethics Code.

III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents the Commission will:

(a) by order approve such proposed rules; or

(b) institute proceedings to determine whether the proposed rules should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rules are consistent with the requirements of Title I of the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rules that are filed with the Commission, and all written communications relating to the proposed rules between the Commission and any person, other than those that may be withheld from the public in accordance with

the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All submissions should refer to File No. PCAOB-2003-05 and should be submitted within [] days.

By the Commission.

Secretary



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The Board has also proposed PCAOB Rule 3100 and a related definition that would appear in Rule 1001. Rule 3100 would require all registered public accounting firms to adhere to the Board's auditing (and related attestation), quality control, and ethics standards, and its independence rules, in connection with the preparation or issuance of any audit report for an issuer (as defined in the Act). Neither Rule 3100, Rule 3700, nor any professional standard or rule adopted by the Board will take effect until approved by the Securities and Exchange Commission ("Commission") pursuant to Section 107 of the Act.

Public

Comment: This release invites comment on the proposed rules herein. Interested persons may submit written comments to the Board. Such comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments may also be submitted by e-mail to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 004 and should be received by the Board no later than 5:00 PM (EST) on May 12, 2003.

Board

Contact: Gordon Seymour, Acting General Counsel (202/207-9034; seymourg@pcaobus.org).

Section 103(a)(1) of the Act directs the Board to establish auditing and related attestation standards, quality control standards, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by the Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors. Similarly, Section 103(b) authorizes the Board to establish such rules as may be necessary or appropriate to implement the auditor independence requirements in, or as authorized under, Title II of the Act. While Section 103(a)(4) directs the Board to convene such expert advisory groups as may be appropriate to aid in standards-setting, it nevertheless affords the



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Board considerable discretion in determining the procedures by which it will develop and adopt Professional Auditing Standards.^{1/} Among other things, for example, it authorizes, but does not require, the Board to designate or recognize Board advisory groups or professional groups of accountants to propose standards to the Board.

This release describes the general process the Board intends to follow in establishing Professional Auditing Standards. As set forth in more detail below, the Board will convene an advisory group to assist it in performing its standards-setting responsibilities. The Board also intends to solicit public comment, and, where appropriate, to convene hearings or roundtable meetings, in order to obtain the views of issuers, accountants, investors, and other interested persons with respect to proposed Professional Auditing Standards. In this regard, the Board welcomes input and advice from established professional bodies and intends to include practicing accountants among the members of its advisory groups. The Board has, however, determined not to exercise its authority to designate any professional group of accountants as a formal participant in the Board's standards-setting process at this time.

This release also announces the proposed adoption of PCAOB Rule 3100 (and a related definition) and Rule 3700 and invites public comment thereon. If adopted, Rule 3100 would require all registered public accounting firms to adhere to the Board's auditing (and related attestation), quality control, and ethics standards, and its independence rules.^{2/} Rule 3700 would address the formation, composition, and other

^{1/} The auditing and related attestation standards, quality control standards, and ethics standards over which the Board has authority under Section 103(a) of the Act, and the independence rules the Board is authorized to adopt under Section 103(b), are collectively referred to in this release as "Professional Auditing Standards." This term is defined in proposed Rule 1001(p)(iv). The proposed definition is similar to that portion of the definition of the term "professional standards" that appears in Section 2(a)(10)(B) of the Act.

^{2/} As discussed below, in accordance with Section 103(a)(3)(B) of the Act, the Board is issuing a separate release concerning the initial, transitional adoption of certain existing auditing, quality control, and other standards, pending Board review of



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basic matters concerning the advisory group convened to aid in the Board's standards-setting process.

A. Adoption of New or Amended Professional Auditing Standards

Consistent with Section 103(a) of the Act, new Professional Auditing Standards will be established – and existing standards will be changed – only by Board rulemaking.^{3/} While, as discussed below, the Board will consider proposed new or amended Professional Auditing Standards recommended to it by other persons, no such proposed rule will become a standard of the Board unless adopted by the Board through rulemaking. The Board's authority with respect to Professional Auditing Standards will take effect as of the date on which the Commission determines, pursuant

those standards. These transitional standards are collectively referred to in this release as "Interim Professional Auditing Standards." Unless modified by the Board, any standard adopted as an Interim Professional Standard has the same effect as any other Professional Auditing Standard, and registered public accounting firms will be subject to the same obligation to comply with the interim standards while they are in effect as with the permanent standards.

^{3/} See also Report of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, on S. 2673, S. Rep. No. 107-205 (July 26, 2002) ("The Committee has concluded that the Board's plenary authority in this area is essential for the Board's effective operation, a position taken during the hearings by a number of witnesses. . . ."). Board rules adopting or modifying Professional Auditing Standards, like all Board rules, become effective only upon approval by the Commission. In addition, the Board recognizes that the Commission may also establish professional standards applicable to accountants that practice before it and audit reports filed with it and that the Commission has the authority to institute proceedings to amend the Board's rules, including those that establish Professional Auditing Standards. See Sections 2(a)(10), 3(c)(2), and 107(b)(5) of the Act.



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to Section 101(d) of the Act, that the Board is so organized as, and has the capacity, to carry out the requirements of Title I of the Act and to enforce compliance therewith.

As a corollary to the Board's exclusive, statutory authority to establish and amend Professional Auditing Standards, all public accounting firms that are registered with the Board must comply with the Board's standards. While this requirement is implicit in the Act, the Board proposes to codify the obligation of registered firms to comply with the Board's standards in proposed Rule 3100. Any registrant that fails to adhere to the Board's Professional Auditing Standards will be subject to Board disciplinary proceedings in accordance with Section 105 of the Act.^{4/}

The Board invites comment on proposed Rule 3100 and the related definition. In particular, the Board seeks views on whether there are other standards, in addition to the Board's Professional Auditing Standards, with which the Board should require registered firms to comply.

B. Procedure for the Adoption of New or Amended Professional Auditing Standards

While the Board will, by rule, establish Professional Auditing Standards, it recognizes that the development of such standards should be an open process in which the accounting profession, the preparers of financial statements, the investor community, and others have the opportunity to participate. The Board encourages proposals and recommendations concerning Professional Auditing Standards. As discussed below, in order to facilitate the input and advice of a broad range of experts, the Board intends to form one or more advisory groups to assist it in standards-setting. In addition, the Board's staff will, of course, be actively involved in this process.

^{4/} In addition, the Act provides that any violation of the Board's rules is to be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq., or the rules and regulations issued thereunder and any person violating the Board's rules "shall be subject to the same penalties, and to the same extent, as for a violation of [the Exchange] Act or such rules or regulations." Section 3(b)(1) of the Act.



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The Board envisions that proposed new Professional Auditing Standards, and changes to such standards, may arise from three sources:

- The Board, with the advice of its staff, may propose a new standard or a change to an existing standard.
- The Board advisory group (or recognized sub-group thereof), or a Board-appointed task force, may recommend to the Board that it propose a new standard or a change to an existing standard.
- Any other person or group may petition the Board and request that it propose a new standard or a change to an existing standard.

In the case of recommendations concerning Professional Auditing Standards that emanate from persons and groups other than the Board and its staff, the Board will consider the recommendation and, consistent with Section 103(c)(2) of the Act, decide, in a timely manner, whether or not to propose the standard in question either as recommended or with modifications.^{5/} In considering such a recommendation, the Board may decide to convene a standards development project by submitting the recommended standard or change to an existing standard to its development process. First, the Board may choose to direct its staff, an ad hoc task force, or both to analyze and evaluate the recommended standard. Next, with Board approval, the analysis and evaluation by the Board's staff (or task force) may be submitted to the advisory group

^{5/} The Board will encourage recommendations from outside persons to contain: (1) a clear description of the perceived problem or issue that the recommended new standard, or recommended change to an existing standard, seeks to address; (2) a clear explanation of how the recommended new standard, or recommended change to an existing standard, directly relates to the perceived problem or issue; and (3) the identity, area(s) of expertise, and appropriate contact information for the person submitting the recommendation. If the Board determines not to act on a recommendation, it may or may not notify the recommender or make a public announcement, depending on the circumstances.



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(or, if established, a recognized sub-group of an advisory group) for consideration. Recommendations or comments from an advisory group (or, if established, a recognized sub-group of an advisory group) would then be submitted to the Board, or staff of the Board designated by the Board to receive such recommendations.

If the Board determines to propose a new or amended Professional Auditing Standard, it will do so in accordance with an exposure process. Normally, the Board will publish the proposal and afford interested persons an opportunity to comment, for a period of no less than 21 calendar days.^{6/} Depending on the nature of the proposal, the Board may, in addition to accepting written comment, hold a public hearing, convene a roundtable meeting, commission research, or take other steps to obtain input and data concerning the proposed standard. The Board may also ask the advisory group or a task force to advise it concerning the proposal, and the advisory group or task forces may, in some cases, hold hearings, convene roundtables, or commission research. After considering the public comment (and any other relevant input received), the Board will vote on whether or not to adopt the proposed standard. Approval will require the affirmative vote of a majority of the Board. Any standard adopted by the Board will not take effect unless approved by the Commission in accordance with the Act.^{7/}

^{6/} There may be occasional exceptions to the public comment process, such as in emergencies or other unusual circumstances where further public comment does not appear necessary. The Board will only have a comment period of less than 21 days if it determines that a shorter period is necessary or appropriate under the circumstances. In any such cases, Board rules would still be submitted to the Commission for approval under Section 107 of the Act, which would normally entail a further public comment period.

^{7/} Section 107(a)(4) of the Act generally requires the Commission to publish any proposed rule of the Board for public comment before determining whether to approve the rule or to institute disapproval proceedings.



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C. Advisory Groups and Task Forces

Section 103(a)(4) of the Act provides that the Board shall “convene, or authorize its staff to convene, such expert advisory groups as may be appropriate . . . to make recommendations concerning the content (including proposed drafts) of auditing, quality control, ethics, independence, or other standards required to be established under this section.” The Board has decided to exercise this authority to convene a standing advisory group to participate in the standards-setting process. The role of the advisory group will be to assist the Board in reviewing existing auditing standards, in formulating new or amended standards, and in evaluating proposed standards suggested by other persons. The Board contemplates that the advisory group will have somewhere between 15 and 30 members. The Board may, based on the circumstances of particular projects, form ad hoc task forces comprised of smaller groups of members of the advisory group, of the Board’s staff, and possibly other persons.

The advisory group will be comprised of individuals with a variety of perspectives, including practicing auditors, preparers of financial statements, the investor community, and others.^{8/} The Board expects that the advisory group will have fairly equal representation among these broad groups and that no one group will dominate the advisory group.^{9/} The members will be selected by the Board, although the Board will consider nominations for advisory group members from a broad range of persons with an interest in the quality of the audits of public companies. Each member of the advisory group will have expertise in at least one of the following areas:

- Public company accounting;

^{8/} The Board anticipates that academia, state accounting regulators, and similar interest-groups will be represented on the advisory group.

^{9/} For example, given the broad range of constituencies the Board intends to invite, the Board expects that each of the accounting/auditing, finance, and investment fields will generally be limited to no more than one-third of the total group



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- Public company auditing;
- Public company finance;
- Public company governance;
- Investing in public companies; and
- Other disciplines that the Board deems to be relevant.

Members on an advisory group will serve in their individual capacities and therefore may not delegate their duties as advisory group members, including attendance at meetings. Advisory group members will also be subject to certain provisions of the Board's Ethics Code, including provisions designed to protect non-public information and avoid conflicts of interest.^{10/}

D. Board Professional Auditing Standards Agenda

The Board will be vigilant for the need to adopt new Professional Auditing Standards, especially in response to emerging issues and problems that arise in connection with audits of issuers. In addition, there are three standards-setting projects that the Board intends to commence as rapidly as possible following the Commission's determination pursuant to Section 101(d), that the Board is capable of carrying out its responsibilities under the Act. These three projects are described briefly below.

1. Review of Interim Professional Auditing Standards

In Release No. 2003-006, the Board announced that, pursuant to Section 103(a)(3)(B) of the Act, it has adopted certain standards as Interim Professional

^{10/} In a separate release issued today, the Board has invited comment on its proposed Ethics Code. See Proposal of Ethics Code for Board Members, Staff and Designated Contractors and Consultants, PCAOB Rel. No. 2003-004 (April 16, 2003).



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Auditing Standards. These standards were promulgated by various other bodies and pre-date the Commission's determination, under Section 101(d), that the Board is capable of carrying out its responsibilities under the Act. Rules 3200T, 3300T, 3400T, 3500T, and 3600T (which are discussed in Release No. 2003-006) incorporate these Interim Professional Auditing Standards into the Board's rules.

Despite the need to adopt these existing standards on an initial, transitional basis in order to assure continuity and certainty in the standards that govern audits of public companies, the Board has not determined whether it would be appropriate to include any of the Interim Professional Auditing Standards as permanent Board standards.^{11/} In order to make that determination, the Board will establish a schedule for the review of all Interim Professional Auditing Standards. The Board intends to commence this review as soon as possible. The objective of the review will be to determine, on a standard-by-standard basis, whether the Interim Professional Auditing Standards should become permanent standards of the Board, be repealed, or be modified. As the review of each interim standard is completed, the Board will adopt that standard as a permanent Professional Auditing Standard, with or without modifications, repeal the standard, or take any other appropriate action regarding the standard.

The schedule and procedure for the review of the interim standards will be the subject of a separate release. The Board invites public comment and suggestions concerning the appropriate priorities for the review of the Interim Professional Auditing Standards and concerning any changes to them that the Board should consider.

2. Statutory Professional Auditing Standards

A second Board standards-setting project that will commence shortly after the Commission's Section 101(d) determination is the implementation of the provisions of the Act that require the Board to adopt standards in specific areas. For example,

^{11/} The inclusion of the letter "T" after these rules signifies that the rules are only transitional standards.



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Sections 103(a)(2)(A)(i) and (ii) of the Act^{12/} require that the Board adopt auditing standards requiring that registered public accounting firms –

- prepare, and maintain for a period of not less than seven years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report; and
- provide a concurring or second partner review and approval of such audit report (and other related information), and concurring approval in its issuance, by a qualified person associated with the public accounting firm, other than the person in charge of the audit, or by an independent reviewer.

Section 103(a)(2)(B) of the Act requires that the Board adopt quality control standards for registered public accounting firms relating to –

- monitoring of professional ethics and independence from issuers on behalf of which the firm issues audit reports;
- consultation within such firm on accounting and auditing questions;
- supervision of audit work;
- hiring, professional development, and advancement of personnel;
- the acceptance and continuation of engagements; and
- internal inspection.

The Board's staff will develop proposals to implement these statutory mandates as quickly as possible. As in the case of the review of the Interim Professional Auditing

^{12/} With respect to standards required by Section 103(a)(2)(A)(iii), see section D.3 of this release, infra.



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Standards, the Board may also, where appropriate, seek the assistance of the Board advisory groups and Board task forces.

3. Review of Internal Controls and Section 404 Attestation Standard

In addition to the matters listed above, Section 103(a)(2)(A)(iii) of the Act also requires the Board to adopt auditing standards that require registered public accounting firms to –

“describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b), and present (in such report or in a separate report) –

- (I) the findings of the auditor from such testing;
- (II) an evaluation of whether such internal control structure and procedures –
 - (aa) include maintenance or records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
 - (bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
- (III) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing.”



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This requirement complements Section 404 of the Act. Section 404(a) requires issuers to file with the Commission an annual report assessing the company's internal controls. Section 404(b) provides that the issuer's auditor must "attest to, and report on, the assessment made by the management of the issuer." Section 404(b) further provides that "[a]n attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board."

The Commission has proposed rules to implement the internal control reporting provisions of Section 404.^{13/} The Board recognizes its correlative obligation to issue or adopt standards for the attestation of these reports by issuers' auditors. In this connection, the Board is aware that the Interim Professional Auditing Standards include a pre-existing standard governing engagements to issue an examination report on the effectiveness of an entity's internal control over financial reporting (or on an assertion thereon).^{14/} The Board is also aware that, on March 18, 2003, the Auditing Standards Board of the American Institute of Certified Public Accountants issued an exposure draft of an additional standard on internal control reporting.^{15/} In discharging its responsibilities under Sections 103(a)(2)(A)(iii) and 404(b), the Board will review both the existing standard and the AICPA's proposal.

The Board intends to address this issue as a matter of priority. To that end, the Board intends to convene a roundtable meeting in the near future to explore whether a new standard with respect to internal control reporting is needed in light of Section

^{13/} See SEC, Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Rel. No. 33-8138 (October 22, 2002).

^{14/} See Reporting on an Entity's Internal Control Over Financial Reporting, ASB Statement on Standards for Attestation Engagements No. 10 (Codification of Statements on Auditing Standards, AT sec. 501 (AICPA 2002)).

^{15/} See Proposed Statements on Auditing Standards, Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit, AICPA ASB (March 18, 2003).



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404(b). The details of the Roundtable meeting will be the subject of a separate release. If the Board determines that such a standard is needed, it will commence a rulemaking proceeding, in accordance with the general procedures outlined in this release, to determine the nature and content of that standard. Interested persons will also be afforded an appropriate opportunity to express their views to the Board in that proceeding.

E. Board Determination Regarding Section 103(a)(3)(A) of the Act

Section 103(a)(3)(A)(i) of the Act authorizes the Board, in discharging its responsibilities with respect to professional standards, to “adopt as its rules, subject to the terms of section 107, any portion of any statement of auditing standards or other professional auditing standards” that were proposed by a professional group of accountants designated or recognized by the Board, by rule, for that purpose, or by an advisory group convened by the Board. Even if the Board elected to designate such a group, the Board would still be required to determine that any standard proposed by the designee meets the requirements of the Act. In addition, the Board may modify, supplement, revise, or subsequently amend, modify, or repeal, in whole or in part, any portion of any such standard.

The Board has decided not to exercise its authority under Section 103(a)(3)(A) to designate a group of accountants or an advisory group as a source of auditing standards. Absent future Board action, no Board advisory group or outside group will have any special ability to submit proposed standards to the Board.^{16/} Nevertheless, as

^{16/} Under Section 103(a)(3)(A) of the Act, the effect of an advisory group or a professional group of accountants being designated, by rule, by the Board for standards-setting purposes appears to be that the Board would then engage in standards-setting by adopting (with any necessary modifications, supplements or revisions) the advisory or professional group’s standards without engaging in its own rulemaking processes. See Report of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, on S. 2673, S. Rep. No. 107-205 (July 26, 2002) (“The Board may adopt as part of its rules (and modify as appropriate for that purpose, at the time of



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discussed above, the Board will consider carefully proposed auditing standards recommended to it by any person or group, including any group of accountants. If the Board determines that it is appropriate and consistent with the Board's standards-setting priorities and statutory responsibilities, it will publish such proposals for comment or take other appropriate action.

The Board will continue to consider its authority under Section 103(a)(3)(A) and could, in the future, designate one or more advisory groups or professional groups of accountants pursuant thereto. Any such designation would, pursuant to the requirements of Section 103(a)(3)(A), be made by a rule of the Board, subject to the Board's public rulemaking procedures, including Commission approval.

F. Request For Public Comment

The Board invites the views of interested persons with respect to the issues raised for comment in this release. Written comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments may also be submitted by e-mail to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 004 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on May 12, 2003.

Following the close of the comment period, the Board will determine whether to adopt, and submit to the Commission for approval, proposed Rule 3100 (and the related definition) and Rule 3700.

adoption or thereafter), any portion of a statement of auditing, quality control, or ethics standards that meets the bill's statutory tests and that is proposed (i) by a professional group of accountants (designated by a rule of the Board for that purpose), or (ii) by one or more advisory groups of practicing accountants or other interested parties convened by the Board.").



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* * *

On the 16th day of April, in the year 2003, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ISSUED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Acting Secretary

April 16, 2003

APPENDICES:

1. Proposed Rules Relating to Professional Auditing Standards and Advisory Groups
2. Section-by-Section Analysis of Proposed Rules Relating to Professional Auditing Standards and Advisory Groups



Appendix 1 – Proposed Rules Relating to Professional Auditing Standards and Advisory Groups

RULES OF THE BOARD

SECTION 1. GENERAL PROVISIONS

1001. Definitions of Terms Employed in Rules.

When used in the Rules, unless the context otherwise requires:

(p)(iv) Professional Auditing Standard

The term “professional auditing standard” means any auditing standard, standard for attestation engagements, quality control policy or procedure, ethical or competency standard, and independence standard (including any rule implementing title II of the Act) that is established or adopted by the Board under Section 103 of the Act.

SECTION 7. PROFESSIONAL STANDARDS

Part 1 – General Requirements

3100. Professional Auditing Standards Applicable to Registered Public Accounting Firms.

A registered public accounting firm and its associated persons shall comply with all applicable professional auditing standards.

Note: Under Section 102(a) of the Act, public accounting firms are not required to register with the Board until 180 days after the date of the determination of the Commission under section 101(d) that the Board has the capacity to carry out the requirements of Title I of the Act (the “mandatory registration date”). The Board intends that, during the period preceding the mandatory registration date, this rule would apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.



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Part 7 – Establishment of Professional Standards

3700. Advisory Groups.

(a) Formation.

To assist it in carrying out its responsibility to establish professional auditing standards, the Board will convene one or more advisory groups, in accordance with Section 103(a)(4) of the Act.

(b) Composition.

Advisory groups, in combination or as sub-groups within one advisory group, will contain individuals with expertise in the following areas:

- (1) Public company accounting;
- (2) Public company auditing;
- (3) Public company finance;
- (4) Public company governance;
- (5) Investing in public companies; and
- (6) Other areas that the Board deems to be relevant to one or more standard.

(c) Selection of Members of Advisory Groups.

Members of advisory groups will be selected by the Board, in its sole discretion, based upon recommendations provided by:

- (1) Board members;
- (2) Staff of the Board;



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- (3) The Commission or its staff;
- (4) Professional groups of accountants;
- (5) Registered public accounting firms;
- (6) Investors;
- (7) Institutions of higher learning; or
- (8) Any other person or body that the Board deems to have an interest in the accuracy of public company financial statements.

(d) Personal Membership.

Membership on an advisory group will be personal to the individuals selected to serve on the advisory group. A member's functions and responsibilities, including attendance at meetings, may not be delegated to others.

(e) Ethical Duties of Advisory Group Members.

Members of an advisory group shall comply with EC 3, EC 8(a) and EC 9 of the Board's Ethics Code.

(f) Ad Hoc Task Forces.

The Board may, in its discretion, establish ad hoc task forces. The membership of such task forces may include, but is not limited to, advisory group members.



Appendix 2 – Section-by-Section Analysis of Proposed Rules Relating to Professional Auditing Standards and Advisory Groups

Rules Relating to Professional Auditing Standards

The proposed rules relating to professional auditing standards consist of PCAOB Rule 3100, plus a new definition that would appear in Rule 1001. Each of the proposed rules, and the new definition, is discussed below.

Rule 1001 – Definitions of Terms Employed in Rules

Rule 1001 contains definitions of terms used in the Board's rules.

Professional Auditing Standards

Rule 1001(p)(iv) would define “professional auditing standard” as any auditing standard, standard for attestation engagements, quality control policy or procedure, ethical or competency standard, and independence standard (including any rule implementing title II of the Act) established or adopted by the Board under Section 103 of the Act. Although the term includes standards other than auditing standards, the Board has used the term “professional auditing standards,” rather than “professional standards,” because the term “professional standards” is defined otherwise in Section 2(a)(10) of the Act. The term “professional auditing standards” is similar to that portion of the definition of the term “professional standards” that appears in Section 2(a)(10)(B) of the Act.



Appendix 2 – Section-by-Section Analysis of Proposed Rules
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Rule 3100 – Professional Auditing Standards Applicable to Registered Public Accounting Firms

Rule 3100 would provide that a registered public accounting firm and its associated persons must comply with all applicable professional auditing standards. A note to the rule clarifies that the rule is intended, before the date 180 days after the Commission's determination under Section 101(d) of the Act, to apply to those public accounting firms that will be required to register with the Board in order to continue to participate in the audits of issuers after that date. This rule is intended to codify the obligation of registered public accounting firms and their associated persons to comply with applicable professional auditing standards and to ensure that the Board's professional auditing standards are enforceable.

Rules Relating to Advisory Groups

Rule 3700 – Advisory Groups

Rule 3700 addresses certain basic matters concerning the formation and use of advisory groups in the Board's standards-setting process. The rule provides that the Board will convene one or more advisory groups, as contemplated in Section 103(a)(4) of the Act. Any advisory group will consist of individuals with expertise in certain,



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specified areas relevant to the Board's standards-setting responsibilities. Members of an advisory group will be selected by the Board. The rule would also permit certain private and governmental groups with an interest in the accuracy of public company financial statements to recommend advisory group members to the Board. The rule also would provide for the Board to establish ad hoc task forces. While such task forces may include advisory group members, a task force may also include other persons.

The rule would further provide that membership on an advisory group will be personal to the individuals selected and that the functions of an advisory group member, including attendance at meetings, may not be delegated to others. This provision is based on a comparable provision in the Financial Accounting Standards Board's rules governing the members of the Financial Accounting Standards Advisory Council (FASAC).

Finally, Rule 3700 would provide that members of a Board advisory group must comply with certain provisions in the Board's Ethics Code. Specifically, the Rule would make advisory group members subject to EC 3, EC 8(a) and EC 9 of the Board's proposed Ethics Code. These provisions of the Board's proposed Ethics Code address, respectively, general ethical principles applicable to service for the Board,



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disqualification in the case of conflicts of interest, and the non-disclosure of non-public information.



Exhibit 2(a)2

Tab Number	Comment Source
1	The American Institute of Certified Public Accountants, May 12, 2003
2	American Bar Association, May 16, 2003
3	Anonymous Submission, May 13, 2003
4	California Public Employee's Retirement System ("CalPERS"), May 15, 2003
5	Card Decisions Inc., May 12, 2003
6	Jerry Casler, May 12, 2003
7	CSU Sacramento, John Corless, May 1, 2003
8	Deloitte & Touche, May 12, 2003
9	Ernst & Young, May 12, 2003
10	Financial Executives International, The Committee on Corporate Reporting, May 8, 2003
11	Grant Thornton, May 12, 2003
12	Institut der Wirtschaftsprüfer, May 12, 2003
13	The Institute of Internal Auditors, May 12, 2003
14	International Federation of Accountants, May 12, 2003
15	KPMG International, May 9, 2003
16	Heath D. Lewis, May 11, 2003
17	Lockheed Martin Corporation, May 12, 2003
18	Marriott International, Inc., April 24, 2003
19	National Association of State Boards of Accountancy, May 8, 2003
20	Prescient, May 12, 2003
21	PricewaterhouseCoopers LLP, May 12, 2003
22	Shillam Consulting Group, Inc., May 9, 2003



May 12, 2003

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. 004
Statement Regarding the Establishment of Auditing and Other Professional Standards**

The American Institute of Certified Public Accountants (“AICPA”) respectfully submits the following written comments on the Public Company Accounting Oversight Board’s (“PCAOB” or the “Board”) proposed rules regarding the establishment of auditing and other professional standards for registered public accounting firms. The AICPA is the largest professional association of Certified Public Accountants in the United States, with more than 350,000 members in public practice, business, industry, government and education.

The AICPA recognizes the enormous effort put forth by the PCAOB members and staff to implement the provisions of the Sarbanes Oxley Act (“the Act”). Initially, a significant responsibility of PCAOB will be to help restore public confidence in audited financial statements of public companies (“issuers”), of which the establishment and maintenance of high quality auditing and other professional standards is critical to that goal. The AICPA is committed to working with the PCAOB to continue developing high quality standards for audits of issuers.

Based on our many years of experience in setting high quality auditing and other professional standards, we offer the following comments, which we believe will provide greater transparency to the PCOAB’s process for setting standards, and provide clarity and other improvements.

In general, the final PCAOB statement should:

- Provide significant transparency and public participation in the PCAOB’s standards-setting process, including a process that would:
 - require the Board to develop, debate and approve technical professional auditing and other standards in public meetings or in “the sunshine”
 - provide sufficient time for public comment on proposed standards

- address PCAOB process issues associated with cooperation and participation with international and other standard setters.
- Create a sufficient number of advisory groups having knowledge of the broad nature and applicability of standards, and clarify their role and operating procedures.
- Avoid confusion over the scope of applicable standards by clearly defining terms.
- Clarify applicability of standards to registered public accounting firms.

Provide significant transparency and public participation in the PCAOB's standards-setting process

Public Debate of the Standards

We recognize that the PCAOB is still in a start up mode and therefore the Board may not have had a great deal of time to recognize and consider all important issues that it will need to deal with in its standard setting process. Additionally, we recognize the Board's need to provide some degree of flexibility in the standard setting process. Nevertheless, we believe that the Board should commit to issue for comment, in the near future, more specific policies and procedures on how professional standards will be set.

Appendix 1 of the PCAOB proposal sets forth Proposed Rules 1001, 3100, and 3700 for which our specific comments relating to those sections are discussed below. It does not set forth any Proposed Rules governing the PCAOB's standard setting process, which is briefly described in the body of the release.

Page 2 of the release invites comment on the proposed rules (3100 and related definition in 1001, and 3700). Since section 3700 deals only with the formation, etc. of the advisory group(s), it isn't clear that comment on the PCAOB's general standard setting process is open for comment. However, Item F on page 15 "invites the views of interested persons with respect to the issues raised for comment in this release," which presumably also encompasses the description of the PCAOB's standard setting process generally. Accordingly, we submit for your consideration the following general comments concerning the PCAOB's standard setting process for auditors of issuers.

In the proposed rule –

- No mention is made about whether PCAOB meetings to deliberate new standards or amendments to existing standards will be open to the public or closed. We believe all Board meetings to deliberate or approve professional auditing and other standards or amendments should be open to the public.

Currently, all AICPA committee meetings at which standard-setting activities are conducted (e.g., Auditing Standards Board (“ASB”) and Professional Ethics Executive Committee (“PEEC”)) are open to the public. During these meetings, any individual is free to listen to the debates on the technical merits and nuances of each proposed new or amended standard. Additionally, it is customary for the chair of the committees to give the privilege of the floor to certain non-committee members to address the committee and to join in the debate and discussion of a proposed standard. This is particularly helpful when the committees are dealing with very complex or specialized areas or when dealing with a particular industry.

We believe that Board policy should be to review and debate each paragraph or section of a proposed standard in an open meeting. By debating each important technical nuance of a standard and then making the necessary and proper wording changes in a public forum provides transparency as to why certain positions are taken by the Board or its staff. This type of open and transparent process (which is the model commonly followed by other standard setters including FASB) allows observers the ability to understand the reasoning of the Board and most importantly allows observers the ability to understand the Board’s rationale. We have always felt and will continue to believe that an open and public debate of the standards by the members of the standard setting body is in the public’s best interest.

It is through this due process of open and public debate leading to an ultimate consensus by those most knowledgeable in the subject matter of the proposed standard that gives a standard “general acceptance.”

A decision of the Board not to debate each technical nuance of each standard will not permit public observers the ability to understand each Board member’s views and rationale on the merits of the standard. To develop a standard otherwise, without an open, robust debate of the standard by the Board and the profession, will result in a standard that is less likely to be viewed as “generally accepted.”

Additionally, we hope that the chair of the PCAOB will permit professional experts the privilege of the floor to engage in the debate as the Board discusses a proposed standard. We believe the Board will find this particularly helpful when dealing with a very complex or specialized area or one dealing with a particular industry. This allows the best and the brightest minds the opportunity to develop the best auditing and other standards in the public’s interest.

- No mention is made of the process the Board will follow at the end of a comment period before remitting the proposed standard to the Securities and Exchange Commission for approval. Will the Board make revisions based on comments received and submit the revised document to the Commission for its exposure process? And if so, will the Board make an analysis available to the public at an open meeting showing how each comment letter was disposed? Additionally, when the Commission receives comments, will the Commission deliberate the proposed

standard and comments in a public forum and revise the proposed standard, or turn the document and the comments back to the PCAOB for disposition?

- The PCAOB identifies three priority projects: a review of interim or transitional standards; implementation of provisions of the Act that require the Board to adopt standards in specific areas; and standards related to internal control reporting pursuant to section 404 of the Act.

Page 10 of the release states, “the schedule and procedure for the review of the interim standards will be the subject of a separate release. The Board invites public comment and suggestions concerning the appropriate priorities for the review of the Interim Professional Auditing Standards and concerning any changes to them that the Board should consider.” Because it isn’t clear whether that comment is being invited now or when the separate release comes out we believe that the PCAOB should separately seek the input of the public on its priorities.

For example, the ASB’s current proposed standards dealing with audit risk are not listed as a priority. We believe that the Board should undertake, as a priority, its consideration and review of these proposed standards and amendments because we believe that the requirements and guidance provided in the proposed standards, if adopted, would result in a substantial change in audit practice and in more effective audits. Additionally, because these proposed standards have been developed jointly between the ASB and the International Auditing and Assurance Standards Board (“IAASB”) failure to act timely on these proposals will create significant differences between PCAOB standards applicable to audits of issuers and international and other auditing standards.

- Pages 13-14 of the release state, “the Board intends to convene a roundtable meeting in the near future to explore whether a new standard with respect to internal control reporting is needed in light of Section 404(b). The details of the Roundtable meeting will be the subject of a separate release. If the Board determines that such a standard is needed, it will commence a rulemaking proceeding, in accordance with the general procedures outlined in this release, to determine the nature and content of that standard. Interested persons will also be afforded an appropriate opportunity to express their views to the Board in that proceeding.” It is not clear from the “general procedures outlined in this release” in what manner “interested persons will also be afforded an appropriate opportunity to express their views to the Board in that proceeding.” We believe that the Board should clarify this issue as soon as possible.

Provide Sufficient Time for Public Comment

- The 21-day comment period described on page 7 of the release is, in our view, insufficient to make public input meaningful. Related footnote 6 further states “there may be occasional exceptions to the public comment process, such as in emergencies or other unusual circumstances where further public comment does not

appear necessary.” We believe the PCAOB should never issue a new or amended standard without thorough due process, including an appropriate exposure period. We further believe that the Board should provide examples of what such an emergency might be and how that emergency could be so great as to override the public’s right to due process through a comment period.

While we agree that the period for exposure could be shortened in some instances from the 60 -90 days typically used by other standard setters, we believe that a comment period of only three weeks is an unreasonably short period of time for a commenter to carefully analyze a proposed (and generally complex) standard and to engage its top technical personnel in the drafting of a comment letter. Particularly for smaller issuers and smaller registered CPA firms where the task of commenting rests with a very small number of individuals (perhaps with only one person) who are not solely devoted to one function within their company or firm, the PCAOB is unfairly slanting the comments it will receive to larger organizations and larger registered CPA firms.

Process of Cooperation and Participation with International and Other Standard Setters

Because there are often differences in the needs of users of audited financial statements, and because the PCAOB’s authority deals with audits of issuers who access the U.S. capital markets, there is likely to develop from PCAOB auditing standards certain auditing requirements that are either not applicable or not appropriate for audits of non-issuers. Maintaining standard setting processes that work cooperatively with other standard setters has to be in the best interest of all possible users and will only serve to enhance the standard setting processes for the PCAOB and other standard setters.

The efficiency of the world’s capital markets depends in part on quality professional auditing and other standards being of the same high quality and being applied consistently around the world. We encourage the PCAOB to work cooperatively with the international standard setters and undertake a standard setting process that will harmonize PCAOB standards with international auditing and other standards with a view towards convergence by 2005. Only through strong international auditing and other standards will public investors be assured that high quality audits are conducted around the world.

Accordingly, the PCAOB’s final statement should address process issues relative to working with other standard setters. This should encompass such matters as dealing with agenda-setting, cooperative development of proposed standards, the role of advisory boards and the need for broader international communication and exposure of proposed standards.

Create a sufficient number of advisory groups having knowledge of the broad nature and applicability of standards, and clarify their role and operating procedures

The proposed rule governing advisory groups set forth in Appendix 1 broadly outlines their formation (“the Board will convene one or more advisory groups”); composition (accounting, auditing, finance, governance, investing, and other); selection of members (by the Board, based upon recommendations by anyone); personal membership (member’s functions and responsibilities, including attendance at meetings, may not be delegated to others); ethical duties (compliance with EC 3, EC 8(a), and EC 9 of the PCAOB’s proposed Ethics Code); and ad hoc task forces (at the Board’s discretion; membership may include but is not limited to advisory group members).

Certain language in the release accompanying the Proposed Rules could be read to infer the PCAOB is considering only one advisory board, while other sections suggest the Board is open to the idea of multiple advisory boards.

Item B. on pages 5-7 suggest that the nature of the “assistance” to be provided by the advisory group (or groups) primarily will be as a source of ideas and comments on guidance drafted by staff or, in some cases, staff and ad hoc task forces, rather than a participant in the drafting of standards (or a “wordsmithing” type of reviewer). For example page 6 of the release states that the advisory group (among others) “may recommend to the Board that it propose a new standard or a change to an existing standard.” Page 6-7 of the release states that “with Board approval, the analysis and evaluation [of a recommended standard] by the Board’s staff (or task force) may be submitted to the advisory group (or, if established, a recognized sub-group of an advisory group) for consideration. Recommendations or comments from an advisory group...would then be submitted to the Board, or staff of the Board designated by the Board to receive such recommendations.” Page 7 further states that “the Board may also ask the advisory group or a task force to advise it concerning the proposal [a proposed rule], and the advisory group or task forces may, in some cases, hold hearings, convene roundtables, or commission research.”

Based on our understanding of how the Board intends to use an advisory group and given that the technical skills and competencies for the different areas of professional standards are not the same, (for example, someone specializing or knowledgeable in auditing standards would not necessarily have knowledge or the skills to deal with independence or quality control standards), we propose that there should be three (*at a minimum two*) advisory groups, one that focuses on auditing and attestation standards, one that focuses on quality control standards and one that focuses on ethics (including independence) standards. Members for each group should be selected on the basis of their expertise in those specific areas.

Additionally, no mention is made in the Proposed Rule or in the release of the following

—

- Whether advisory group meetings will be open to the public or closed. Additionally, there is no mention about how the advice rendered by the advisory group will be incorporated into the work of the Board and its staff. In order for the public to have

the confidence that the Board is responsive to the advice of any advisory group, we believe that these meetings should be open to the public.

- The number of members on the “one or more advisory groups.” (The release on page 8, however, states that “the Board contemplates that the advisory group will have somewhere between 15 and 30 members.”) The number of members on the advisory group (or groups) is a factor in determining how the advisory group will function and should be specified in the final rule.
- The term of service on an advisory group (or groups) nor who will chair such an advisory group and how that chair will be selected.
- The approximate number of advisory group meetings that will be held annually, or how far in advance the meeting dates will be established (which might help advisory group members in fulfilling their responsibility not to delegate attendance at meetings to others).
- How potential advisory group members will demonstrate their qualifications or their expertise in accounting, auditing, finance, governance, investing, or other disciplines.
- Any limits on the number of advisory members that could be associated with one firm, company or association. To select multiple members from the same firm, company or association will likely have the effect of limiting the views of the advisory group.
- Indications that public companies, firms or associations of different sizes would be represented. There are vast differences in the size and needs of issuers as well as vast differences in the size and needs of firms that audit issuers. Unless the views of these different sizes are represented, the staff and Board will not have the benefit of understanding the needs of these different constituents.

Avoid confusion over scope of applicable standards by clearly defining terms

1001. Definitions of Terms Employed in Rules

The Board uses the term professional auditing standards to mean “any auditing standard, standard for attestation engagements, quality control policy or procedure, ethical or competency standard, and independence standard (including any rule implementing title II of the Act) that is established or adopted by the Board under Section 103 of the Act.”

The PCAOB uses the term professional auditing standard rather than professional standards because the term professional standards is defined otherwise in Section 2(a)(10) of the Act, that is, the definition also encompasses accounting standards. The

term professional auditing standards is similar to that portion of the definition of the term professional standards that appears in Section 2(a)(10)(B) of the Act.

The characterization of attestation, quality control, ethical, and independence standards as professional auditing standards is not only imprecise but misleading. When the need arises to use a “generic” term, the PCAOB should consider using a term such as “professional standards other than accounting standards, including auditing standards, standards for attestation engagements, quality control policy or procedures, ethical or competency standards, and independence standards.” This would permit the PCAOB to remain consistent with the language in the Act without inappropriately misidentifying various types of professional standards.

The reason why it is inappropriate to use the term professional auditing standards to include other types of standards is because these other standards do not relate to the performance and reporting of an audit engagement. While we agree that these other standards are of utmost importance in creating a foundation for the auditing standards, they really are different in their applicability. For instance, quality control standards are standards governing a firm’s system of quality control that encompasses how an auditor performs an audit engagement. They also include guidance in other areas, for example, on how a firm monitors and inspects its quality control system that is not directly related to how an auditor carries out his or her audit responsibilities. Similarly, ethical and independence standards are applicable to all professional personnel (audit and non-audit) in the firm whereas auditing standards are applicable to an auditor in carrying out his or her audit responsibilities.

Under the transitional standards, an engagement partner will issue an audit report signed by his or her firm stating that the audit was conducted in accordance with “auditing standards generally accepted in the United States of America.” By encompassing all of these other non-audit standards within the definition of professional auditing standards, you are requiring an engagement partner to certify that all quality control, independence standards and attestation standards are also being followed throughout the firm for engagements and personnel who are unrelated to that specific audit engagement.

Presented a different way, if it was determined that a firm did not follow a specific quality control or independence standard applicable firm wide, the literal reading of the definition could lead someone to believe that every audit was deficient or substandard because professional auditing standards were not followed? We hope that was not the intent of the Board and therefore we believe that the definition of professional auditing standards should be modified to include only auditing standards.

The clarification of this issue is particularly important in light of Section 105 of the Act.

Additionally the Proposed Rules throughout discuss independence standards separately from ethical standards. Are independence standards deemed by the PCAOB (or by the Act) to stand apart from rather than be a subset of ethical standards? If so, we believe

that the PCAOB rules should describe the difference between the two and how they will be applied and enforced.

Clarify applicability of standards to registered public accounting firms

3100. Professional Auditing Standards Applicable to Registered Public Accounting Firms

The Proposed Rule states that “A registered public accounting firm and its associated persons shall comply with all applicable professional auditing standards.”

Read literally, this rule could be interpreted to mean that the firm and its personnel need to comply with PCAOB rules even for audits and other types of engagements performed for non-issuers. Therefore, we believe the final rule should clearly indicate that the PCAOB’s professional auditing and other standards apply only to a registered public accounting firm and its associated persons and only in their conduct of auditing issuers.

Additionally, the note underneath the rule states in part that “the Board intends that, during the period preceding the mandatory registration date, this rule would apply to public accounting firms that would be required to be registered *after* the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms” (italics added). As described in Appendix 2, this Proposed Rule is intended to be applicable to public accounting firms that will be required to register with the PCAOB in order to continue to participate in the audits of issuers after the mandatory registration date.

While we understand that the reason for this provision is to prevent firms that intend on registering from avoiding compliance with the rules prior to registration, the way the rule is written suggests that any public accounting firm that decides, at some future date (for example 10 years from now), to perform audits of issuers would have to follow the PCAOB’s professional auditing standards from the date that the Board adopts this rule. CPA firms who do not audit issuers today have no idea as to whether they will or will not audit an issuer in the future. Therefore, we recommend that the rule be rewritten to state, “this rule would apply to public accounting firms that would be required to be registered **on** the mandatory registration date.”

This identical wording also appears throughout the PCAOB's release on interim standards. Therefore, we believe such wording should be changed and conformed to the wording adopted for the final rule.

We appreciate the opportunity to comment on the proposed statement, and would be pleased to meet with Board members and staff to discuss our comments.

Sincerely,



William F. Ezzell, CPA
Chairman of the Board



Barry C. Melancon, CPA
President and CEO



AMERICAN BAR ASSOCIATION

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May 16, 2003

Via e-mail: comments@pcaobus.org

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

PCAOB Rulemaking Docket Matter No. 004 (the "Proposal")

Dear Members and Staff of the PCAOB:

We write on behalf of the Committees on Law and Accounting and Federal Regulation of Securities of the Section of Business Law of the American Bar Association (the "Committees")* to comment on the process that the Board proposes to use in establishing auditing and other professional standards (the "Professional Standards") for registered public accounting firms, as required by Title I of the Sarbanes-Oxley Act of 2002 (the "Act").

The comments expressed in this letter represent the views of the Committees only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committees.

We commend the Board for (i) developing an open and transparent process by which the Professional Standards will be adopted, (ii) providing a mechanism for input from various interests, regarding the proposed Professional Standards, and (iii) establishing appropriate priorities for its standard setting.

* References to "we" and "our" mean the Committees.

We have four comments on the Board's proposal. (We have not addressed issues relating to public accounting firms which audit the financial statements of broker-dealers pursuant to Section 17(e) of the Securities Exchange Act of 1934.)

First, we believe that it is the Board's intent consistent with the intent of Congress that Professional Standards apply only to registered public accounting firms in connection with their audits and reviews of the financial statements of "issuers," as that term is defined in Sec. 2(a)(7) of the Act, and to attest services provided by those firms, as required by the Act. Thus, the Professional Standards should not apply to firms in connection with their audits of the financial statements of non-issuers, such as governmental entities, not-for-profit entities or foreign and other entities that are not "issuers" or to other services provided by public accounting firms to non-issuers. To avoid possible confusion, however, we believe that the Board's rules should make this distinction.

Second, we understand that, in the Professional Standards, the Board generally intends to provide for a comment period of no less than 21 calendar days. While we recognize that the Board would retain discretion to establish longer comment periods, in our experience 21 calendar days does not provide sufficient opportunity for organizations, such as ours, and other entities to comment meaningfully on Proposals with far reaching consequences. The Board recognizes the value of the comment process in shaping its standards, and we urge the Board to remain flexible in establishing the length of its comment periods and to consider a comment period of 30 calendar days, rather than 21 calendar days, as the minimum period for comments on most of its proposals.

Third, the Proposal provides that advisory group members will be selected in the Board's sole discretion based upon recommendations provided by Board members, Board staff, SEC members or staff, professional groups of accountants, registered public accounting firms, investors, institutions of higher learning, or "any other person or body that the Board deems to have an interest in the accuracy of public company financial statements." Since the Board ought to encourage public participation in the process and will retain discretion for the selection of advisory group members, we suggest that the Board simply indicate that it will consider recommendations from persons or groups with an interest in the accuracy of public company financial statements, including, but not limited to, Board members, Board staff, SEC members or staff, professional groups of accountants, registered public accounting firms, investors and institutions of higher learning.

Finally, insofar as the Board has now adopted a set of "interim professional auditing standards" and indicated its intent to review those standards on a standard-by-standard basis, we suggest that the Board consider collecting and, to the extent consistent with the law of copyright, making available on its web site all of the currently applicable Professional Standards. As it now stands, public accounting firms (domestic and foreign) and others seeking to ascertain the Board's interim Professional Standards will have to gather various AICPA (including ASB and SECPS), SEC and ISB pronouncements – which may be unnecessarily burdensome for foreign entities and others.

We are grateful for the opportunity to comment on the Proposal. In addition, members of our Committees would be pleased to meet with representatives of the Board to discuss or comments if the Board or its staff so desires.

Respectfully submitted,

Thomas L. Riesenber, Chair
Committee on Law and Accounting

Stanley Keller, Chair
Committee on Federal Regulation of Securities

Drafting Group:

Gregory L. Doody, Esq.
David B. Hardison, Esq.
Thomas L. Riesenber, Esq.
Richard H. Rowe, Esq.

I would like to keep this input anonymous. It represents my personal viewpoint after many years in Internal Audit and many other years in general business and corporate governance. Some of the following comments raise questions for the external audit community and I do not wish for my personal comments to affect in any way the business relationship my company has with our external auditor, one of the big four and a very good one at that.

The subject of this note is on SOX section 404 and more specifically on the external auditor's attestation as to management's assessment of the internal control structure over financial reporting. At the risk of breaking my arm patting myself on the back, I think you will find the note reasoned and of value.

The issue is to the view of Congress, in writing 404, on the size and nature of the work that would be required to position the external auditor to be able to provide the attestation. There are many factors in this issue, and there is already much input to the SEC and PCAOB. For my purposes, these are most notably from the AICPA and the FEI.

In one of its submissions to the SEC, the FEI cited Senate Report No. 107-205 on S-O and quoted "In requiring the registered accounting firm preparing the audit report to attest to and report on management's assessment of internal controls, the Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges of fees."

The FEI also expressed a growing concern that the PCAOB would hastily adopt auditing and attestation standards that would be set solely by the AICPA's Auditing Standards Board. It further complained about the inherent conflict therein and the increasing level of marketing by public accounting firms offering consulting services on compliance with the internal control attestation requirement that they themselves were defining.

The PCAOB offers some help in this regard. In its release No. 2003-005, "Statement Regarding the Establishment of Auditing and Other Professional Standards" we find on Page 12 the following:

"3. Review of Internal Controls and Section 404 Attestation Standard

In addition to the matters listed above, Section 103 (a)(2)(A)(iii) of the Act also requires the Board to adopt auditing standards that require registered public accounting firms to -

'describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b), and present (in such report or in a separate report) -

- (I) the findings of the auditor from such testing;
- (II) an evaluation of whether such internal control structure and

procedures -

- (aa) include maintenance of records that in *reasonable detail* accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
 - (bb) provide *reasonable assurance* that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
- (III) a description, at a minimum, of *material weaknesses* in such internal controls, and of any *material noncompliance* found on the basis of such testing." (my emphasis applied)

In contrast, in reviewing the ASB's Exposure Draft and Proposed Statement on Auditing Standards and Auditing An Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit Page 4 of 16, paragraph 7 we find:

"For the purpose of expressing an opinion on internal control, tests of controls that the auditor performs should be sufficient to obtain a *high level of assurance* about their operating effectiveness."

In additional guidance from the AICPA, their "Key Issues For Management" of March 13, 2003 states:

"An audit (or examination) of the effectiveness of internal control over financial reporting will most likely require *significantly more work* than what the auditor was doing previously with respect to internal control in a financial statement audit, because an audit of internal control requires testing of a broader range of controls as well as sufficient testing to obtain a *high level of assurance about their operating effectiveness*. . ." (Again, my emphasis applied)

As I read this, the SOX legal requirement for external audit's opinion on reported financials is to "provide *reasonable assurance* that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles" while the AICPA proposed standard for 404 attestation is "tests of controls that the auditor performs should be sufficient to obtain a *high level of assurance* about their operating effectiveness."

In other words, the proposed testing of the controls over processes that lead to the audited financials are against a higher standard than the audited financials themselves. I don't believe this is what the authors of Sarbanes-Oxley intended. I also don't believe it is necessary to have more testing for the attestation than is required on the financial reports. It just doesn't make sense. Respectfully offered this 13th day of May, 2003.



Mark Anson, Ph.D., CFA, CPA, Esq.

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May 12, 2003

Office of the Secretary

PCAOB

1666K Street, N.W.

Washington, D.C. 20006-2803

Re: Rulemaking Docket Matter 004

Office of the Secretary:

I am writing to you on behalf of the California Public Employees' Retirement System (CalPERS). CalPERS is the largest public pension system in the U.S., with approximately \$135 billion in assets. We manage the retirement benefits and health insurance on behalf of nearly 1.3 million members.

CalPERS is very supportive of the efforts of the PCAOB to improve standards of financial reporting by publicly-traded companies and to improve standards of auditing those financial statements. CalPERS appreciates the opportunity to comment on the Proposed Rule 3100 and Proposed Rule 3700. CalPERS expresses general support of these two proposed rules.

Proposed Rule 3100, Professional Auditing Standards. CalPERS expresses strong support for Proposed Rule 3100. CalPERS believes that the PCAOB should be the body that promulgates the standards for all audit and attest work performed for publicly-traded companies by registered audit firms. CalPERS believes that the process of setting these audit standards should be under a Board that serves the interests of all parties that are affected by these standards.

Proposed Rule 3700, Advisory Groups and Task Forces. CalPERS expresses strong support for Proposed Rule 3700. We support the Board's standards-setting process of: (1) reviewing existing professional auditing standards,

Office of the Secretary, PCAOB

Page 2 of 2

May 12, 2003

(2) considering auditing standards required by Sarbanes-Oxley Act of 2002 and
(3) a review of the standard for an auditor's attestation relating to internal controls pursuant to Section 404 (b) of the Act. CalPERS would like the Board to consider the following two items:

- (1) An appropriate balance of membership between the financial information suppliers – auditees and auditors; and financial information users – equity and credit investors;
- (2) An appropriate avenue for minority viewpoints in the advisory reports.

In summary, CalPERS appreciates the work of the PCAOB Board and the opportunity to comment and participate. We look forward to continual interchange of information and ideas with the PCAOB.

If you have any questions regarding our comments on the two proposed rules, please contact Ted White, Director of Corporate Governance, at (916) 341-2731, or Larry Jensen, Chief of the Office of Audit Services, at (916) 231-7807.

Sincerely,



Mark Anson
Chief Investment Officer

From: Tim.Leech@carddecisions.com
Sent: Monday, May 12, 2003 5:05 PM
To: Comments
Cc: bbishop@theiia.org; blovell@theiia.org; mcorcoran@harborviewpartners.com;
Bruce.McCuaig@carddecisions.com
Subject: PCAOB Rulemaking Docket Matter No. 004

Attention: Gordon Seymour

Dear Mr. Seymour:

PCAOB Release No. 2003-005 has indicated on page 13 that you will be undertaking a review of both the existing external audit standards and the AICPA's exposure draft in the area of section 404 certification and you will be convening a roundtable to explore if a new standard on internal control reporting is needed. I am writing to provide some perspectives for those activities and table the position that there is an urgent need for a new and significantly more thoughtful standard on internal control reporting certifications. It is my opinion that the exposure draft proposed by the AICPA on March 18, 2003 is based on outdated thinking, is not in the best interests of the public, and will not assist in restoring the confidence of the investing public.

It is my opinion that the AICPA exposure draft on internal control reporting significantly undervalues the potential reliability of information produced by work units that is quality assured by an independent and competent internal audit unit and ignores the need for a macro level risk analysis related to the external disclosure process. In cases where clients can demonstrate that their internal analysis and external reporting framework is reliable, a lower level of external audit testing than that proposed by the AICPA is warranted. The position being taken by public accounting firms thus far in 2003 has already driven external assurance costs up significantly, in spite of the caveat in the Sarbanes Oxley legislation that this work should not be the subject of a separate engagement and there should only be a modest overall increase in the work required. As the requirement for SOX 404 certification nears, a number of our clients have indicated that their external auditors are calling for radically higher fees that will eventually be passed on to investors in the form of lower profits. Public accounting firms are justifying significant fee increases on the basis of the additional work they claim will be necessary to comply with the AICPA exposure draft. Given the AICPA position paper states that external auditors shall not rely on internal quality assurance processes, regardless of reliability, this is hardly surprising. We have also been advised by clients that some external audit firms are promoting special consulting assignments that see them play key roles in the development of the control status representations that they will later be engaged to report on pursuant to SOX section 404.

A White Paper I have authored is attached which outlines an alternative auditing approach to that proposed by the AICPA which I believe provides recognition for those companies that have effective risk and control systems and internal quality assurance frameworks. Additional details on the conceptual auditing approach to client produced assessments from section 11 of one of our training courses is also attached.

I would be pleased to meet with the Board and explain the concepts in these documents in greater detail if there is interest. I believe that it is of paramount importance to the goal of restoring stakeholder confidence that a new, more efficient and more effective auditing standard for section 404 representations be developed. At the current time, it appears a whole new generation of external auditor conflicts of interest are beginning to emerge in the area of internal control representation and certification.

I look forward to hearing from you.

Yours sincerely,

Tim Leech

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Sarbanes-Oxley Sections 302 & 404

A White Paper Proposing Practical, Cost Effective Compliance Strategies

Prepared by:

Tim J. Leech, FCA·CIA, CCSA, CFE



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April 2003

Complying with Sarbanes-Oxley Sections 302 & 404

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EXECUTIVE SUMMARY

The Sarbanes-Oxley Act of 2002 ("SOX") imposes significant new requirements on companies listed on U.S. stock exchanges. These rules are particularly radical in the areas of assessment and oversight of control systems that support external financial disclosures.

Regulatory requirements related to internal control representations have been around in various forms, in various business sectors, for many years. The new component causing significant consternation in the business community is that a company's external auditor, for the first time, must provide an annual opinion on the reliability of the control representation made by a company's CEO and CFO. Simply put, there must now, perhaps for the first time in a serious way, be a sound, demonstrable and persuasive basis for the CEO/CFO representations on control status.

Since SOX was passed in July of 2002, tens of thousands of pages have been written on the implications of this legislation, interpretations of the legislation, and the specific implementation plans of the various enforcement agencies, including the SEC, charged with applying these new laws. Although there are a number of contentious SOX sections that have created debate, comments and objections, sections 302 and 404 create the most radical, ongoing and potentially onerous compliance obligations. Other countries may follow the U.S.' lead and impose requirements similar to those in sections 302 and 404.

This paper sets out a point-by-point interpretation of the requirements imposed by these sections and provides practical, cost effective recommendations to respond. Traditional audit/compliance approaches and tools in use in most companies today are woefully inadequate to meet the virtually "real time" assessment and monitoring expectations imposed by sections 302 and 404. The strategies proposed in this paper, to be cost effective and add value, require the adoption of enterprise risk and control assessment and monitoring technology. Real value will only be realized when the assessment and monitoring systems linked to SOX are also used to foster continuous improvement, keep control costs as low as possible, and maintain residual risks at acceptable levels.

Three strategies are proposed to prepare for the audit of the CEO/CFO control representation required by section 404. These include a "big picture" macro level risk and control assessment related to a company's entire external disclosure process; a more rigorous documentation, prioritization and assessment of the sub-processes that support SEC 10K and 10Q disclosures; and, for those looking for a "quick fix", a minimalist approach to compliance, albeit with some significant legal and cost/benefit caveats that need to be carefully considered. Although the first two strategies will require significant culture and role change, they can still be accomplished fairly quickly and at a modest cost. The third option can appear, at least initially, to be a cheaper option, but may have significant hidden costs and provide limited payback.

The paper closes with four cautions companies and their advisors should carefully consider when developing a SOX 302/404 compliance framework and some "best guesses" of what the future holds in this area.

ABOUT THE AUTHOR

Tim J. Leech, FCA·CIA, CCSA, CFE, MBA

Tim J. Leech is the founder and CEO of CARD[®]*decisions* Inc. based in Mississauga, Ontario, Canada. Previously, Tim was the Managing Director of the Canadian subsidiary of Network Security Management Ltd., part of the Hambros Bank group of companies headquartered in London, England. He also served as Director - Control & Risk Management Services with The Coopers & Lybrand Consulting Group in Toronto after a varied career with Gulf Canada in Toronto and Calgary. He holds a Master in Business Administration degree majored in human resources and was elected Fellow of the Institute of Chartered Accountants in recognition of distinguished service to the profession.

Leech's practice includes enterprise-wide risk and assurance management; Collaborative Assurance & Risk Design[™] ("CARD[®]") software development, training and consulting; control and risk self-assessment ("CRSA") training and implementation services; specialized litigation support services; business ethics advisory services; internal audit training and consulting; and control/risk governance consulting services. He has provided training for public and private sector staff located in Canada, the U.S., the European Community, Australia, South America, Africa and the Middle and Far East. Leech has received worldwide recognition as a pioneer in the fields of enterprise risk and assurance management, Collaborative Assurance and Risk Design, and control and risk self-assessment.

Some of Leech's experiences and achievements include:

- pioneering and developing a work team driven approach to control and risk management and reporting that has been recognized globally as a leading edge, control and risk management tool;
- developing Collaborative Assurance and Risk Design[™] training methods and software used by major organizations around the world. Some of the organizations that have acquired licences over the past decade to use CARD[®] training tools internally include: Royal Bank, BellSouth, British Gas, Shell U.K., Georgia-Pacific, NatWest Bank, University of California, CIBC, Mobil, Cabot Corporation, Ansett Airlines, TD Bank, NorthEast Utilities, Chiquita Brands, Compart, City of Detroit, Telephone and Data Systems, Telstra, Western Mining, Royal Bank, Canada Life, and Australian Taxation Office;
- numerous T.V. appearances, a national radio show, and a monthly column on control, ethics, and fraud related topics;
- authoring technical papers in response to exposure drafts of control governance studies in the U.S., the U.K., and Canada including reports by the Treadway Commission, COSO, Cadbury, and CoCo internal control research projects, the Sarbanes-Oxley legislation passed in the U.S. in 2002, and the new professional standards issued by IIA;
- developing technical material for research studies on CSA/CRSA including the IIA report CSA: Making the Choice, and the IIA research study CSA: Experience, Current Thinking and Best Practices and a text published by John Wiley titled "Control Self-Assessment for Risk Management and Other Practical Applications";
- delivery of expert witness services and testimony during civil and criminal actions related to fraud, secret commissions, conflict of interest, breach of contract, and officer/director due diligence;
- developing training tools that have proven effective in a wide range of nationalities and cultures. Training on CARD[®] methods and tools is available in English, Spanish, Greek, and French through Oxley Fitzpatrick in the U.K., Rosés Auditores in Spain, Harborview Partners in the U.S., and participating KPMG and E&Y offices located around the world;
- member of the IIA Enterprise Risk Management & Self-Assessment Advisory Panel and author of the IIA CCSA practice exam; and
- primary author and developer of CARD[®]*map* software - the world's first Collaborative Assurance and Risk Design[™] groupware. CARD[®]*map* software is used by major companies and public sector organizations around the world.

PREFACE

I started my career as an apprentice external auditor with Coopers & Lybrand (now Pricewaterhouse Coopers) in 1979. Since that time I have worked as an internal auditor, corporate accounting manager, forensic accountant, Director of a control and risk management consulting practice, Managing Director of an international control and security firm and, for the last 12 years, CEO of a firm specializing in enterprise risk and assurance training, consulting, and software. Over those many years, there has never been an instance in memory where a corporate governance reform has produced a response of the magnitude and gravity provoked by the Sarbanes-Oxley Act of 2002. This legislation impacts in a significant way on regulators, boards of directors, senior management, personnel all across an organization, lawyers, investment dealers, external and internal auditors, credit agencies, foreign governments, and many others. The Sarbanes-Oxley Act ("SOX") represents the highest corporate governance compliance bar raised anywhere in the world to date.

The legislation has produced a veritable blizzard of interpretations and editorials from journalists, law firms, public accounting firms, internal auditors, academics and others. As I prepared to write this paper, my research covered the legislation, interpretations of the legislation from the Securities Exchange Commission ("SEC"), interpretations and commentary on the SEC interpretations from CFOs, major legal and accounting firms and others, editorials written by business journalists, and more. As I waded through this rapidly expanding body of literature and "expert advice", and fielded questions from public companies all across North America, it became increasingly clear that many companies are confused and looking for an understandable and practical interpretation of the legislation, particularly with respect to compliance with sections 302 and 404. This paper explains, in as simple terms as is possible, SOX sections 302 and 404 of SOX and provides practical, cost effective suggestions for companies that want to comply with these new rules.

I hope you find my paper interesting and useful. If you have criticisms, suggestions or comments on this paper and are prepared to share them, please e-mail them to me at Tim.Leech@carddecisions.com. Feedback on this White Paper, both positive and negative, will be posted in the Industry Info/Articles section of our web site www.carddecisions.com.

I would also like to extend special thanks to my technical review panel including my partner, Bruce McCuaig, Mike Corcoran, CEO Harborview Partners, Parveen Gupta, Associate Professor Lehigh University, Larry Hubbard, CEO Larry Hubbard & Associates, and Jon Elks, SVP Risk Management and Assurance Cablevision. Their assistance on this paper is greatly appreciated. Any deficiencies in the paper are entirely my own.

Tim Leech FCA·CIA, CFE, CCSA
April 2003

INTRODUCTION

In October of 1987 the Report of the Commission on Fraudulent Financial Reporting, better known as the Treadway Commission report, made the following recommendation:

For the top management of a public company to discharge its obligations to oversee the financial reporting process, it must identify, understand, and assess the factors that may cause the financial statements to be fraudulently misstated.

The stated mission of the Treadway Commission was “to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence.”

As a result of the Treadway Commission, the SEC proposed rules in 1988 that bear striking similarities to SOX sections 302 and 404. As a direct result of an aggressive counter lobby from a wide range of interest groups these proposals were not enacted.

Following the recommendations of the Treadway Commission, the five professional groups in the U.S. that sponsored Treadway developed a control framework titled “Committee of Sponsoring Organizations Internal Control - Integrated Framework” (commonly known as “COSO”). COSO was intended to help public companies, their auditors, advisors, and regulators better understand the key elements of an effective control framework. COSO was released in final in September of 1992.

The dawn of the 21st century brought with it a spate of new disasters that make the governance problems that led to the creation of the Treadway Commission seem trivial in comparison. Massive corporate governance failures at Enron, WorldCom, Adelphia, Allied Irish Bank, HealthSouth and many other large firms shook the confidence of shareholders, lenders, regulators, and the public with respect to the integrity of senior management, competency of boards of directors, integrity of external auditors, lawyers, investment dealers, and others and, more generally seriously impacted on the confidence of investors in the reliability of external disclosures of listed public companies.

In light of this massive reoccurrence of fraudulent and unreliable financial reporting, U.S. Congress concluded that the few tangible corrective actions that had been taken voluntarily by the private sector since the issuance of the Treadway recommendations in 1987 were not enough. In particular, Congress wanted to redefine a new and more independent auditor/company relationship with significantly more emphasis on the role of the board of directors to oversee and safeguard the reliability of external disclosures and independence of external auditors charged with reporting on those corporate disclosures.

The result of this growing realization was passage of the Sarbanes-Oxley Act of 2002 in July 2002.

Two of the sections of SOX that pose particularly significant implementation and compliance challenges are sections 302 and 404. Attachment 1 to this paper contains the full text of these two sections.

Simply put, these sections require that the CEO and CFO of an organization certify and assert to stakeholders that SEC disclosures, including the financial statements of the company and all supplemental disclosures, are truthful and reliable, and that management has taken appropriate steps to satisfy themselves that the disclosure processes and controls in the company they oversee are capable of consistently producing financial information stakeholders can rely on (Section 302). The company's external auditor must report on the reliability of management's assessment of internal control (Section 404).

SEC Commissioner Cynthia Glassman summarized the intent of these sections in a speech on September 27, 2002 to the American Society of Corporate Secretaries.

Recognizing that awareness must precede action, Sarbanes-Oxley and the Commission's rules require the CEO and Board to make certain that procedures are in place to ensure that they hear bad news. Under the Commission's recently adopted rules, these procedures must ensure that all material information - both financial and non-financial - gets to those responsible for reporting it to the investing public.

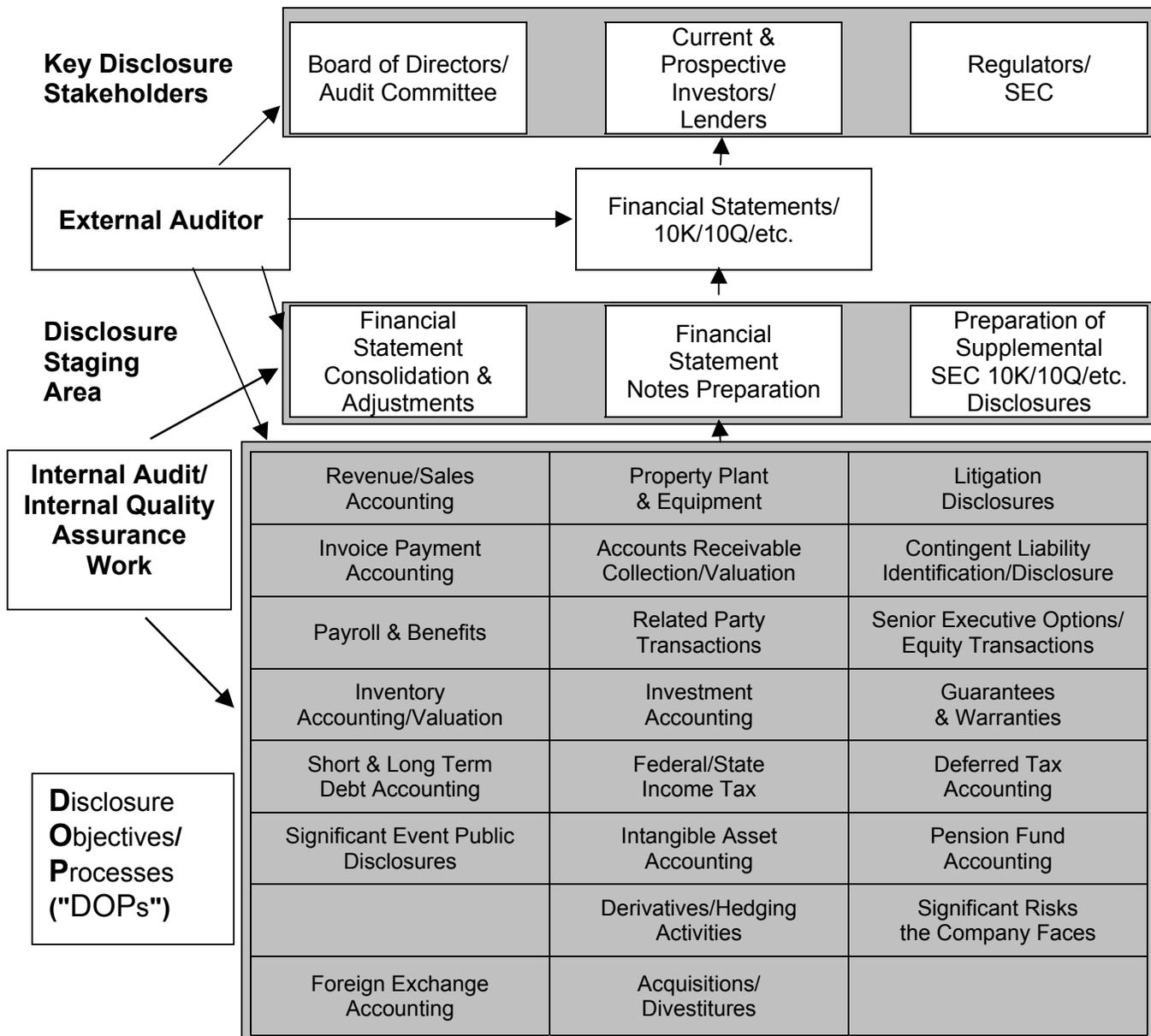
This paper demystifies and interprets SOX sections 302 and 404 and provides practical, cost effective suggestions and cautions companies can use to respond to these radical new governance requirements. It is not a legalistic interpretation of the legislation, but rather a common sense rendition of a fairly complex and radical piece of legislation.

VISUALIZING THE GOALS OF SECTIONS 302 and 404

The fundamentals of sections 302 and 404 can be explained using the diagram below. The primary goal of the disclosure system is summarized in the purpose statement of SOX:

To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to securities laws, and for other purposes.

Sarbanes-Oxley Section 302 & 404 Overview



For key stakeholders to evaluate any organization, be it a bank, insurance company, oil company, manufacturer, retailer, health care provider, etc., they need reliable information on the history, current financial status and future prospects of the company. Key Disclosure Stakeholders are depicted in the top portion of the overview. The primary goal of the legislation can be stated positively:

Ensure that SEC filings including financial statements, notes, and supplemental disclosures, are reliable.

Primary data sets used by the various disclosure stakeholders are monthly, quarterly, and annual financial statements, notes to the financial statements, and the many supplemental disclosures required by the SEC in 10K and 10Q filings. These data sets can be assembled, consolidated and reported at multiple levels of an organization (i.e. they may be developed in a subsidiary and then roll up to a parent company for consolidation). These activities are depicted simply in the 302/404 Overview as steps that occur in the "Disclosure Staging Area". Staging Area activities have been subdivided in to three core activities:

- Financial Statement Consolidation and Adjustments
- Financial Statement Notes Preparation
- Preparation of Supplemental SEC 10K/10Q/and Other Disclosures

The data necessary to assemble the disclosures comes from a wide range of sources. Illustrative information sources are depicted in the overview as a universe of "Disclosure Objectives/Processes" ("DOPs"). Each DOP has an associated end result objective of timely and reliable disclosure of some sub-set of the company's disclosure package; and a process or system, including internal controls, that support it and manage risks that would cause it to be unreliable. The DOPs depicted in this overview are not exhaustive and will vary depending on the size, complexity and business sector of the organization. Some of the DOPs are highly automated and flow information to the Disclosure Staging Area via sophisticated computer systems. Others are partially automated. A few are done manually and involve significant levels of judgment. The DOPs must deliver generally reliable and complete information to the Disclosure Staging Area for the final consolidated package to be reliable. Some of the DOPs are particularly significant and capable of creating material and dangerous disclosure problems. Others are less critical.

Many of the biggest corporate frauds in history have occurred in the Disclosure Staging Area at a level well above the more micro DOP control processes. Highly visible recent examples include Enron, WorldCom, Xerox, and HealthSouth. Particular attention needs to be paid to ensuring there are adequate controls in place to ensure that senior level executives, including CEOs and CFOs, do not improperly force staff to make inappropriate adjustments in the Disclosure Staging Area prior to release to Key Disclosure Stakeholders.

LINKING SECTION 302 TO THE 302/404 OVERVIEW

To focus senior executives on their responsibility for reliable external disclosures Congress enacted SOX section 302. A point-by-point analysis of this section follows.

Section 302 Requirement	Link to the Overview
302(a)(1) the signing officer has reviewed the report	CEO and CFO must review SEC disclosures shipped from the Disclosure Staging Area to Key Disclosure Stakeholders.
302(a) (2) based on the officer’s knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;	The CEO and CFO must not allow any SEC disclosures to be shipped to stakeholders from the Disclosure Staging Area with falsehoods or omissions. The "omit to state" portion of this section means that the CEO and CFO must take steps to ensure that the flow from the DOPs is reliable and complete.
302(a)(3)based on such officer’s knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;	This requirement suggests that the disclosures to key stakeholders must be more than just being in compliance with generally accepted U.S. accounting principles - they must “ fairly present in all material respects ”. This could mean that, in a case like Enron, if the use of Special Purpose Entities caused the statements to not “fairly present in all material respects”, but they were still technically in accordance with U.S. generally accepted accounting principles, this would need to be corrected.
302(a)(4)(A) the signing officers—are responsible for establishing and maintaining internal controls	The CEO and CFO are responsible for setting up and maintaining appropriate and sufficient controls in the Disclosure Staging Area and for the universe of DOPs to ensure timely and reliable external disclosures.
302(a)(4)(B) the signing officers —have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;	The CEO and CFO must be confident that there are adequate controls to ensure that timely and reliable information is flowing to the Disclosure Staging Area related to all key DOPs. For example, if a material lawsuit was launched against the company in a foreign subsidiary, the system must be capable of identifying the situation on a timely basis and feeding the necessary information to the Disclosure Staging Area.

Section 302 Requirement	Link to the Overview
<p>302(a)(4)(C) the signing officers — have evaluated the effectiveness of the issuer’s internal controls as of a date within 90 days prior to the report; and</p>	<p>This is one of the most serious and onerous requirements imposed by SOX. The CEO and CFO are expected to be able to demonstrate that there is a reliable process in place to evaluate, at least quarterly, the controls in place to ensure the reliability of the data being produced by the Disclosure Staging Area and all DOPs. It is important to note that looking at controls in a vacuum without understanding and evaluating the risks that threaten disclosure objectives will produce sub-optimal results and is inconsistent with the principles in the new draft COSO framework scheduled for release in April 2003. The omission of risk identification and assessment in the assessment process should be considered a significant risk in its own right. Very few companies have formally documented the end result DOPs that support SEC disclosures, the risks to those DOPs, the controls used to mitigate those risks, and current performance data (i.e. the frequency that the Disclosure Staging Area(s) and DOPs produce errors or omissions).</p>
<p>302(a)(5)(A) the signing officers have disclosed to the issuer’s auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)---all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer’s ability to record, process, summarize, and report financial data and have identified for the issuer’s auditors any material weaknesses in internal controls; and</p>	<p>The CEO and CFO must be aware of and report to their external auditor and Audit Committee the Disclosure Staging Area(s) and/or DOPs that are producing, or may produce as a result of serious control deficiencies, unreliable and/or incomplete information. It is important to note that the vast majority of companies, at any point in time, have Disclosure Staging Areas and/or some number of DOPs that produce inaccurate or incomplete information. Companies that say they have no control problems should be considered high potential candidates for a corporate governance disaster. Healthy companies recognize, acknowledge, and address the fact there are always control problems - problems that can, but only rarely do, preclude reliable external disclosures.</p>

Section 302 Requirement	Link to the Overview
<p>302(a)(5)(B) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function) -----any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and</p>	<p>This section requires that the CEO and CFO advise the external auditor and audit committee of any situation, regardless of materiality, that indicates dishonesty on the part of any employee that works in a Disclosure Staging Area or plays a significant role in any of the controls that support any of the DOPs that feed the Disclosures Staging Area(s). An example would be if the Controller of a subsidiary is caught falsifying an expense report, putting in an accrual for a liability that had not yet been incurred, or recognizing a sale in the accounts that had not yet been earned. Strictly interpreted, all of these situations would be a reportable item under this section. Depending on how broadly the SEC interprets "employees who have a significant role in the issuer's internal controls", this rule may apply to hundreds of employees that play a significant role in Disclosure Staging Areas, business operations, or any of the DOP control systems.</p>
<p>302(a)(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.</p>	<p>This section requires that in any situation where controls were evaluated at a point in time and subsequently an event occurs that could impact in a significant way on the controls or the reliability of the control processes, this must be documented and reported by the CEO and CFO, including any steps underway to correct it. Presumably, the company must have a system in place capable of scanning the disclosure/risks/ controls universe and detecting significant changes. It isn't clear from the wording whether this is a "to the best of my knowledge" law, with no requirement to positively seek information as to whether changes in the risk/control universe have occurred, or a more onerous expectation that positive steps must be taken by the company to identify significant changes in the control environment.</p>

LINKING SECTION 404 TO THE 302/404 OVERVIEW

Section 404 adds further emphasis to Section 302 by requiring an annual management assessment of controls and an external audit or opinion on its reliability.

Section 404 Requirement	Link to the Overview
<p>S404(a)(1)(2) RULES REQUIRED.</p> <p>The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 to contain an internal control report, which shall—</p> <ul style="list-style-type: none"> (1) state responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. 	<p>This section requires that there be a report that</p> <ul style="list-style-type: none"> (1) formally acknowledges the responsibility of management for creating and maintaining controls to manage the risks that could cause inaccurate, incomplete or fraudulent data to be shipped from the Disclosure Staging Area(s) or from any of the significant DOPs, and (2) contains an assessment of the reliability of the controls in the Disclosure Staging Area(s) and DOPs to manage risks that could cause, or result in, inaccurate, incomplete and/or fraudulent disclosures being released to key stakeholders. <p>The SEC proposed the content and format of these assertions in the fall of 2002 and will soon be finalizing the specific wording that must be used.</p>
<p>S404(b) INTERNAL CONTROL EVALUATION AND REPORTING.</p> <p>With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An</p>	<p>The external auditor must provide an opinion on the reliability of the assessment developed by management in section 404(a)(2). This requires an audit opinion on the reliability of the management representations on the effectiveness of the controls in the Disclosure Staging Area(s), and controls used to ensure that the DOPs, collectively, generate reliable disclosures for key stakeholders. Although there is a strong bias in the wording, and in many interpretations of the wording, that management will assert that controls are “adequate” or “effective”, presumably it would also be acceptable, and much more plausible, if management disclosed in their</p>

Section 404 Requirement	Link to the Overview
<p>attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.</p>	<p>assessment Disclosure Staging Areas and DOPs that have significant levels of process variability or error rates. The external auditor would then agree or disagree with that assessment much the same way an auditor can give a clean opinion on financial statements that disclose a very bad year in terms of financial results. Once information on process variability/error rate in Disclosure Staging Areas or DOPs is disclosed to the external auditor, the onus would then be on the external auditor to decide if they are still able to give a clean opinion on the financial statements, whether additional work is required by management and/or the external auditor to compensate for the process quality problem from the DOPs and/or Disclosure Staging Areas, or if they are precluded from issuing a "clean report" on the accounts.</p>

WHAT'S WRONG WITH THE STATUS QUO?

In most situations, when a government enacts new legislation and regulation of the significance and impact of SOX, it indicates the government of the day believes the existing corporate governance regulatory framework has failed, and failed badly. This conclusion has been reached to varying degrees by regulators in the U.S., U.K., Australia, Canada, Europe, South Africa and elsewhere.

The Basel Committee, part of the Bank for International Settlements, has been working since 1998 on the development of a new corporate governance framework to address what they consider to be an ineffective and broken corporate governance regime. (Note: this work is generally known as Basel Capital Accord II). Basel identified a list of key governance deficiencies present in banks in countries all over the world that have been involved in significant frauds and/or control breakdowns. Many of the corporate governance problems identified by Basel in banks globally have also been present in recent corporate sector disasters including Enron, WorldCom, Allied Irish Bank, HealthSouth, and others. The Basel listing of bank corporate governance deficiencies and a summary of the "Sound Practices" Basel has proposed to address them is included as Attachment 3 to this paper.

In addition to the problems identified by the Basel governance study, a summary of personal observations on what's wrong with the status quo drawn from over 20 years working with companies around the world is included as Attachment 10. The SOX 302/404 recommendations proposed in this paper are an attempt to address as many of these deficiencies as possible, while still creating a cost effective compliance program that adds value.

The deficiencies identified by the Basel Committee in Attachment 3 and the issues identified in Attachment 10 must all be addressed over the longer term to restore and maintain the confidence of the investment community.

EVALUATING THE BUSINESS CASE FOR SOX COMPLIANCE

Today's business environment is challenging to say the least. There is continuous pressure and demands from customers, competitors, regulators, unions and other key stakeholders. Time and money are scarce commodities that need to be used wisely.

While acknowledging that the administrative burden imposed by SOX is a consideration, the SEC has indicated that they will not tolerate companies that do not make sincere and genuine efforts to evaluate the risk and control management systems that support the reliability of external disclosures. There will be even less tolerance for companies that allow the issuance of inaccurate and/or fraudulent disclosures and are later caught. SEC Commissioner, Cynthia Glassman, in a speech to the American Society of Corporate Secretaries stated:

“one factor we will look at is whether the company took seriously its obligation to detect fraud. Obviously, no system of controls can prevent all misconduct; however, if a company can demonstrate that it has satisfied its obligation to implement good procedures, then in my eyes it has a significant better chance of receiving leniency (assuming the other criteria set out in the report are met) In short, if you are looking for leniency you had better be able to show that you cared about preventing corporate misconduct before you discover that it occurred.”

Putting aside for a moment “We have to comply with Sarbanes-Oxley, it’s the law” and/or “If we don’t comply and are caught our officers and directors could face fines and jail time”, SOX presents an opportunity that can help transition an organization from traditional, silo based risk and control approaches to integrated, Enterprise-wide Risk and Assurance Management (‘ERAM”). An overview of the differences between a traditional, silo-based approach to risk and control management and ERAM is included in Attachment 11 to this paper. Significantly more value can be derived from existing assurance functions/activities by adopting new and better assurances methods and tools to identify root causes of current and potential control breakdowns. The business case for going beyond the “letter of the law” and adopting the spirit of SOX and a broader ERAM approach is steadily gathering support around the world.

PRACTICAL AND COST EFFECTIVE 302/404 COMPLIANCE STRATEGIES

Practical, cost effective recommendations to comply with SOX sections 302 and 404 follow.

RECOMMENDATION #1- Evaluate at a macro level the risks, controls, and residual risk status over the entire SEC 10K/10Q external disclosure process.

Since many of the biggest disasters in corporate governance history have occurred in the Disclosure Staging Area, it makes sense to focus on “the big picture” and the “really big risks” first. A macro level analysis of section 302/404 disclosure risks and controls can usually be accomplished quite quickly through self-assessment forums or, if self-assessment is not a good fit for the current corporate culture, more traditionally in a collaborative way using in-house assurance specialists or an external consultant. An experienced risk and assurance consultant should be able to complete a macro level SOX analysis using traditional data gathering and audit techniques in less than 20-30 days of work even in a fairly large company.

The approach involves creating a formal, documented assessment of the risks, controls and residual risk status related to the macro level objective to:

Ensure SEC 10K and 10Q disclosures are complete and reliable.

The core elements of a risk and control assessment are shown in Attachment 6.

The analysis starts by documenting a list of key risks to this macro level objective. These are then ranked in terms of likelihood, consequence, mitigation estimate/control effectiveness, and residual risk status. Steps should be taken to ensure that fundamental risks that have caused major failures elsewhere are included in the evaluation. (e.g. “Executive compensation system increase pressure on senior executives to manage/distort profit”, “External auditors are not current on SEC disclosure rules”, “External auditors lose objectivity due to commercial pressures and partner reward systems”, “Material breach of debt covenant not identified”, “Key employees lie about critical disclosure information”, etc). The use of a Risk Source model and a range of completeness techniques to identify the key risks that threaten this micro objective are strongly recommended.

An overview of three sample Risk Source Models is included in Attachment 5. The use of risk identification completeness aids should be considered mandatory. If an important risk is missed, the reviewer/auditor will not look for and evaluate the controls in place/use to manage it. The new COSO Enterprise Risk Management Conceptual Framework scheduled for release in draft in the spring of 2003 attaches great importance to the role of risk analysis in a company's macro control framework. The

new version of COSO should provide an excellent source of guidance for companies developing SOX compliance programs.

The next step is to identify the controls currently in use/place to mitigate the risks identified. The use of a control model is strongly recommended for this step. Most comment letters filed in response to the draft SEC implementation guidance for SOX section 404 (RIN 3235-A166) from large public accounting firms and the AICPA strongly advocate the use of "control criteria", a documented and acknowledged control framework, when making and reporting on control representations.

Sample control models are included as Attachment 4. COSO, the Canadian CoCo and the international CARD[®] *model* frameworks and others can all be used to help evaluate internal controls. The original 1992 COSO framework works very well when evaluating the macro level control framework for the enterprise as a whole, but can be more difficult to apply on an individual objective or when searching for a control to mitigate a specific risk. For macro level control evaluations readers should consult the September 1992 Evaluation Tools volume of COSO, page 201. COSO capabilities in this area will be significantly enhanced with the release of the updated COSO framework scheduled for release in draft in the draft of 2003. The "NEW AND IMPROVED COSO" is expected to include the following components: analysis of the internal environment, event identification, risk assessment, risk response, control activities, information and communication, monitoring, limitations and roles, and responsibility sections. (Source: COSO presentation, IIA GAM Conference, March 2003)

After risks and controls have been identified, documented and evaluated, the next step is to document a picture of the current risk situation after existing controls are considered, including information on current "Process Reliability/Variability". This step includes identifying Key Process Indicators ("KPIs") or Process Reliability/Variability data. This information includes such things as the number and dollar value of adjustments to the accounts that have been made following external audit testing, (i.e. adjustments to the accounts or supplemental disclosures identified by the external auditor or caught through internal processes prior to approving the disclosure package), the number and dollar value of adjustments that are made in key accounting/disclosure processes that relate to prior periods, (i.e. mistakes/omissions found in prior periods), and any other information that helps answer the question of "What do we know right now about the reliability and completeness of the processes that provide data to assemble financial statements, the notes to the financial, and the supplemental SEC disclosures." This approach is entirely consistent with analysis techniques advocated by leading quality systems like Baldrige, Six Sigma and ISO 9000.

In cases where unacceptable residual risk concerns are identified, action plans must be developed to address them.

The use of an automated computer system to capture this macro level analysis, track progress addressing any unacceptable risks, and monitor risk and control status in future periods is strongly recommended to meet quarterly status analysis requirements

and keep costs to a minimum. There are a variety of software packages on the market designed for this purpose and more are emerging. Offerings in this space include CARD[®] *map* software offered by CARD[®] *decisions*, Risk Navigator offered by Paisley, fORM from Methodware, Horizon from JPMorganChase, Visual Assurance from Kilcare, Magique from Horwath Software, Risk Prism offered by PwC, and others.

It is essential when completing this macro level analysis to document and evaluate the "big picture" controls. "Big picture" controls are designed to manage the most significant risks and prevent inappropriate senior executive override, including the role played by any internal disclosure committee or process, the role of the audit committee, the role of the external auditor, the role of in-house and external legal counsel related to significant disclosures, the rigor and reliability of the process used by the CEO and CFO to support their sign-off of disclosures, the reward/punishment system to encourage truthful disclosures and discourage fraudulent and/or excessively aggressive disclosures, high level reasonability assessments done by analysts, performance monitoring activities, and other significant controls. Although controls such as general ledger account analysis and reconciliation, consolidation checklists and sign-offs, passwords, and other traditional controls are easily audited, they are not the major controls capable of preventing disasters like Enron, WorldCom, HealthSouth and others.

RECOMMENDATION #2 – UTILIZE TECHNOLOGY TO PROVIDE SUPPORT FOR SOX 302/404 REPRESENTATIONS

The use of technology to support SOX compliance programs helps integrate the efforts of all assurance providers, facilitates preparation, analysis and quarterly monitoring of the consolidated risk and control position, encourages the participation of work unit personnel, and provides an easy to use platform for assurance work performed by internal and external auditors. Key steps to implement an automated SOX 302/404 compliance system follow.

1. In addition to completing the macro, "big picture" risk and control analysis outlined in Recommendation #1, document the universe of significant DOPs (Disclosure Objectives/Processes) that feed the Disclosure Staging Area. See page 5 of this paper for an illustrative overview of DOPs. This overview can also be depicted as a collection of business processes that feed the Disclosure Staging area. It is better for purposes of risk and control assessment if the DOPs are stated as end result objectives to stress the outcomes required. Whenever possible, identify a DOP owner or sponsor in business units and/or Disclosure Staging Area that has lead responsibility for assessing the risk and control status for each DOP. Accountability, combined with an effective monitoring/oversight program, are key elements of a solid compliance framework.
2. Decide whether primary documentation/assessment work necessary to support external control representations will be completed and maintained by work unit

personnel or risk and control assurance specialists, such as internal audit and/or contract assurance personnel. (NOTE: It can be quite expensive to maintain current, quarterly updated data using assurance specialists/auditors alone) An overview of 10 different assurance approaches that can be used is included as Attachment 2. To meet the requirement for timely and continuous monitoring of risks and controls the use one or more self-assessment approaches combined with one or more direct report audit methods is strongly recommended. During the transition/implementation phase, Internal Audit and/or contract personnel can be used to help with the initial set-up of the necessary SOX risk and control documentation. After the initial documentation is complete, seriously consider assigning ongoing maintenance of the risk and control documentation of the DOPs to work unit personnel.

3. Rank the DOPs in terms of their "Importance" to consolidated external disclosures. Importance ratings are generally based on criteria such as materiality of the information produced by the DOP, consequences of a misstatement, and importance to stakeholders. Pay particular attention to DOPs and Disclosure Staging Area activities that involve high levels of judgment and/or where Generally Accepted Accounting Principles allow a range of treatment options. These are sometimes referred to as "Profit Adjustment Accounts". Profit Adjustment Accounts are used, both legitimately and otherwise, for discretionary quarterly and annual profit smoothing or profit position optimization. These accounts are usually well known to both the corporate accounting personnel and experienced external auditors. There is growing pressure on audit committees to understand and monitor these "swing" accounts.
4. Gather and consolidate all of the information that is currently known about risks and controls related to the DOPs and input the information to the risk and assurance database. Risk and control information sources include corporate policy statements, work unit documentation, risk and control self-assessment documentation, internal audit reviews, any external specialist reviews done on complex topics such as derivatives, foreign exchange, complex tax issues, external audit control assessment documentation, and other data. Pay particular attention to gathering and documenting "best available" performance indicator data that provides insight in to the current reliability/variability of the DOPs and Disclosure Staging Areas. This approach to identifying and analyzing Key Performance Indicators on important DOPs is consistent with some of the new and better external audit methodologies in use. Both the quantity and quality of the information on risks and controls developed to date by your external auditors will vary widely depending on the firm you use, the budget pressure you have applied, and the integrity and competence of the individual audit partner assigned to your account.
5. Concentrate initial formal risk and control assessment work on DOPs that are considered to be of high importance to your external disclosures and/or have demonstrated a historical pattern of error/variability. Take steps to identify the

major risks and “significant controls” that are used to mitigate those risks. The March 2003 AICPA exposure draft “REPORTING ON AN ENTITY’S INTERNAL CONTROL OVER FINANCIAL REPORTING” states: *“The practitioner should evaluate the design and operating effectiveness of significant controls for each of the components of internal control and for each significant account balance, class of transactions, and disclosure and related assertions.”* Over time, coverage will have to be expanded to include all significant DOPs to meet the needs of your external auditor for section 404 assertions.

6. To keep external audit review work and fees to a minimum, if the risk and control assessments have been prepared by work unit personnel or a special risk and control documentation team, consider having your internal audit group or an outsourced equivalent, evaluate the process used to perform the disclosure risk and control assessment and complete any substantive testing considered necessary to determine if the control status representations are reliable. Attachment 2 overviews a range of different traditional direct report and self-assessment assurance strategies that can be used to support control representations. Attachment 8 provides an overview of a structured 6 level quality assurance framework that can be used to quality assure SOX control status/deficiency representations generated by work units and/or management personnel. The willingness of external auditors to rely on quality assurance work done by internal audit staff at this point is unclear. External auditing standards related to section 404 audit opinions have not been finalized by the Public Company Accounting Oversight Board as of April 2003. The draft AICPA guidance in the area states *“The practitioner should **not** rely on the results of internal auditor procedures as the principal evidence of the operating effectiveness of controls over significant accounts, classes of transactions, and disclosures. However, the practitioner may consider such work in determining the nature, timing, and extent of his or her testing”* (page 18 of 45, Reporting on an Entity’s Internal Control Over Financial Reporting, issued in draft by the AICPA in March 2003).
7. To meet section SOX section 302 requirements for reliable quarterly representations, DOP primary owners/sponsors should update process variability/error rates and input any new information on risks that threaten the DOPs and/or the controls in use to mitigate those risks each quarter. The status of any action plans to address concerns should also be updated. This activity needs to be documented and a trail maintained in the system to provide evidence of a quarterly review required by section 302.
8. Identify DOPs and Disclosure Staging Areas that exhibit significant variability/error and/or have significant residual risks. Under SOX section 302(a)(5) “significant deficiencies” need to be reported upwards to your audit committee and your external auditor together with documentation of any corrective actions underway. Any “significant deficiencies” identified should be reviewed by the CEO and CFO responsible for signing the required 302/404

quarterly and annual control representations. This step should be done prior to reporting these issues to the external auditor and audit committee. Some companies have also created a Disclosure Review Committee for this purpose. Evidence that this review has occurred should be documented and kept on file.

9. Your external auditor will need to evaluate the Disclosure Staging Area and DOP process variability/error rates and the impact of any “significant deficiencies” identified internally to determine their impact, if any, on their opinion on the management control representation required by SOX section 404. They will also need to consider the impact, if any, of the control deficiencies on their opinion on the financial statements.

RECOMMENDATION #3 – THE SOX 302/404 MINIMALIST APPROACH – USE IT AT YOUR OWN RISK

If your organization is not sold on the business case for the type of approach outlined in Recommendations #1 and #2, you will likely gravitate to the “Minimalist Approach”. The ramifications of opting for a minimalist approach on your company’s ability to attract qualified audit committee members, the Corporate Governance Score (“CGS”) assigned to your company by rating agencies and any related implications of your CGS on your cost of capital, implications on your ability to obtain cost effective Director and Officer insurance, the likely reactions of any regulators that oversee your business sector, and other factors should all be considered.

To execute this approach you need to confer with your external auditor to determine the bare minimum amount of work they will accept to provide you with a sign-off on your assertion. Until specific auditing standards for SOX section 404 attestations are finalized and released by Public Company Accounting Oversight Board (PCAOB), external auditors will be only able to provide “best guesses” of their actual requirements. They will also have to carefully assess the implications of the Minimalist Approach on their legal liability.

It is expected that at least some of the external audit firms will accept approaches significantly less rigorous than those suggested in Recommendation #1 and #2.

It is expected that finalized audit standards for audit opinions on management control representations will be issued over the next few months. Subject to the feedback you get from your external auditor, you will then need to negotiate the optimal combination of internal and external assessment work to keep your external audit fee to an acceptable level and still obtain a positive section 404 audit report.

CAUTIONS TO CONSIDER

CAUTION #1 – CONTROL ASSESSMENT TEMPLATES PROVIDED BY YOUR EXTERNAL AUDITOR

If you are considering using a SOX section 302/404 control assessment template/software developed by your external audit firm, check with your legal counsel to get an opinion on whether this would violate any independence rules established by SOX and/or the SEC. Since a pre-populated control assessment template makes assumptions about what are, and are not, key controls, and explicitly or implicitly makes assumptions about the likelihood and consequence of various risks, this may preclude the external audit firm from rendering an objective opinion on a senior management control representation. If you have the misfortune to have a serious and very public control disaster after a positive section 404 audit opinion, your external auditor's independence in the control assessment and representation process may be questioned. This could, in a worse case scenario, bring into question whether the external audit opinion on your control representation and/or financial statements had been compromised.

CAUTION #2 – INVOLVEMENT OF YOUR EXTERNAL AUDITOR DEVELOPING YOUR CONTROL REPRESENTATION

If you are considering using your external audit firm to play a role in the development of SOX section 302/404 risk and control documentation, check with your legal counsel to ensure that this will not violate any independence rules. You should also discuss their involvement with your Audit Committee to ensure that they are happy with this external audit service activity. In addition to technical legal issues, you will also need to consider whether outside parties, including any future litigants/plaintiffs, would consider direct involvement of your external auditor in the development of your company's risk and control analysis and control representation an independence problem. You may also wish to check with your Director and Officer ("D&O") and Errors and Omission ("E&O") insurance carrier(s) to determine if the utilization of your external auditor to help assess your risk and control status related to external financial disclosures impacts in any way on your insurance coverages/premiums.

CAUTION #3 – INCREASED LEGAL LIABILITY FROM INCREASED RISK/CONTROL STATUS INFORMATION

While developing the risk and control analysis required to support a SOX section 302/404 representations you may identify situations where very serious concerns and problems exist. In some cases, these problems may have existed and been known by management personnel for some time. These issues may not have been visible and/or documented previously. You should immediately confer with legal counsel to determine the best course of action to deal with issues of this type.

CAUTION #4 – OBSOLESCENCE OF APPROACHES THAT FOCUS ON CONTROL COMPLIANCE AND IGNORE RISK IDENTIFICATION/ASSESSMENT

Some of the older style control assessment methods and tools focus attention almost exclusively on the existence of what are generally known as "Direct controls". Little or no attention is paid in these older methods to documenting end result objectives, identifying and assessing the likely risks to those objectives, and considering the broader range of control types, including such things as commitment controls, capability controls, measurement and oversight controls and others, necessary to manage key risks. Although the 1992 version of COSO did not focus heavily on the critical importance of risk identification and assessment, the new COSO conceptual framework scheduled for release in final in late 2003 significantly elevates and explains the importance of these steps. The adoption of methods and tools that do not explicitly include risk identification and analysis could result in your external auditor denying a positive opinion on your control representation. It is generally expected that the new 2003 COSO conceptual framework will form the primary assessment criteria that will be used by external auditors to form their opinion on CEO and CFO control representations required by SOX section 404.

WHAT THE FUTURE HOLDS

Although history tells us that projecting the future is a difficult task to say the least, my best guesses of SOX 302/404 trends and developments follow:

BEST GUESS #1 - ACCEPTANCE OF QUALITY PRINCIPLES

Financial disclosure regulators will slowly encourage the use of the more "scientific" process assessment approaches that have been promoted by the quality movement for many decades. This will eventually require companies to measure and report process variability/error rates in the processes that support external disclosures to senior management, audit committees and external auditors.

BEST GUESS #2 - ELEVATION OF THE IMPORTANCE OF RISK ASSESSMENT

The importance on identifying outcomes required from disclosure systems and identifying and assessing risks to those outcomes will become mandatory as the newest generation of the COSO framework is released in 2003, and the global movement to adopt Enterprise Risk Management accelerates.

BEST GUESS #3 - IMPROVED AUDIT QUALITY

SOX section 404 will force internal and external auditors to focus more attention on the reliability of the processes that support external disclosures. This emphasis should, assuming efforts to restore independence to external auditor/company relationships succeed, result in a lower incidence of, and less material, external auditor failures.

BEST GUESS #4 - PLAINTIFFS AND REGULATORS WILL EXPLOIT HOLES IN "QUICK FIX" SOX COMPLIANCE PROGRAMS

SOX 302/404 has now, to a much greater degree, codified U.S. corporate risk and control governance expectations. In cases where a company has the misfortune of having a material external disclosure misstatement, the amount of effort the company has expended to comply with sections 302 and 404 will play a key role in determining plaintiff and regulator damages and punishments.

BEST GUESS #5 - INCREASED USE OF WORK UNIT RISK & CONTROL SELF-ASSESSMENT ("RCSA")

The new requirements for quarterly monitoring of all DOPs and Disclosure Staging Areas will provide an incentive for companies that have historically relied on traditional "direct report" assessment approaches done by internal audit and compliance personnel to adopt, to a much greater extent, risk and control self-assessment.

Attachment 1

SOX Sections 302 & 404: Full Text

SEC. 302. CORPORATE RESPONSIBILITY FOR FINANCIAL REPORTS.

(a) REGULATIONS REQUIRED. — The Commission shall, by rule, require, for each company filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)), that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that —

- (1) the signing officer has reviewed the report;
- (2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
- (3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;
- (4) the signing officers:
 - (A) are responsible for establishing and maintaining internal controls;
 - (B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
 - (C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and
 - (D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;
- (5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function) —
 - (A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
 - (B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
- (6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

(b) **FOREIGN REINCORPORATIONS HAVE NO EFFECT.** — Nothing in this section 302 shall be interpreted or applied in any way to allow any issuer to lessen the legal force of the statement required under this section 302, by an issuer having reincorporated or having engaged in any other transaction that resulted in the transfer of the corporate domicile or offices of the issuer from inside the United States to outside of the United States.

(c) **DEADLINE.** — The rules required by subsection (a) shall be effective not later than 30 days after the date of enactment of this Act.

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.

- (a) **RULES REQUIRED.** — The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall —
- (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
 - (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
- (b) **INTERNAL CONTROL EVALUATION AND REPORTING.** — With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Attachment 2

SOX Assurance Strategies - Options Overview

<p>DIRECT REVIEW & REPORT BY ASSURANCE SPECIALISTS</p> <p>DRR#1 COMPLIANCE FOCUS Assurance Specialists review and report on conformance with rules/policies/audit questionnaires.</p> <p>DRR #2 PROCESS FOCUS Assurance Specialists examine business process(es) and provide opinions/ observations on adequacy/effectiveness/status of the process(es).</p> <p>DRR #3 OBJECTIVE FOCUS Assurance Specialists select one or more end result objective(s) for assessment and provide opinions on adequacy/ effectiveness/risk status.</p> <p>DRR #4 RISK FOCUS Assurance Specialists select a context such as business unit, process, or objective(s) and identify and rank the risks and assess the effectiveness of the controls currently in place to mitigate them.</p> <p>DRR #5 CONTROL FRAMEWORK FOCUS Assurance Specialists review the macro level control framework used to manage the area/topic selected using the assessment criteria in one or more management control model (e.g. COSO, CoCo, CARD[®] model).</p> <p>PRODUCT: REPORT FROM THE ASSURANCE SPECIALIST PROVIDING OPINIONS/ OBSERVATIONS ON CURRENT ADEQUACY OR EFFECTIVENESS OF COMPONENT REVIEWED.</p>	<div style="border: 1px solid black; padding: 5px; margin-bottom: 10px;"> <p>MACRO OBJECTIVE: Ensure SEC disclosures, including the financial statements, notes to the financial statements, and applicable supplemental disclosures, are complete, timely and reliable.</p> </div> <div style="border: 1px solid black; padding: 5px; margin-bottom: 10px; background-color: #e0e0e0;"> <p style="text-align: center; font-weight: bold;">Disclosure Staging Area</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 33%; text-align: center;">Revenue/Sales Accounting</td> <td style="width: 33%; text-align: center;">Property Plant & Equipment</td> <td style="width: 33%; text-align: center;">Litigation Disclosures</td> </tr> <tr> <td style="text-align: center;">Invoice Payment Accounting</td> <td style="text-align: center;">Accounts Receivable Collection/Valuation</td> <td style="text-align: center;">Contingent Liability Identification/Disclosure</td> </tr> <tr> <td style="text-align: center;">Payroll & Benefits</td> <td style="text-align: center;">Related Party Transactions</td> <td style="text-align: center;">Executive Equity Activity</td> </tr> <tr> <td style="text-align: center;">Inventory Accounting/Valuation</td> <td style="text-align: center;">Investment Accounting</td> <td style="text-align: center;">Guarantees & Warranties</td> </tr> <tr> <td style="text-align: center;">Short & Long Term Debt Accounting</td> <td style="text-align: center;">Federal/State Income Tax</td> <td style="text-align: center;">Deferred Tax Accounting</td> </tr> <tr> <td style="text-align: center;">Share Register/ Stock Option Activity</td> <td style="text-align: center;">Intangible Asset Accounting</td> <td style="text-align: center;">Pension Fund Accounting</td> </tr> <tr> <td style="text-align: center;">Research & Development Activity/Accounting</td> <td style="text-align: center;">Derivatives/Hedging Activities</td> <td style="text-align: center;">Risks the Company Faces</td> </tr> <tr> <td style="text-align: center;">Foreign Exchange Accounting</td> <td style="text-align: center;">Acquisitions/ Divestitures</td> <td style="text-align: center;">Business Segment Disclosure</td> </tr> <tr> <td style="height: 30px;"></td> <td></td> <td></td> </tr> </table> </div>	Revenue/Sales Accounting	Property Plant & Equipment	Litigation Disclosures	Invoice Payment Accounting	Accounts Receivable Collection/Valuation	Contingent Liability Identification/Disclosure	Payroll & Benefits	Related Party Transactions	Executive Equity Activity	Inventory Accounting/Valuation	Investment Accounting	Guarantees & Warranties	Short & Long Term Debt Accounting	Federal/State Income Tax	Deferred Tax Accounting	Share Register/ Stock Option Activity	Intangible Asset Accounting	Pension Fund Accounting	Research & Development Activity/Accounting	Derivatives/Hedging Activities	Risks the Company Faces	Foreign Exchange Accounting	Acquisitions/ Divestitures	Business Segment Disclosure				<p>SELF-ASSESSMENT BY RESPONSIBLE WORK UNIT(S)</p> <p>SA#1 COMPLIANCE FOCUS Work units self-assess their state of compliance and prepare a report on conformance with rules/policies.</p> <p>SA#2 PROCESS FOCUS Work units self-assess business process(es) and report opinions/ observations on adequacy/effectiveness/ status.</p> <p>SA#3 OBJECTIVE FOCUS Work units select one or more end result objective(s) for assessment and report opinions/observations on adequacy/effectiveness.</p> <p>SA#4 RISK FOCUS Work units select one or more objectives and identify and rank the risks or threats to that context, rate the likely effectiveness of controls currently in place to mitigate them, and provide a report on residual risk status.</p> <p>SA#5 CONTROL FRAMEWORK FOCUS Work units review the macro level framework used to manage the area/ topic selected against the criteria in one or more control frameworks.</p> <p style="text-align: center; font-weight: bold;">ASSURANCE SPECIALISTS PERFORM A QUALITY ASSURANCE REVIEW ON THE SELF-ASSESSMENT PROCESS AND/OR REPRESENTATIONS AND REPORT ON THE RELIABILITY.</p>
Revenue/Sales Accounting	Property Plant & Equipment	Litigation Disclosures																											
Invoice Payment Accounting	Accounts Receivable Collection/Valuation	Contingent Liability Identification/Disclosure																											
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Research & Development Activity/Accounting	Derivatives/Hedging Activities	Risks the Company Faces																											
Foreign Exchange Accounting	Acquisitions/ Divestitures	Business Segment Disclosure																											

Attachment 3

Basel Bank Governance Deficiencies Summary

Summary of Deficiencies in Risk/Control/Assurance Management Identified By the Basle Committee on Banking Supervision *(Note: Based on our global experiences, the deficiencies identified are common to all organizations, both public and private sector)*

1. Board of Directors and senior management did not establish strong control cultures.
2. Senior management failed to emphasize the importance of a strong control culture through their words and actions and, most importantly, through the criteria used to determine compensation and promotion.
3. Senior management failed to ensure that the organization structure and management accountabilities were well defined.
4. Senior management weakened the control culture by promoting and rewarding managers who were successfully generating profits but failed to implement control policies or address audit findings.
5. Accountabilities were not clearly defined.
6. Inadequate risk recognition and assessment processes.
7. Some banks failed to observe certain key internal control principles especially segregation of duties.
8. Senior management did not respond appropriately to information they were receiving.
9. High-level reviews were not being done. Situations that should have been flagged as abnormalities were not investigated by senior management.
10. Information was not reliable or complete and communication was not effective.
11. Banks failed to adequately communicate employee's duties and control responsibilities or disseminated policies through channels, such as electronic mail, that did not ensure that the policy was read, understood and retained.
12. Lines of communication did not exist for the reporting of suspected improprieties by employees.
13. Banks did not effectively monitor their risk/control systems. The systems did not have the necessary built-in ongoing monitoring processes and the separate evaluations performed were either not adequate or were not acted upon appropriately by management.
14. There was a failure to consider and react to day-to-day information provided to line management and other personnel indicating unusual activity.
15. Failure to react to situations indicating a heightened level of risk.

Summary of Deficiencies in Risk/Control/Assurance Management Identified By the Basle Committee on Banking Supervision *(Note: Based on our global experiences, the deficiencies identified are common to all organizations, both public and private sector)*

16. Internal audit was not effective in many problem banking organizations. This was caused by piecemeal audits, lack of a thorough understanding of business processes, and inadequate follow-up when problems were noted.
17. Fragmented audit approaches resulted because the internal audits were structured as a series of discrete audits of specific activities within the same division or department, within geographic areas, or within legal entities.
18. Inadequate knowledge and training of internal audit staff in trading products and markets, electronic information systems, and other highly sophisticated areas.
19. Internal audit staff were hesitant to ask questions when they suspected problems, and when questions were asked, they were more likely to accept an answer than to challenge it.
20. Management did not accept the role and importance of internal audit and did not appropriately follow-up on issues identified.
21. Senior management failed to receive timely and regular tracking reports that indicated critical issues and the subsequent corrective actions taken by management.

Source: Supervisory Lessons Learned from Internal Control Failures, Appendix II, Framework for Internal Control Systems in Banking Organizations, Basle Committee on Banking Supervision, Basle, September 1998. (www.bis.org/publ/bcbs40.htm)

**Basel Committee on Banking Supervision
Sound Practices for the Management and Supervision
of Operational Risk
February 2003**

Developing an Appropriate Risk Management Environment

Principle 1: The board of directors should be aware of the major aspects of the bank's operational risks as a distinct risk category that should be managed, and it should approve and periodically review the bank's operational risk management framework. The framework should provide a firm-wide definition of operational risk and lay down the principles of how operational risk is to be identified, assessed, monitored, and controlled/mitigated.

Principle 2: The board of directors should ensure that the bank's operational risk management framework is subject to effective and comprehensive internal audit by operationally independent, appropriately trained and competent staff. The internal audit function should not be directly responsible for operational risk management.

Principle 3: Senior management should have responsibility for implementing the operational risk management framework approved by the board of directors. The framework should be consistently implemented throughout the whole banking organisation, and all levels of staff should understand their responsibilities with respect to operational risk management. Senior management should also have responsibility for developing policies, processes and procedures for managing operational risk in all of the bank's material products, activities, processes and systems.

Risk Management: Identification, Assessment, Monitoring and Mitigation/Control

Principle 4: Banks should identify and assess the operational risk inherent in all material products, activities, processes and systems. Banks should also ensure that before new products, activities, processes and systems are introduced or undertaken, the operational risk inherent in them is subject to adequate assessment procedures.

Principle 5: Banks should implement a process to regularly monitor operational risk profiles and material exposures to losses. There should be regular reporting of pertinent information to senior management and the board of directors that supports the proactive management of operational risk.

Principle 6: Banks should have policies, processes and procedures to control and/or mitigate material operational risks. Banks should periodically review their risk limitation and control strategies and should adjust their operational risk profile accordingly using appropriate strategies, in light of their overall risk appetite and profile.

Principle 7: Banks should have in place contingency and business continuity plans to ensure their ability to operate on an ongoing basis and limit losses in the event of severe business disruption.

Role of Supervisors

Principle 8: Banking supervisors should require that all banks, regardless of size, have an effective framework in place to identify, assess, monitor and control/mitigate material operational risks as part of an overall approach to risk management.

Principle 9: Supervisors should conduct, directly or indirectly, regular independent evaluation of a bank's policies, procedures and practices related to operational risks. Supervisors should ensure that there are appropriate mechanisms in place which allow them to remain apprised of developments at banks.

Role of Disclosure

Principle 10: Banks should make sufficient public disclosure to allow market participants to assess their approach to operational risk management.

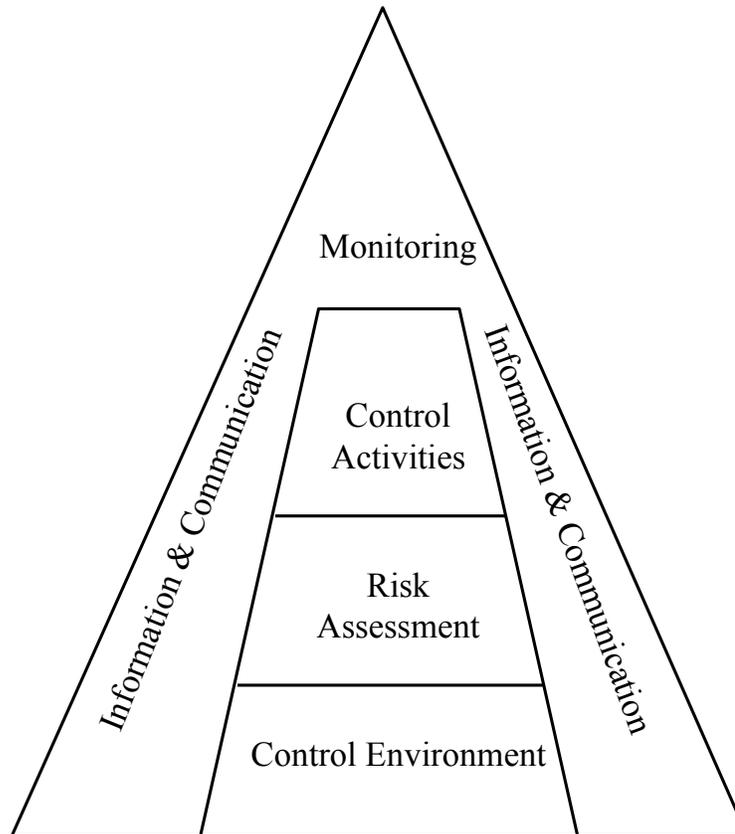
Source: Basel Committee, Bank for International Settlements, Sound Practices for the Management and Supervision of Operational Risk, February 2003, www.bis.org/publ/bcbs96.htm

Attachment 4

Control Models

COSO FINAL SEPTEMBER 1992

The Model



The Definition

Internal control is a process, effected by an entity's board of directors, management and other personnel, designated to provide reasonable assurance regarding the achievement of objectives in the following categories:

- *Effectiveness and efficiency of operations.*
- *Reliability of financial reporting.*
- *Compliance with applicable laws and regulations.*

The control environment provides an atmosphere in which people conduct their activities and carry out their control responsibilities. It services as the foundation for the other components. Within this environment, management assesses risks to the achievement of specified objectives. Control activities are implemented to help ensure that management directives to address the risks are carried out. Meanwhile, relevant information is captured and communicated throughout the organization. The entire process is monitored and modified as conditions warrant.

COSO 1992 (U.S.)

<p>1. CONTROL ENVIRONMENT</p> <p>1.1 Integrity and Ethical Values 1.2 Commitment to Competence 1.3 Board of Directors/Audit Committee 1.4 Management Philosophy and Operating Style 1.5 Organization Structure 1.6 Assignment of Authority and Responsibility 1.7 Human Resource Policies and Practices</p> <p>2. RISK ASSESSMENT</p> <p>2.1 Entity-Wide Objectives 2.2 Activity-Level Objectives 2.3 Risk Identification 2.4 Change Management</p> <p>3. CONTROL ACTIVITIES</p> <p>3.1 Top Level Reviews 3.2 Direct Functional or Activity Management 3.3 Information Processing 3.4 Physical Controls</p>	<p>3. CONTROL ACTIVITIES (CONT'D)</p> <p>3.5 Performance Indicators 3.6 Segregation of Duties 3.7 Controls Over Information Systems</p> <ul style="list-style-type: none"> • Data Centre • Application Development & Maintenance • System Software • Access Security • Application Controls <p>4. INFORMATION AND COMMUNICATION</p> <p>4.1 Information 4.2 Communication</p> <p>5. MONITORING</p> <p>5.1 Ongoing Monitoring 5.2 Separate Evaluations 5.3 Reporting Deficiencies</p>
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NOTE:

The subpoints noted under each category heading are derived from the narrative in the COSO Framework volume. COSO does not attempt to list specific subelements in the framework for each category but does provide detailed criteria for each category posed as questions.

COSO Enterprise Risk Management Conceptual Framework - Expected April 2003

Conceptual Framework - Key Concepts

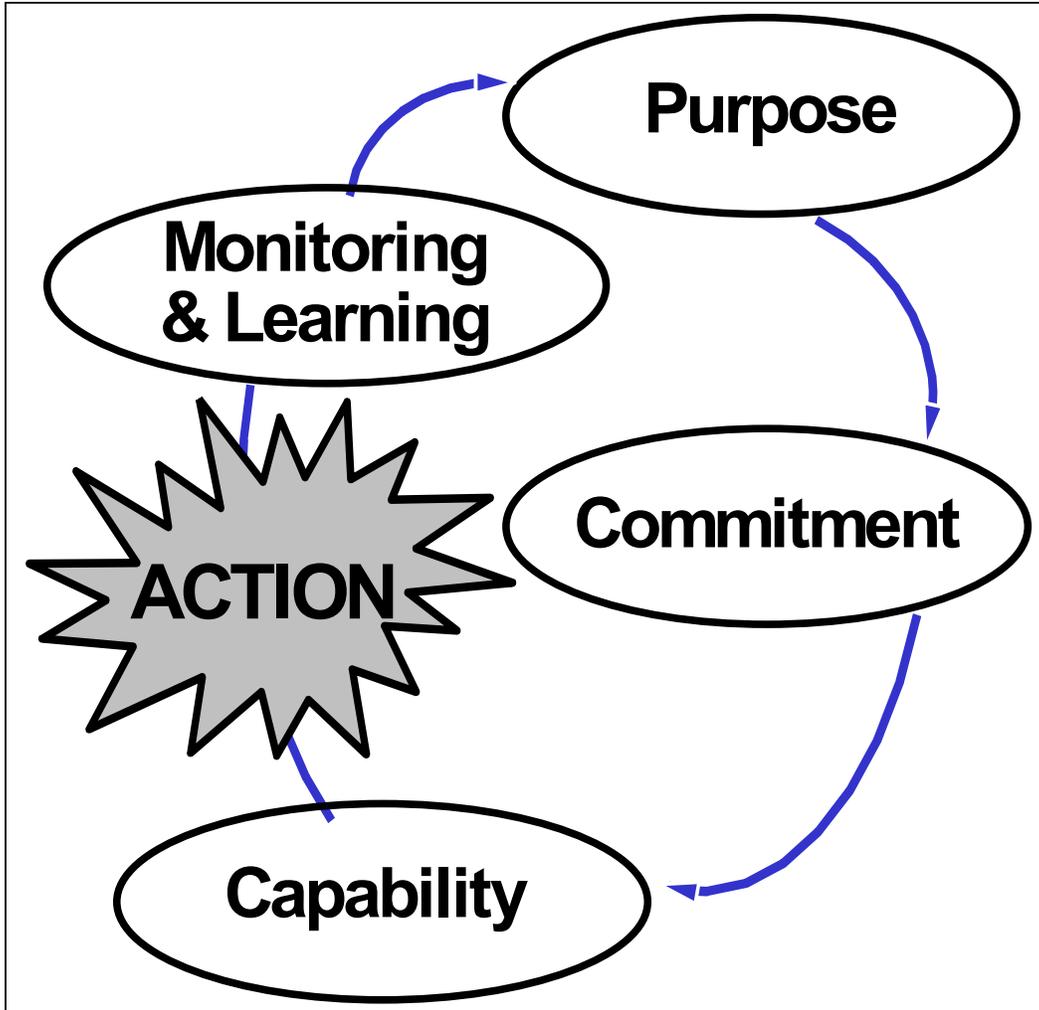
1. Internal Environment
2. Event Identification
3. Risk Assessment
4. Risk Response
5. Control Activities
6. Information and Communication
7. Monitoring
8. Limitations
9. Roles and Responsibilities

Draft Enterprise Risk Management definition

..... a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise designed to identify and manage potential events that may affect the entity and to provide reasonable assurance regarding the achievement of entity objectives.

SOURCE: COSO presentation, GAM Conference Orlando, Florida, March 2003

CoCo SEPTEMBER 1995



Reproduced with permission from the Canadian Institute of Chartered Accountants.

CoCo SEPTEMBER 1995 IN CANADA

Exhibit B - The Criteria

PURPOSE

- A1 Objectives should be established and communicated.
- A2 The significant internal and external risks faced by an organization in the achievement of its objectives should be identified and assessed.
- A3 Policies designed to support the achievement of an organization's objectives and the management of its risks should be established, communicated and practised so that people understand what is expected of them and the scope of their freedom to act.
- A4 Plans to guide efforts in achieving the organization's objectives should be established and communicated.
- A5 Objectives and related plans should include measurable performance targets and indicators.

COMMITMENT

- B1 Shared ethical values, including integrity, should be established, communicated and practised throughout the organization.
- B2 Human resource policies and practices should be consistent with an organization's ethical values and with the achievement of its objectives.
- B3 Authority, responsibility and accountability should be clearly defined and consistent with an organization's objectives so that decisions and actions are taken by the appropriate people.
- B4 An atmosphere of mutual trust should be fostered to support the flow of information between people and their effective performance toward achieving the organization's objectives.

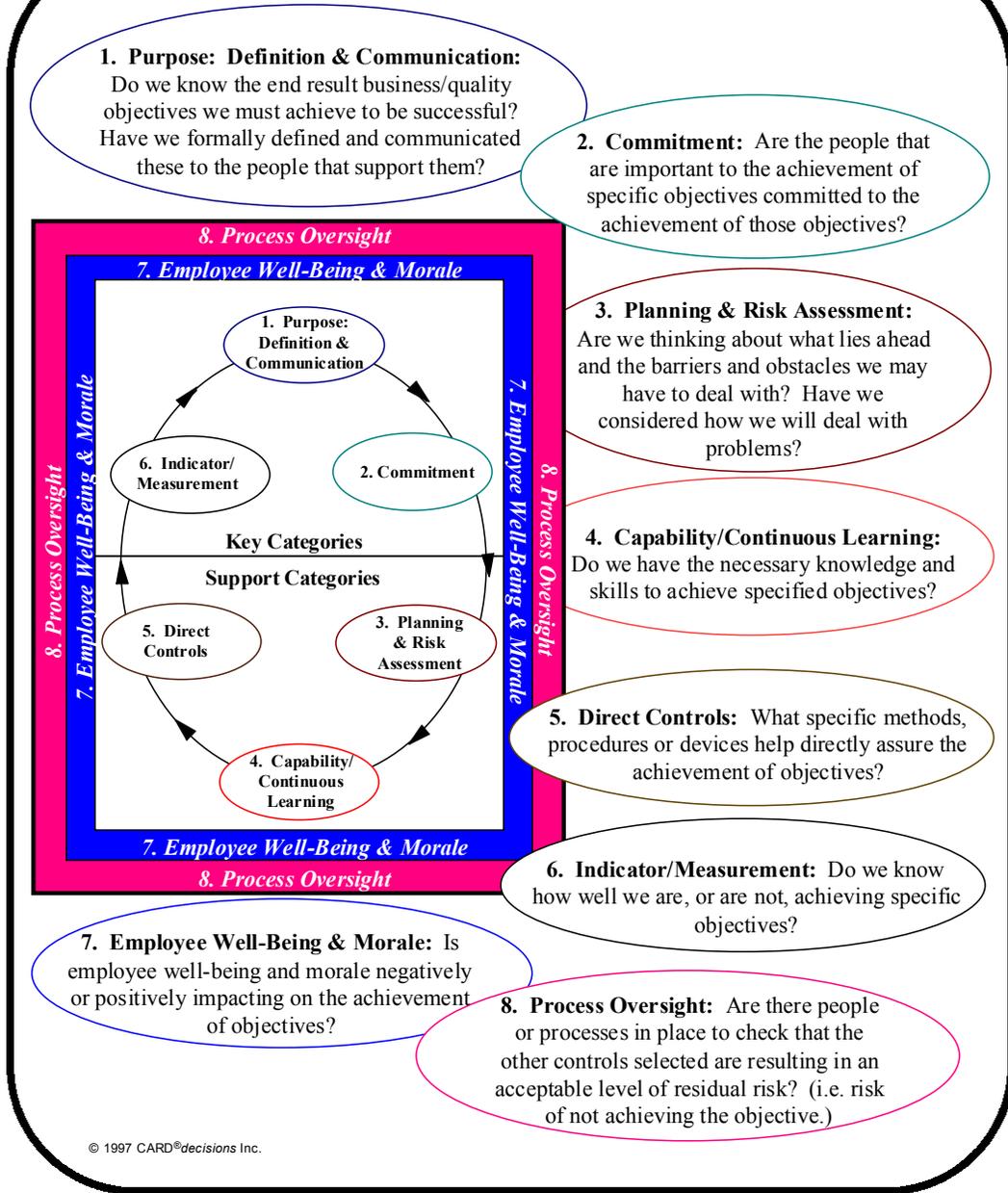
CAPABILITY

- C1 People should have the necessary knowledge, skills and tools to support the achievement of the organization's objectives.
- C2 Communication processes support the organization's values and the achievement of its objectives.
- C3 Sufficient and relevant information should be identified and communicated in a timely manner to enable people to perform their assigned responsibilities.
- C4 The decisions and actions of different parts of the organization should be coordinated.
- C5 Control activities should be designed as an integral part of the organization, taking into consideration its objectives, the risks to their achievement, and the inter-relatedness of control elements.

MONITORING AND LEARNING

- D1 External and internal environments should be monitored to obtain information that may signal a need to re-evaluate the organization's objectives or control.
- D2 Performance should be monitored against the targets and indicators identified in the organization's objectives and plans.
- D3 The assumptions behind an organization's objectives and systems should be periodically challenged.
- D4 Information needs and related information systems should be reassessed as objectives change or as reporting deficiencies are identified.
- D5 Follow-up procedures should be established and performed to ensure appropriate change or action occurs.
- D6 Management should periodically assess the effectiveness of control in its organization and communicate the results to those to whom it is accountable.

CARD[®]model



NOTE: The first version of this control framework was developed in 1986 at Gulf Canada Resources. It has undergone numerous revisions over the years based on feedback from internal and external auditors, work unit personnel and senior management around the world. The next version release is scheduled for May 2003. This framework and the sub-elements shown on the next page are "Freeware" and are available for use by the general public with attribution to CARD[®]decisions. CARD[®]model is acknowledged as a practical and leading international framework in IIA publications "Control Self-Assessment: A Practical Guide", pages 34 and 35 and "Implementing the Professional Practices Framework", pages 141 to 143.

CARD[®]menu

- | | |
|---|---|
| <p>1. PURPOSE: DEFINITION & COMMUNICATION</p> <p>1.1 Definition of Corporate Mission & Vision</p> <p>1.2 Definition of Entity Wide Objectives</p> <p>1.3 Definition of Unit Level Objectives</p> <p>1.4 Definition of Activity Level Objectives</p> <p>1.5 Communication of Business/Quality Objectives</p> <p>1.6 Definition and Communication of Corporate Conduct Values and Standards</p> <p>2. COMMITMENT</p> <p>2.1 Accountability/Responsibility Mechanisms</p> <p>2.1a Job Descriptions</p> <p>2.1b Performance Contracts/Evaluation Criteria</p> <p>2.1c Budgeting/Forecasting Processing</p> <p>2.1d Written Accountability Acknowledgements</p> <p>2.1e Other Accountability/Responsibility Mechanisms</p> <p>2.2 Motivation/Reward/Punishment Mechanisms</p> <p>2.2a Performance Evaluation System</p> <p>2.2b Promotion Practices</p> <p>2.2c Firing and Discipline Practices</p> <p>2.2d Reward Systems - Monetary</p> <p>2.2e Reward Systems - Non-Monetary</p> <p>2.3 Organization Design</p> <p>2.4 Self-Assessment/Risk Acceptance Processes</p> <p>2.5 Officer/Board Level Review</p> <p>2.6 Other Commitment Controls</p> <p>3. PLANNING & RISK ASSESSMENT</p> <p>3.1 Strategic Business Analysis</p> <p>3.2 Short, Medium and Long Range Planning</p> <p>3.3 Risk Assessment Processes - Macro Level</p> <p>3.4 Risk Assessment Processes - Micro Level</p> <p>3.5 Control & Risk Self-Assessment</p> <p>3.6 Continuous Improvement & Analysis Tools</p> <p>3.7 Systems Development Methodologies</p> <p>3.8 Disaster Recovery/Contingency Planning</p> <p>3.9 Other Planning & Risk Assessment Processes</p> <p>4. CAPABILITY/CONTINUOUS LEARNING</p> <p>4.1 Knowledge/Skills Gap Identification and Resolution Tools/Processes</p> <p>4.2 Self-Assessment Forums & Tools</p> <p>4.3 Coaching/Training Activities & Processes</p> <p>4.4 Hiring and Selection Procedures</p> <p>4.5 Performance Evaluation</p> <p>4.6 Career Planning Processes</p> <p>4.7 Firing Practices</p> <p>4.8 Reference Aids</p> <p>4.9 Other Training/Education Methods</p> | <p>5. DIRECT CONTROLS</p> <p>5.1 Direct Controls Related to Business Systems</p> <p>5.2 Physical Safeguarding Mechanisms</p> <p>5.3 Reconciliations/Comparisons/Edits</p> <p>5.4 Validity/Existence Tests</p> <p>5.5 Restricted Access</p> <p>5.6 Form/Equipment Design</p> <p>5.7 Segregation of Duties</p> <p>5.8 Code of Accounts Structure</p> <p>5.9 Other Direct Control Methods, Procedures, or Things</p> <p>6. INDICATOR/MEASUREMENT</p> <p>6.1 Results & Status Reports/Reviews</p> <p>6.2 Analysis: Statistical/Financial/Competitive</p> <p>6.3 Self-Assessments/Direct Report Audits</p> <p>6.4 Benchmarking Tools/Processes</p> <p>6.5 Customer Survey Tools/Processes</p> <p>6.6 Automated Monitoring/Reporting Mechanisms & Reports</p> <p>6.7 Integrity Concerns Reporting Mechanisms</p> <p>6.8 Employee/Supervisor Observation</p> <p>6.9 Other Indicator/Measurement Controls</p> <p>7. EMPLOYEE WELL-BEING & MORALE</p> <p>7.1 Employee Surveys</p> <p>7.2 Employee Focus Groups</p> <p>7.3 Employee Question/Answer Vehicles</p> <p>7.4 Management Communication Processes</p> <p>7.5 Personal and Career Planning</p> <p>7.6 Diversity Training/Recognition</p> <p>7.7 Equity Analysis Processes</p> <p>7.8 Measurement Tools/Processes</p> <p>7.9 Other Well-Being/Morale Processes</p> <p>8. PROCESS OVERSIGHT</p> <p>8.1 Manager/Officer Monitoring/Supervision</p> <p>8.2 Internal Audits</p> <p>8.3 External Audits</p> <p>8.4 Specialist Reviews & Audits</p> <p>8.5 ISO Review/Regulator Inspections</p> <p>8.6 Audit Committee/Board Oversight</p> <p>8.7 Self-Assessment Quality Assurance Reviews</p> <p>8.8 Authority Grids/Structures & Procedures</p> <p>8.9 Other Process Oversight Activities</p> |
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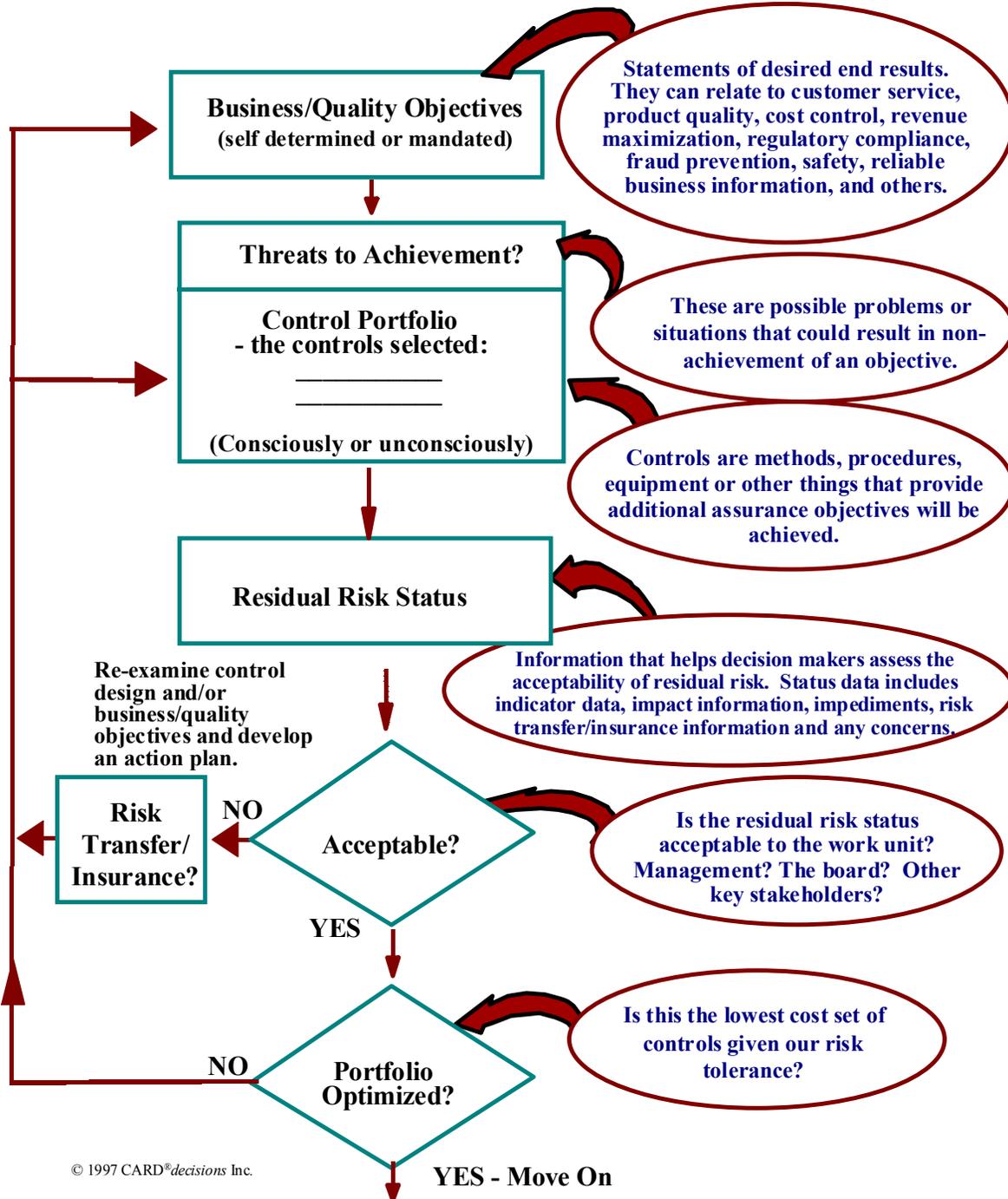
Attachment 5

Risk Source Models

AS/NZS 4360: 1999 D2	AS/NZS 4360: 1999 D5
<ol style="list-style-type: none"> 1. Commercial and legal relationships 2. Economic circumstances 3. Human behaviour 4. Natural events 5. Political circumstances 6. Technology and technical issues 7. Management activities and controls 8. Individual activities 	<ol style="list-style-type: none"> 1. Diseases 2. Economic 3. Environmental 4. Financial 5. Human 6. Natural hazards 7. Occupational health and safety 8. Product liability 9. Professional liability 10. Property damage 11. Public liability 12. Security 13. Technological

CARD[®] decisions Risk Source Framework	
<ol style="list-style-type: none"> 1. Commercial/Legal 2. Competition 3. Control Design 4. Customers 5. Employees 6. Environmental Liability 7. Equipment/Technology 8. Finance/Economic 	<ol style="list-style-type: none"> 9. Fraud/Corruption 10. Human Behaviour 11. Missing Objectives 12. Natural Events 13. Political Influences 14. Product/Service Liability 15. Public Perception 16. Suppliers

Attachment 6



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Attachment 7

Risk Management Capability Assessment Criteria

<p>1. Risk Assessment</p> <p>How do you identify and measure the threats/risks that could impact on the achievement of your business objectives?</p>	<p>SCORE:</p> <div style="border: 1px solid black; width: 40px; height: 40px; margin: 0 auto; display: flex; align-items: center; justify-content: center;"> / 10 </div>
<p>2. Control Assessment</p> <p>How healthy are your control frameworks? How long has it been since you evaluated their effectiveness?</p>	<p>SCORE:</p> <div style="border: 1px solid black; width: 40px; height: 40px; margin: 0 auto; display: flex; align-items: center; justify-content: center;"> / 10 </div>
<p>3. Control Cost Optimization</p> <p>Could you eliminate some controls and still have an acceptable residual risk level at a lower overall cost?</p>	<p>SCORE:</p> <div style="border: 1px solid black; width: 40px; height: 40px; margin: 0 auto; display: flex; align-items: center; justify-content: center;"> / 10 </div>
<p>4. Risk Testing the Future</p> <p>Do you consider and evaluate risks when making important business decisions and preparing strategic plans?</p>	<p>SCORE:</p> <div style="border: 1px solid black; width: 40px; height: 40px; margin: 0 auto; display: flex; align-items: center; justify-content: center;"> / 10 </div>
<p>5. Planning for Serious Risk Situations</p> <p>Do you have contingency plans in place to deal with low probability, high risk situations that could cripple your unit or the company? Do you periodically revisit these plans to reassess their adequacy?</p>	<p>SCORE:</p> <div style="border: 1px solid black; width: 40px; height: 40px; margin: 0 auto; display: flex; align-items: center; justify-content: center;"> / 10 </div>
<p>6. Worst Case Scenarios</p> <p>Have you considered the possibility of high risk situations which, if they occurred together, could have a devastating effect on the company?</p>	<p>SCORE:</p> <div style="border: 1px solid black; width: 40px; height: 40px; margin: 0 auto; display: flex; align-items: center; justify-content: center;"> / 10 </div>

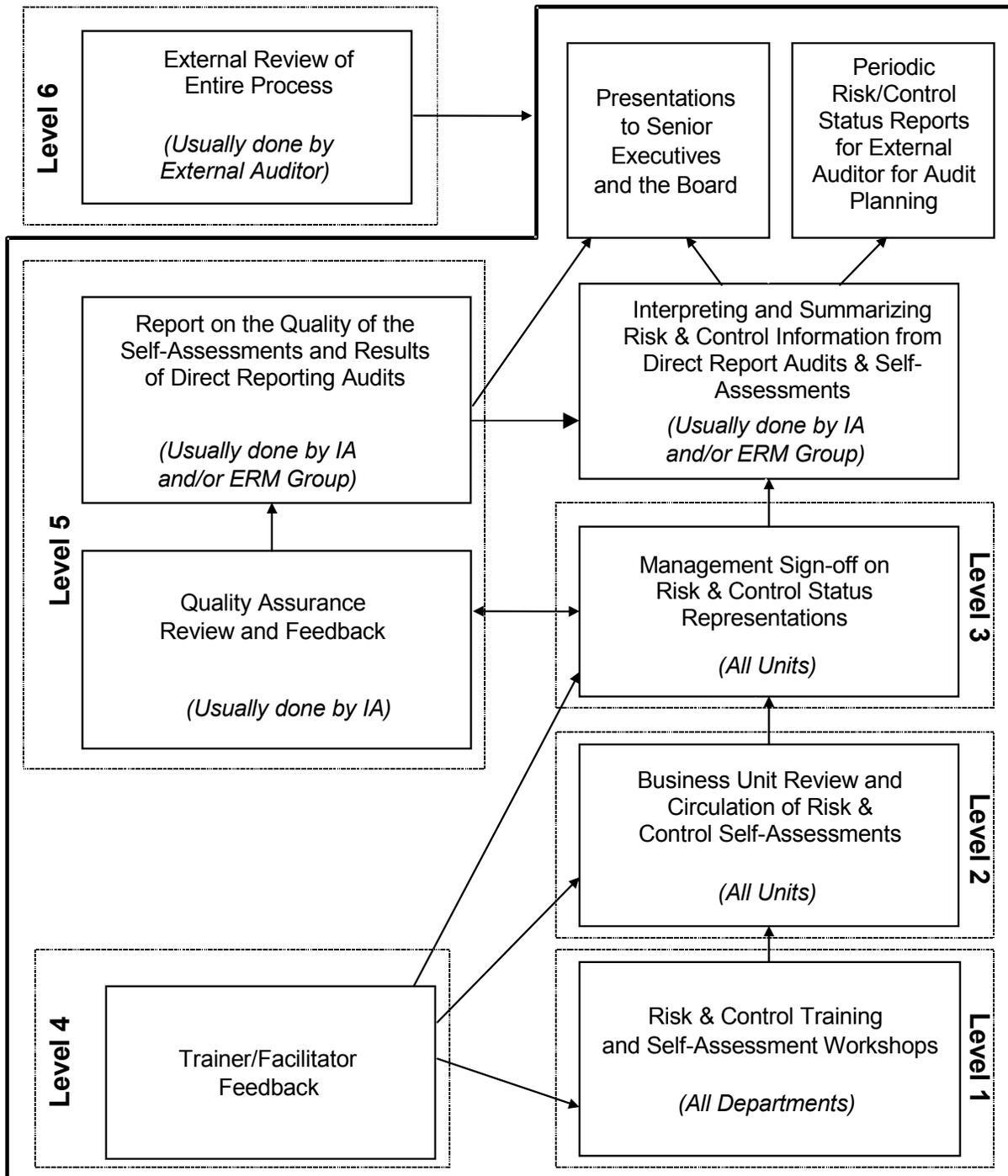
<p>7. Early Warning Systems</p> <p>Do you regularly monitor your risk status for early warning signs that changes are needed to your controls and/or objectives?</p>	<p>SCORE:</p> <p></p>
<p>8. Risk Transfer/Financing Options</p> <p>Have you considered risk transfer and insurance options available to avoid or reduce the consequences of specific threats/risks to your business objectives?</p>	<p>SCORE:</p> <p></p>
<p>9. Regular Reevaluation</p> <p>Do you periodically reassess the acceptability of your risk acceptance decisions?</p>	<p>SCORE:</p> <p></p>
<p>10. Oversight Process</p> <p>Does Senior Management and the Board of Directors understand the major risks the company faces and take steps to ensure work units are identifying, measuring, controlling and monitoring risks?</p>	<p>SCORE:</p> <p></p>
<p style="text-align: right;">TOTAL RISK FITNESS SCORE: </p>	

Note: This CARD[®] *decisions* risk management evaluation tool is recognized as an emerging best practice tool in the IIA publication "Implementing the Professional Practices Framework" on page 126. The new IIA professional standards require Internal Auditors evaluate their company's risk management system. On page 100 the IIA Professional Standards Guide states:

The new Implementation Standard 2110 A1 makes it clear internal auditors should review the risk management system as part of their assurance activities for the board and senior management. This represents new territory for most internal audit shops. Few organizations have established processes for assuring the adequacy and effectiveness of risk management procedures.

Attachment 8

SOX 302/404 Quality Assurance Strategies



Sarbanes-Oxley Key Result Areas Regarding Risk & Control

1. Ensure senior management and the Board are provided with timely and reliable information on the state of risk and control to meet SOX sections 302 and 404.
2. Ensure the company's external auditor is provided with reliable information on the state of risk and control and, specifically, the level of variability/error in the processes that support external accounting disclosures.

6 Quality Assurance Levels That Provide Assurance That Self-Assessment Representations Are Reliable

Level 1 Quality Assurance - During the Workshop From the Group and the Facilitator

Level 2 Quality Assurance - During the Business Unit's Review of Results Developed in Self-Assessment Workshops

Level 3 Quality Assurance - During the Consensus Sign-off of Self-Assessment Results by Work Unit Senior Management

Level 4 Quality Assurance - Through Feedback on Quality From the Self-Assessment Trainers/Facilitators

Level 5 Quality Assurance - Through an Independent Review Including Testing of the Self-Assessment representations and the Feedback/Reporting/Coaching Process (usually done by Internal Audit)

Level 6 Quality Assurance - Through an Independent Review of the Entire Risk & Control Assessment and Reporting Process done by the Company's External Auditor.

Attachment 9

Sample Management Representation to Audit Committee

We, the undersigned, acknowledge to the Audit Committee that we have:

- (1) *Responsibility for developing and maintaining internal controls and disclosure controls that provide reasonable assurance that ABC's financial statements and supplemental SEC disclosures present fairly the results of operation and the financial position of ABC Inc. in accordance with generally accepted accounting principles and other applicable SEC regulation.*
- (2) *Responsibility for overseeing that the organization has cost effective risk and control management systems that provide reasonable assurance ABC's external disclosure objectives will be achieved.*
- (3) *Reviewed the significant control and risk issues identified by work units and management through the company's risk and control self-assessment process, and the significant issues identified by our Internal Audit department and our External Auditor, Smith & Jones, that have been brought to our attention. We have initiated steps to adjust controls in areas where the error rates and/or residual risks identified related to the non-achievement of ABC's disclosure objectives were considered to be excessive and/or unacceptable.*
- (4) *Reviewed our process to manage risk and control and this year's report on our risk management process prepared by our Internal Audit for the Audit Committee. We are satisfied that our risk and control assessment framework process provides you, our Audit Committee, and our External Auditors, Smith & Jones, with a reliable and materially complete report on the status of risk and controls related to our external disclosure objectives as required by sections 302 and 404 of the Sarbanes-Oxley Act of 2002.*

CEO

CFO

Attachment 10

What's Wrong with the Status Quo? - Detailed Comments

1. CORPORATE SECTOR RESISTANCE TO CONTROL REPRESENTATIONS

Proposals have been made by the SEC since 1979 calling for representations on the reliability of control systems from senior management with a report to stakeholders on the reliability of management's assessment from their external auditors. These proposals were routinely defeated as a result of the significant power of various lobby groups in the U.S. A central argument against the proposed representation requirements was that the business community was taking steps to reform and additional regulatory burden was unnecessary, and/or the Foreign Corrupt Practices Act was already doing the job. Unfortunately, it is my observation that many of these lobby groups were far more interested in entrenched self-interests than maintaining the confidence of the investment community and long-term viability of capital markets. It is unfortunate that necessary changes to corporate governance regimes have had to be imposed on the business community by regulators, instead of being self generated by internal and external professional institutes. A central tenant of being a professional is to place the interests of your client ahead of your personal interests. There appears to have been widespread confusion in the internal and external audit professions on who is their primary client.

2. OPINING ON WHETHER CONTROL IS "ADEQUATE"

Colossal and recurring external auditor failures around the world regularly demonstrate the difficulty of providing opinions on the reliability of financial statements. Positive audit opinions are regularly issued on materially false financial disclosures in spite of the fact that the U.S. has developed thousands of pages of rules on how they should be prepared to "fairly" present the company's financial status. The difficulty of providing an opinion or an assertion that internal control is "adequate" or "effective" to ensure the reliability of external financial disclosures is exponentially greater. There are very few guidelines to help auditors decide when there are "adequate" internal controls. Field research done by CARD[®] *decisions* with hundreds of groups of senior level internal audit and management personnel has consistently demonstrated that, given the exact same circumstances in a case situation, few groups and few individuals in those groups agree on the combination of control elements from a predetermined control design menu that would provide an "effective" or "adequate" level of control. This is true

in spite of the fact that internal audit departments around the world routinely give opinions to clients on whether the clients' internal controls are "adequate". It takes very little applied research to demonstrate conclusively that audit opinions on what constitutes an "adequate" level of control involve a huge amount of highly subjective judgment. These findings suggest that reporting these highly subjective opinions on whether controls are "adequate" or "effective" to key stakeholders does not meet the goals of comparability, reliability, and repeatability, key criteria for sound assurance and audit methods.

3. INABILITY OF EXISTING CONTROL ASSESSMENT TOOLS TO PREDICT DISASTER

In hundreds, if not thousands of cases, internal auditors around the world have reported to senior management and audit committees that controls in a company or sub-unit of a company are "adequate" or "effective". Massive control failures, some causing the complete demise of major companies, have occurred in organizations shortly after positive assurance reports were delivered. Few, if any, attempts have been made by the Institute of Internal Auditors or American Institute of Certified Public Accountants, or any other professional or research group I am aware of to study why the internal risk and control assessment approaches and tools used by auditors in these organizations failed to identify and predict these massive failures. There is no empirical evidence at this point that the auditor opinion success rate is any higher in companies where the auditors use control criteria to form their opinions, such as COSO, the U.S. control model, or CoCo the Canadian control model, than those companies where auditors making "modelless" control status representations and/or opinions.

4. LIMITED COVERAGE OF THE TOTAL RISK UNIVERSE

The majority of formal, documented risk and control assessment work has historically been prepared by auditors and/or external consultants. This analysis usually only covers a small fraction of the total universe of end result financial statement objectives and processes in any given year, let alone, each quarter. Very few organizations today can demonstrate that they have documented the risks, controls and process variability related to all key processes that feed the Disclosure Staging Area shown on page 6. Even fewer companies have demonstrable and reliable self-assessment regimes in place to ensure that these processes are being monitored on a quarterly basis to determine if they are producing reliable product to feed the Disclosure Staging Area - a key requirement of SOX sections 302 and 404.

5. **NOT LOOKING IN THE RIGHT PLACES**

As a general statement, internal auditors have historically done very little work to assess the quality of controls in the Disclosure Staging Area shown on page 6. This is true in spite of the fact that history tells us that many of the biggest financial reporting failures in history occurred in the Disclosure Staging Area. Primary reasons cited by Internal Auditors for not focusing assessment efforts on this area are that it would overlap with work done by the External Auditor, they lack staff with current knowledge of Generally Accepted Accounting Principles ("GAAP") and SEC disclosure rules, and/or they have been told by the CFO not to examine the processes used to produce external disclosures. In many companies, the head of Internal Audit reports to the CFO. Examining and reporting problems in the Disclosure Staging Area would mean reporting deficiencies in processes owned and/or controlled by the CFO and, in some severe cases, ethics/integrity problems related to the activities of their boss (e.g. Enron, WorldCom, HealthSouth, etc). It doesn't take a genius to know that reporting your boss is "Integrity Challenged/A Crook" would be a CLM – a Career Limiting Move.

6. **NO REWARDS FOR DISCLOSING THE TRUTH**

The SOX requirement that there must be a process in place to report significant deficiencies in internal control upwards to external auditors and the audit committee is generally inconsistent with the culture of "catch me if you can" that has evolved in many companies. There are few rewards in most companies for work units that tell internal or external auditors problems they are aware of with the current reliability of risk and control management processes. Major culture changes are usually necessary to encourage work units to report bad news. In many companies these culture changes have not occurred. In case after case of major corporate reporting failures, the Board of Directors, CEO and CFO are claiming they didn't know what was going on. Over the course of my career I have heard more than one U.S. Chief Legal Counsel state categorically, "There is no way we want the CEO and/or Board knowing about those problems". The Richard Nixon "plausible deniability" principle is still a cornerstone in more than a few companies as a result of direct advice from their legal advisors. In cases where the CEO, CFO and Board genuinely didn't know what was going on in their companies, this was virtually assured by the design of the corporate reward/business systems they established.

7. **EXTERNAL AUDIT METHODOLOGIES**

In the late 70s when I was training to be an external auditor with Coopers & Lybrand we were taught that we must evaluate controls over the key processes that contribute to the financial statements. This activity had to be documented with interview and flowcharts. We had to identify the "key controls" in those processes, the controls essential to ensuring the reliability of the information being produced, for testing and evaluation. As time went by, the emphasis placed by external audit

firms on documenting and evaluating the control environment and processes that feed the financial statements, and the training costs, time, and fees that it required, came under heavy pressure from clients that wanted lower external audit fees. The goal of many companies was to get the cheapest possible signature on the financial statements that could be obtained from a major accounting firm with a globally recognized name (i.e. the "cheapest possible signature"). To accomplish this, the major external audit firms moved to approaches that placed more emphasis on testing of balance sheet balances and analysis of financial ratios and less emphasis on attempting to evaluate the likely reliability of the processes and control environment that produce the numbers. This transition away from formal, documented risk and control evaluation occurred in spite of the fact that the complexity of the business environments, and the dependency on computer systems that create the numbers in external disclosures, increased exponentially. Many new external auditors trained in the 1990s received only limited training on how to formally assess risks and controls in the business processes that support the many financial statement disclosure line items and supplemental disclosures. Little effort appears to have been expended anywhere in the world to empirically study the specific external audit methods in use today to critically gauge their predictive ability (i.e. back test failures to examine the reliability of vulnerability analysis done by external auditors during the planning stage). Access to the information necessary to complete this type of study would likely be blocked or severely restricted by legal advisors of external audit firms concerned with litigation exposure unless there was strong regulatory support for such a study.

8. INTERNAL AND EXTERNAL AUDITORS, STANDARD SETTERS, AND REGULATORS IGNORE BREAKTHROUGHS IN QUALITY MANAGEMENT

Over the past 20 years major advances have been made in the area of process quality control and assurance. Frameworks such as ISO 9000, Malcolm Baldrige and Six Sigma teach people to focus on process reliability and reducing process variability and error. The focus in these systems is on identifying and controlling process variability and driving down error and rework. Although financial disclosures are nothing more than the sum of the reliability of dozens of sub-processes, the tremendous advances in quality thinking have been largely ignored by the key players involved in seeking and providing assurance on external financial disclosures, and the professional bodies and regulators who oversee these activities. The Basel Capital Accord reforms in the banking sector constitute the first signs of hope in this area. The Sarbanes-Oxley legislation does not appear to explicitly recognize these quality principles.

9. INTERNAL AND EXTERNAL AUDITORS, STANDARD SETTERS AND REGULATORS IGNORE BREAKTHROUGHS IN RISK MANAGEMENT

In 1995 the Australian/New Zealand Standard on Risk Management [AS/NZS 4360], was released. It is credited with playing a key role in shifting the emphasis from a focus on controls compliance to a focus on management of risks

to business objectives and/or processes. The core elements of risk management are shown in Attachment 6 to this paper. A central element of the risk management movement is that assessments should start with seeking clarity on the outcome(s) sought, examine risks that threaten the achievement of the outcome(s) and then, and only then, examine the existence and quality of "Risk Treatment", the selection and implementation of appropriate control options for dealing with risk. Although the Basel bank governance reforms have clearly recognized that a risk focus is far superior to a fixation on controls compliance (see Attachment 3 page 3), there is very little recognition in SOX that the emphasis should be on evaluating and reporting on the quality of an organization's risk identification, measurement and mitigation strategies related to reliable financial disclosures. While some might argue that evaluating the "adequacy" of internal controls implicitly considers, and must include, evaluating the risks and the objectives to be achieved, there are important and significant differences.

10. INDIFFERENT AND NON DISCRIMINATING CUSTOMERS

Over the years I have worked with hundreds of large companies all over the world on risk and assurance assignments. In more than a few of these companies, senior management and audit committees showed very little interest in understanding and critically evaluating the quality of the assurance products and services delivered by internal and external auditors. High quality assurance products and services often received the exact same reaction from senior executives and Audit Committees as extremely poor quality assurance products and services. After observing this disconcerting phenomenon in scores of major listed public companies, I can only conclude that the senior management and audit committees in those companies either didn't care what they received in the way of assurance products or services, and/or couldn't recognize a good product and service from a bad one. Indifferent customers do not drive continuous improvement and promote the evolution of high quality assurance products and services

Attachment 11

Contrasting Traditional Assurance Strategies and ERAM

<u>Historical/Traditional</u>	<u>The New Vision</u>
<ul style="list-style-type: none"> • Assign Duties/Supervise Staff • Policy/Rule Driven • Limited Employee Participation and Training • Narrow Stakeholder Focus • Auditors and Other Specialists are the Primary Control Analysts/Reporters 	<ul style="list-style-type: none"> • Empowered/Accountable Employees • Continuous Improvement/learning Culture • Extensive Employee Participation and Training • Broad Stakeholder Focus • Staff at all levels, in all functions, are the Primary Control Analysts/Reporters
MANAGEMENT AND STAFF - HISTORICAL/TRADITIONAL	MANAGEMENT AND STAFF - THE NEW VISION
<ul style="list-style-type: none"> • Are responsible for complying with prescribed methods and procedures. • Receive limited training on control and quality assessment and design. • Often consider auditors, consultants, and other specialists to be the experts on control and quality systems and design. • Outside specialists are often called in to analyze areas where concerns and/or problems exist. • Are often not allowed or encouraged at lower levels to analyze and make decisions relating to risk acceptance or control design. • The personnel doing the work are often not directly responsible for selecting the controls used that help assure that their business/quality objectives are achieved. • Candidness and full disclosure on the current state of control and risk is not encouraged and is often discouraged and punished. • Fear and blame are sometimes utilized as strategies when problems surface. • Internal control and total quality/continuous improvement are not integrated programs or concepts. 	<ul style="list-style-type: none"> • Are accountable for designing and maintaining control systems that provide the desired level of assurance regarding the achievement of business/quality objectives. • Are provided with adequate risk and control assessment and design skills to properly fulfill their responsibility to report to Officers, the Board, and others on the current status of control, quality and risk. • Consensus at all levels on relevant business/quality objectives and levels of acceptable risk is a primary goal. • Candid disclosure of the state of control and the risks being accepted by the unit/organization is encouraged and rewarded. • Accountability for business/quality objectives exists and is accepted by staff at all levels, in all functions. • Employees at all levels are responsible for finding new and better ways to improve and optimize control portfolios to better achieve key business/quality objectives. • Employees at all levels and in all functions continually reassess the adequacy and appropriateness of control choices and make adjustments when new information emerges regarding risk status, prioritization of objectives, and the control options available. • Control and quality management are considered to be synonymous terms and are fully integrated programs/concepts.

Contrasting Traditional Assurance Strategies and ERAM

<u>Historical/Traditional</u>	<u>The New Vision</u>
<ul style="list-style-type: none"> • Assign Duties/Supervise Staff • Policy/Rule Driven • Limited Employee Participation and Training • Narrow Stakeholder Focus • Auditors and Other Specialists are the Primary Control Analysts/Reporters 	<ul style="list-style-type: none"> • Empowered/Accountable Employees • Continuous Improvement/Learning Culture • Extensive Employee Participation and Training • Broad Stakeholder Focus • Staff at all levels, in all functions, are the Primary Control Analysts Reporters
AUDIT - HISTORICAL/TRADITIONAL	AUDIT - THE NEW VISION
<ul style="list-style-type: none"> • A primary objective is to perform audits and report findings to senior management, and/or external stakeholders. • Relations with auditees are sometimes adversarial. • Auditors are viewed as the control "experts". Control assessment training is directed primarily to auditors and staff specialists. • A primary audit objective is to report on whether units are complying with prescribed controls, procedures and standards. • How auditors decide what constitutes "effective" or "adequate" control frameworks. How much risk is considered acceptable is often not explicitly disclosed. • Auditors are measured primarily on execution of prescribed audit and review processes. • Auditors receive limited training on risk and control design concepts and ways to "optimize" control frameworks. • Internal auditors rarely examine and report on control frameworks related to customer service, product/service quality, safety, environmental compliance, and other "non-financial" areas. • Quality auditors rarely examine or report on regulatory compliance, corporate ethics, fraud prevention and detection or the reliability of management representations to the Board and/or external stakeholders. 	<ul style="list-style-type: none"> • Primary audit objectives are to: <ul style="list-style-type: none"> - raise the risk and control assessment and design skills of all staff; - provide accurate and complete information to the Officers, the Board and external stakeholders on the state of risk and control management systems; - assist staff at all levels to design and maintain better, more optimal risk and control management frameworks. • A key audit role is to foster more effective risk and control management through training, coaching, facilitation, and feedback to staff - unless quality assurance reviews suggest that representations by work units are misleading and the "good faith" assumption is not appropriate. • Auditors help to ensure that the organization's business/quality objectives recognize a range of stakeholders, including customers and regulators, and that operative objectives are consistent with the corporate mission/vision. • Auditors are measured on, and accountable for, achievement of the primary objectives noted above, not on excellent execution of traditional audit processes (i.e. focus on results not activity execution). • Auditors should be skilled and knowledgeable risk and control design analysts and excellent technical auditors. These skills should extend to customer service, product quality, environmental compliance, fraud prevention and detection, and safety, as well as traditional financial reporting objectives.

Ensuring the Reliability of Self-Assessment Results

Section Objective:

This section provides participants with techniques to independently quality assure the reliability of risk and control status representations prepared by work units and senior management.

BACKGROUND

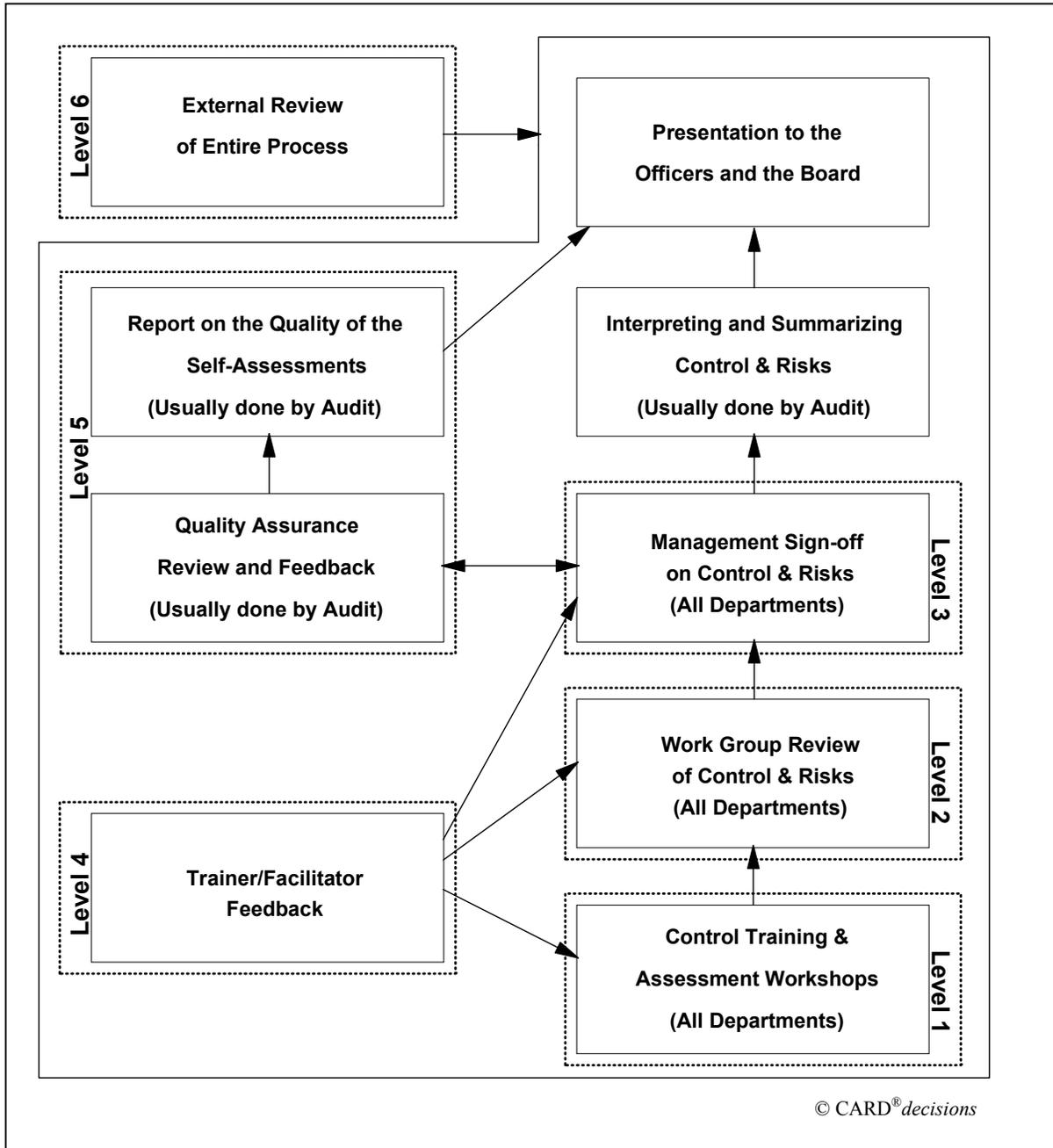
People, when they first learn or hear about self-assessment, frequently ask questions such as:

- How can auditors be involved in self-assessment and still maintain its independence?
- How do we know people are telling the truth in the self-assessment workshops?
- Are audit departments that utilize self-assessment in compliance with the Institute of Internal Auditor standards and standards established by other professional and regulatory bodies?
- Can we trust and rely on results developed through self-assessment workshops and other activities?

This section contains a description of the six level quality assurance framework developed by CARD[®] *decisions* to ensure that, when self-assessment is utilized, senior management and the Board are provided with reliable information on the status of control and risk, and, to provide answers to the questions posed above.

Ensuring the Reliability of Self-Assessment Results

Control & Risk Self-Assessment: Six Levels of Quality Assurance



Ensuring the Reliability of Self-Assessment Results

6 Quality Assurance Levels That Provide Assurance That Self-Assessment Representations Are Reliable

Level 1 Quality Assurance - During the Workshop From the Group and the Trainer

Level 2 Quality Assurance - During the Work Unit's Review of *CARD[®]line* Results Developed in the Workshop

Level 3 Quality Assurance - During the Consensus Sign-off of the *CARD[®]line* Results by Senior Management

Level 4 Quality Assurance - Through Feedback From the Trainers/
Facilitators

Level 5 Quality Assurance - Through an Independent Review Including Testing of the *CARD[®]line* representations and the Feedback/Reporting/Coaching Process

Level 6 Quality Assurance - Through an Independent Review and Feedback/Reporting on the Functioning of the Entire Self-Assessment and Reporting Process

Ensuring the Reliability of Self-Assessment Results

Level 1 Quality Assurance - During The Workshop

Level 1 Q.A. occurs when self-assessment group members themselves provide input and comments when completing the individual assessments. This input assists in developing self-assessments which are accurate and complete. The facilitator also has significant influence over quality through the questions posed and the recording process.

For effective quality assurance of this type to occur the group members must feel comfortable speaking up and contributing during the self-assessment sessions. In some instances this may mean the staff must feel comfortable correcting statements/assertions made by supervisory and management personnel. In other instances it may involve participants amplifying and clarifying statements made by other team members based on that participant's first hand knowledge and experience in the area. The facilitator must be willing to pose questions which encourage the other group members to challenge views presented by team members (e.g. "That's a good point, Sue, how do the rest of you feel about it"?, etc.).

PREREQUISITES FOR EFFECTIVE LEVEL 1 Q.A.

- Good representation of group members at the session - ideally most unit staff attend the session.
- The trainer/facilitator must be properly trained and must set the stage for candidness and open communication through selective use of ice breakers, workshop exercises and material, and effective facilitation skills.
- Management personnel must be willing to refrain from imposing views on the group and must set the stage by indicating that candidness is what is expected and what is required from all participants.
- Domineering, authoritative management may have to be excluded from the session.
- The trainer/facilitator may have to deal with workshop participants who are a negative influence on the group and impeding the group's progress.
- The trainer/facilitator should be knowledgeable about the group's purpose and activities and should be able to get the group to open up by asking probe questions and drawing out attendees who are not contributing.

Ensuring the Reliability of Self-Assessment Results

Level 2 Quality Assurance - During The Work Group's Review

This quality assurance level occurs if the group takes the time after the initial self-assessment size-up to circulate and review the assessments they have done. In cases where a group does take this step, valuable information is often added to the assessments prepared by the group.

This is a particularly important process step in cases where the entire group is not present at the session. Input should be sought from the personnel not present at the session who contribute to the business objective. This step also has the added benefit of providing some training to those who did not participate in the workshop due to time restrictions, distance, vacation, etc.

This process is facilitated if the workshop information has been captured in a groupware database such as *CARD[®]map*. Authorized staff can review session output and add comments or initiate further discussions.

PREREQUISITES FOR EFFECTIVE LEVEL 2 Q.A.

- Willingness of the unit manager/supervisor to share the size-ups and request that staff take the time to review and propose additions/amendments.
- Encouragement/advice from the facilitator to take this step.
- Willingness and commitment of the unit personnel to doing a good job on the self-assessments. This is usually a direct function of the commitment level shown by the senior management team.
- Existence of automated tools that allow for efficient dissemination of *CARD[®]line* information and consideration of comments.

Ensuring the Reliability of Self-Assessment Results

Level 3 Quality Assurance - During Consensus Sign-Off By Senior Management

This quality assurance step occurs when the senior officer (or manager responsible) reviews the self-assessments prepared by the group and discusses the assessments with the group that produced the work. In an ideal situation, the senior manager reaches consensus with the group on the specific objective statements they have developed, and is satisfied that the assessments are consistent with his or her understanding of the controls and procedures.

An area of particular importance at this stage of quality assurance is the senior manager's agreement with the group's risk acceptance decision. Although a senior manager may not be familiar with all of the detailed controls and procedures, they frequently have a sound general understanding of problems and concerns. Most importantly, the senior manager can bring a broad corporate perspective to the risk acceptance decisions made by the group.

PREREQUISITES FOR EFFECTIVE LEVEL 3 Q.A.

- The senior manager must be willing to take the time to review the self-assessments produced by the group and provide feedback to the business unit that prepared the assessment. Effectiveness is enhanced when the senior manager has a clear understanding of the corporation's mission and the current corporate strategies and objectives.
- The Internal Audit Department or other self-assessment sponsors must have taken time to educate the senior managers in the company on the self-assessment process and have communicated how the information produced by the process will be used. The senior managers should be aware that the central consolidation/synthesis group will take the position that the self-assessments they receive represent that business unit's view of their mandate and attitude towards risk acceptance.
- The trainer/facilitator should encourage the senior management review/feedback process by indicating that final risk acceptance ratings and acceptance decisions should be reviewed by the senior manager with responsibility for the area or activity. When software is used this step can be done quickly and easily through on-line review and comment features.
- Presentations made to the Officers should reinforce that the self-assessments are the product of the Departments or work groups and that, in the final analysis, the self-assessments are owned by the Officer responsible for the area that produced the self-assessments.

Ensuring the Reliability of Self-Assessment Results

Level 4 Quality Assurance - Feedback From The Trainer/Facilitator

Once the group has produced draft self-assessments the trainer/facilitator should provide feedback, both in writing and verbally, on the assessments produced by the group. Key areas for feedback include the following:

- completeness of the objectives listing and prioritization of objectives;
- apparent completeness of the control listings and residual risk indicators, impacts, impediments, and concern listings;
- consistency of the ratings arrived at by the group between the written self-assessments and the verbal contributions that occurred during the assessment sessions;
- any suggestions the facilitator might have to optimize the control portfolio (i.e. more effective and/or less costly controls); and
- feedback on the process including suggestions on how the assessment process could be done more effectively in the future.

This can be done via the groupware database when ERAM software is utilized.

PREREQUISITES FOR EFFECTIVE LEVEL 4 Q.A.

- Adequately trained facilitator.
- Commitment of the self-assessment sponsor that trainer/facilitator feedback is a key step that must be completed for every session.
- Integration of the performance measurement system in place in the sponsoring department.
- Adequate resources to provide a feedback/coaching report to each business unit that completes a self-assessment.
- Business units are made aware that a feedback report on their draft and/or final report is a component of the process.

Ensuring the Reliability of Self-Assessment Results

Level 5 Quality Assurance - Independent Review/Audit Testing

This level of quality assurance involves an adequately trained and qualified person or team completing a quality assurance review/audit of the self-assessments prepared by the business unit.

In addition to most of the items included in a Level 4 review, the representations made by the business unit regarding the business objectives, controls in use, and the residual risks can be audited for completeness and accuracy. As in any audit, decisions must be made regarding the design and extent of the audit procedures employed. These decisions are normally influenced by the existence and quality of Levels 1 to 4.

Conceptually, this independent quality review/audit is the same as an external audit of the financial statements produced by management (i.e. the objective is to give an opinion on the reliability of the representation).

At the completion of the quality assurance review/audit, a coaching/feedback/audit report is prepared setting out any findings and recommendations that flow from the review/audit work completed. An opinion is usually prepared for the corporation's top management and Board of Directors on the quality/reliability of the assessment process used and the content of the self-assessments prepared by the various business units.

The business objectives identified by the business unit must be examined for adherence to the basic rules of setting clear, desired results to ensure that they represent valid end result objectives or sub-objectives. As well they must be audited for completeness. This is done by comparing the objectives to such things as job descriptions, budgets, department mission statements, standardized audit programs that are available for the area in question, knowledge of the business area under review, and other indicators.

The Threats to Achievement and controls listed for each objective must be audited for accuracy and completeness. A sample of the key controls alleged to be in use should be checked to determine if they are functioning as described by the preparer/representor (i.e. sampling can be used). Steps should also be taken to determine if there are other relevant controls that have not been identified by the group that relate to the business objective being assessed that would influence the overall acceptance rating. Standard audit planning and execution skills are applicable to this stage of quality assurance.

When ERAM software is used this step can be completed in the ERAM system.

Ensuring the Reliability of Self-Assessment Results

Level 5 Quality Assurance - Independent Review/Audit Testing

Residual risk indicators, impacts and concern listings must also be reviewed and audited to determine if they provide a reasonably complete and accurate picture of the real and/or potential residual risks that fall out of the control/quality portfolio selected by the group. This area of the review requires strong business knowledge of the area and good analytical skills.

PREREQUISITES FOR EFFECTIVE LEVEL 5 Q.A.

- Adequately trained quality assurance personnel who have a sound understanding of the business area. This sometimes necessitates supplementing the quality assurance review staff with outside specialists, and/or having a broad mix of skills and disciplines on staff in the Department responsible for completing or coordinating the independent quality assurance reviews. Examples of quality assurance specialists that may be required include environment, computer security, safety, product quality control and other disciplines.
- A well defined and planned quality assurance review methodology and working paper documentation format.
- Internal quality assurance review procedures for the independent review group to ensure that staff are completing thorough quality assurance reviews in the areas that they are assigned to.
- Business units that are willing to cooperate and provide the necessary time and resources to complete a Level 5 quality assurance review.
- Understanding and commitment from the senior management team regarding the purpose and use of the quality assurance reports produced.

Ensuring the Reliability of Self-Assessment Results

Level 6 Quality Assurance - Independent Report On The Entire Process

A sixth level of quality assurance is possible if an outside, independent party completes a review on the entire self-assessment framework and provides an opinion on the reliability of the results being produced. This review process is very similar in principle to a review of an organization's systems development methodology.

This level of review should be done by an outside party independent of the installation and maintenance process. The report on the reliability of the self-assessment program should be provided directly to the Audit Committee and the senior management team.

Ensuring the Reliability of Self-Assessment Results

Concluding Remarks

Organizations have had independent external review of management's representations relating to financial results and status for many years.

The reliability of these financial statement representations, and the quality of the independent review of these representations has been severely criticized over the past decade (i.e. "the expectation gap").

Studies have concluded that the quality of the internal control framework is the single most important indicator of the reliability of management representations. This applies to areas as diverse as safety, environment, accounting, cost control, statutory compliance and many others.

It would seem to be a logical extension to require management to prepare self-assessments on the various elements of the internal control and risk management framework and to report the results of those self-assessments to those ultimately responsible for corporate governance.

The six quality assurance processes outlined in this section have been designed to provide assurance to top decision makers and/or stakeholders that information provided by the self-assessment process is reliable and the self-assessment process is functioning well. An effective self-assessment program will enhance the overall quality of the control and risk management framework over time and increase the likelihood of achieving key business and quality objectives.

From: Jerry Casler [jerrycasler@hotmail.com]
Sent: Monday, May 12, 2003 5:00 PM
To: Comments
Subject: Docket Matter No. 004

Ladies and Gentlemen:

My name is Jerry Casler. I am the General Auditor of a U.S. multinational and member of the Institute of internal Auditors. I speak for neither my company nor my professional organization, but for myself as a concerned citizen.

Let me begin by thanking you for the opportunity of offering my input on this important matter. I will be brief.

I strongly urge you to give the highest priority possible to the establishment and issuance of standards for Section 404 compliance, specifically management's assessment and the external auditor's attestation.

Existing guidance and positions taken by affected parties disclose a divergence of interpretations of the law as written and the underlying intent of Congress. Until you, through the proposed Roundtable or by other means, can rationalize these differences, there is a high risk of considerable, but perhaps unintended, expense being borne by shareholders in the U.S and abroad.

That said, there is a recognized and urgent need to re-establish the public's trust in our financial markets through consistently credible financial reporting. I do not believe these needs are mutually exclusive. In any case however, the need to clarify and decide on the standards is most urgent.

Respectfully,

Jerry L. Casler
jerrycasler@hotmail.com

Protect your PC - get McAfee.com VirusScan Online
<http://clinic.mcafee.com/clinic/ibuy/campaign.asp?cid=3963>

From: Corless, John [corlessj@csus.edu]
Sent: Thursday, May 01, 2003 8:16 PM
To: Comments
Subject: Docket No. 004

I hope the wordiness of existing Statements on Auditing Standards will be avoided. Straightforward language which does not burden the reader with endless references to previous standards will be helpful. I would suggest that the three general standards and the three fieldwork standards of the ten Generally Accepted Auditing Standards would be a good starting point in establishing new professional standards.

John Corless
Professor of Accountancy
CSU-Sacramento
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May 12, 2003

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. 004
Statement Regarding the Establishment Of Auditing and Other Professional Standards

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 *Statement Regarding the Establishment of Auditing and Other Professional Standards*, PCAOB Rulemaking Docket Matter No. 004 (April 18, 2003). We support the goals of the Sarbanes-Oxley Act of 2002 (the "Act") to restore investor confidence, as well as the Board's efforts to faithfully implement the Act.

Introduction

One of the core duties of the Board, as determined through the Act, is to "establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards

relating to the preparation of audit reports for issuers....”¹ The standard setting process is a substantial undertaking and will hold great significance to not only the accounting profession but also to issuers and investors. In this comment letter we have identified those aspects of the Board’s proposal that we believe should be clarified or modified to help ensure that the Board’s standards are applied appropriately, that the Board’s standard setting process considers meaningful input from all interested parties, and results in standards that promote effective audits for issuers.

The Board’s Authority Relates to the Audits of Issuers

The release of the proposed rule states that “Rule 3100 would require all registered public accounting firms to adhere to the Board’s auditing (and related attestation), quality control, and ethics standards, and its independence rules, *in connection with the preparation or issuance of any audit report for an issuer* (as defined in the Act).”² This is consistent with Section 103 of the Act, which states that the Board has the duty to establish “auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers....”³ Although we believe it is the intention of the Board to faithfully implement this Section of the Act, the text of the proposed rule could lead one to believe the Board’s standards have a broader scope beyond the audits of issuers because the text of the proposed rule does not specifically refer to the audits of issuers. We do not believe it is the intention of the Board for registered public accounting firms, which are also actively involved in performing engagements for non-

¹ See Act, § 101(c)(2).

² PCAOB Release No. 2003-005, at p. 2 (emphasis added).

³ See Act, § 101(c)(2).

issuers, to be required to follow only those standards adopted by the Board. Still, as currently written, the text of the proposed rule is overly broad and could be misinterpreted by auditors, issuers, and the public.

To illustrate, Rule 3100 refers in the title to “Professional Auditing Standards Applicable to Registered Public Accounting Firms” and states, “a registered public accounting firm and its associated persons shall comply with all applicable professional auditing standards” (as defined and established by the Board).⁴ This proposed text is problematic because as written, it would supercede auditing, ethics, and independence standards set by other regulatory bodies such as the United States General Accounting Office, international bodies such as the International Auditing and Assurance Standards Board, other non-U.S. governmental regulatory bodies, individual states within the United States, as well as standards applicable to the audits of private companies. However, in the performance of audits of non-issuers, registered accounting firms may be required to follow these other standards not promulgated by the Board. Read literally, the proposed text would require that once a firm becomes registered it would be required to follow standards set by the Board and unable to follow standards set by other bodies in carrying out the audits of non-issuers. This would result in the audits of certain non-issuers being found in violation of other U.S. regulations and the laws of many countries. The same issue exists with respect to PCAOB Release No. 2003-006, Establishment of *Interim Professional Auditing Standards*.

⁴ PCAOB Release No. 2003-005, at A1-i.

Based on the above, and because it is critical that the text of the rules be precise and specifically refer to the audits of issuers, we recommend that the current wording in the proposed rule be modified such that the title of Rule 3100 refers to “Professional Standards Applicable to Registered Public Accounting Firms in Connection with the Audits of Issuers” and that the text of Rule 3100 clarify that the Board’s standards apply to registered firms in connection with the preparation of audit reports for issuers. This wording is consistent with the duties of the Board as established by the Act and the discussion of the proposed rule during the Board’s open meeting on April 16, 2003. Additionally, we also recommend that PCAOB Release No. 2003-006, *Establishment of Interim Professional Auditing Standards*, be clarified in a similar manner.

The Board Should Create a Detailed Framework for the Standard Setting Process In Order to Facilitate Meaningful Input

The Board’s release states that the proposal sets forth a “general process” in establishing standards.⁵ However, we believe that in order to facilitate a meaningful, orderly standard setting process, a detailed framework and process for standard setting including the use of the standing advisory group as well other advisory and ad hoc task forces needs to be developed and included in the text of the rule. Although the discussion in the release language provides some detailed information including how potential changes to standards may arise, the potential for open meetings and roundtables depending on the nature of the proposals, and the use of an exposure process, such details are not included in the text of the proposed rule. The proposed text also does not include many of the procedural aspects of the standard setting process. A detailed framework within the text of the Board’s rule is critical to enable all participants and the public to understand the workings of the Board and to facilitate the standard setting process.

⁵ PCAOB Release No. 2003-005, at p. 3.

A detailed framework for the Board's standard setting process should include three elements. First, the detailed framework should include a structure under which issues will arise, the agenda will be developed, and the standards will be proposed, deliberated, exposed for comment, and adopted. Second, the detailed framework should include a discussion of the procedural aspects, such as the frequency and nature of the meetings of the Board as well as its standing advisory group, the terms of the members of the advisory group, and the group's interaction with the Board. Third, the detailed framework should consider different levels of guidance as well as a process for dealing with urgent or emerging issues. Additionally, the detailed framework for the Board's standard setting process should be based on the principle of due process – which would include an open process of discussion, debate and resolution of issues at public meetings, active solicitation and consideration of the views of various constituencies through the exposure process, and publication of dissenting views.

The framework described above is similar to the standard setting process followed by the Financial Accounting Standards Board (the "FASB"). The FASB "follows an extensive 'due process' that is open to public observation and participation; this process is modeled after the Federal Administrative Procedures Act, and in some ways is more demanding."⁶ To establish its agenda, the FASB uses factors such as: pervasiveness of the issue, technical feasibility, practical consequences, convergence possibilities, cooperative opportunities, and availability of resources. The FASB follows an open decision making process which includes publication of its agenda, public announcement of its meetings and future calendar, open Board meetings with open debate of issues, and exposure of proposed standards for public comment. Exposure drafts set forth the

⁶ "Facts About the FASB 2002-2003," <http://www.fasb.org/>.

proposed standard, the proposed effective date and method of transition, background information, an explanation of the basis for the Board's conclusions, and alternative views, if any. FASB often uses a 60-day exposure period, sometimes shorter or sometimes longer depending on the complexity of the standard. The FASB describes its exposure period as "a search for new information and persuasive arguments regarding the issues; it is not simply a 'nose count' of how many support or oppose a given point of view."⁷ Additionally, in order to keep the public informed of its activities, the FASB releases a weekly notice through its "Action Alert" which is posted on the FASB website and provides notice of upcoming meetings, the agendas of the meetings, and brief summaries of actions taken at previous meetings. The FASB still has the flexibility to add dates and agenda items, but such changes are announced as soon as known. Through the entire process the public and all interested parties are kept informed of the FASB's activities and are able to participate in the process.

Based on the principles for the detailed framework recommended above, we have the following suggestions. First, the Board should adopt a step-by-step outline for the standard setting process similar to the process followed by the FASB. Such a process should include the elements described above including how issues will arise, how the agenda will be developed, and how the standards will be proposed, deliberated, exposed for comment, and adopted. This process should include open discussion, debate and resolution of issues at public meetings. It should also include active solicitation and consideration of the views of various constituencies through the exposure process. Such an exposure period should be longer than the 21 days that is discussed in the Board's release; 21 days is too short to provide meaningful input to the standard

⁷ *Ibid.*

setting process. The process should also include the method to be used for handling all comments, including providing to the public an analysis of the reasoning as to the disposition of such comments. Additionally, once the standard is finalized by the Board and published on its website it should be made clear in such posting that the standard is still subject to approval by the Securities and Exchange Commission (the "SEC") and it should include dissenting views of the Board, if any.

Second, the Board and its standing advisory group should conduct regularly scheduled open meetings. The dates for such meetings should be established in advance and published on the Board's website, along with the agenda items, so that the public and other interested parties can plan to attend. The Board should also clarify how it intends to use the standing advisory group and other groups and task forces. The development of ethics, independence, quality control and auditing standards require different expertise. As such, the Board should consider creating different standing advisory groups for each area. Additionally, terms for advisory group members should be established.

Third, the Board should establish different levels of guidance. The highest authoritative level should be the standards as set by the Board and approved by the SEC. At a lower level, the Board should consider issuing interpretive guidance that could be less formal and perhaps outside the rule-making process in order to address emerging and urgent issues. This interpretive guidance could be developed by the staff and perhaps reviewed by the advisory board. Such interpretations would not be binding as standards but would be very helpful to practicing auditors.

Adopting a detailed yet flexible framework as described above will create a method by which meaningful input can occur and will help facilitate the standard setting process.

All Advisory Groups Should Include Active Members of the Auditing Profession

The text of Rule 3700 (b), which describes the composition of the standing advisory group, states that the advisory group will include individuals with expertise in public company auditing, among other individuals. We understand based on the discussion in the proposed release that it is the intention of the Board to include practicing auditors among the constituencies in the standing advisory group. Active consideration of the issues from the perspective of those who will have to execute the standards will be essential to effective implementation of the Board's standards. As such, we suggest that the Board clarify Rule 3100 (b) to state that practicing auditors will be among the individuals included in the advisory group. Additionally, although the composition of other advisory groups and ad hoc groups is not detailed in the proposed rule, we firmly believe that practicing auditors should be included on any such groups.

The proposed rule also states that members of the standing advisory group would be subject to certain provisions of the Board's Code of Ethics (provisions EC3, EC8(a), and EC9). We agree that the members of the advisory group should be required to adhere to these provisions of the Code of Ethics in carrying out their advisory activities for the Board. While we do not believe adhering to the provisions of EC8(a) would be problematic for members of the accounting profession serving on the advisory group, we are concerned that the language in EC8(a) could be used to criticize the Board for placing practicing auditors on the advisory group, simply because they are subject to the Board's oversight, and on that basis alone, do not have the necessary "appearance of independence and objectivity with respect to the Board's function or

activities.”⁸ Therefore, we recommend that the Board revise the language in both Rule 3700(e) and EC8(a) so that it is clear that those who practice in a registered public accounting firm and serve on an advisory group would not be automatically considered to lack the “appearance of independence and objectivity” merely because they are subject to the oversight of the Board.

“Professional Auditing Standards” Should Not Encompass Standards other than Auditing Standards

The Board has proposed to define the term “professional auditing standard” to include any auditing standard, standard for attestation engagements, quality control policy or procedure, ethical or competency standard and independence standard.⁹ Currently each of those standards is referred to separately by specific name (e.g., “auditing standards” and “independence standards”) by both the SEC as well as the accounting profession. To combine all of these separate standards and refer to all of them as “professional *auditing* standards” will confuse all parties involved – investors, the public, issuers, and auditors. Additionally, the Act defines the term “professional standard” to include accounting principles as well as auditing standards, standards for attestation engagements, quality control policies, ethical and competency standards, and independence standards.¹⁰

Therefore, we recommend that the Board replace the proposed term “professional auditing standard” with the term “professional standard” to be consistent with the Act and to avoid confusion among all parties. We further recommend that the phrase “professional

⁸ PCAOB Release No. 2003-004, at A1-vii.

⁹ PCAOB Release No. 2003-005, at A1-i.

¹⁰ See Act, § 1000A (a)(10).

standards for the audits of issuers” be used by the Board to refer to all standards that are to be followed in the audits of issuers.

Conclusion

An effective standard setting process is critical to the mission of the Board. We believe that adoption of the recommendations included herein would enhance the proposed rule and, as discussed above, help to ensure that the Board’s standards are appropriately applied, that the Board obtain meaningful input from all interested parties, and the process results in standards that promote effective audits for issuers.

* * *

We appreciate the opportunity to comment and would be pleased to further discuss the Board’s proposed rule. If you have any questions or would like to discuss these issues further, please contact Robert J. Kueppers at (203) 761-3579.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: Charles Niemeier, Acting Chairman of the PCAOB
Kayla Gillan, Member
Daniel Goelzer, Member
Willis D. Gradison, Jr., Member

! @ #

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May 12, 2003

Ronald S. Boster
Acting Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington, D.C. 20006-2803

**PCAOB Rulemaking Docket Matter No. 004,
Statement Regarding The Establishment Of Auditing And Other Professional Standards**

Dear Mr. Boster:

We are pleased to submit this comment letter to the Public Company Accounting Oversight Board (“PCAOB” or the “Board”) regarding the above-referenced PCAOB Rulemaking Docket Matter. Overall we support proposed PCAOB Rules 3100 and 3700.

Our views and significant comments on these proposed PCAOB Rules are set out in this letter.

Definition of Professional Auditing Standards Applicable to Registered Public Accounting Firms

Proposed PCAOB Rule 3100 states:

A registered public accounting firm and its associated persons shall comply with all applicable professional auditing standards.

It is our understanding that the Sarbanes-Oxley Act of 2002 (the “Act”) requires the PCAOB to establish professional auditing standards for an ‘audit’ of an ‘issuer’ as defined in the Act. The proposed PCAOB Rule could be misinterpreted to mean it would apply to all audits (issuers and non-issuers) performed by a registered public accounting firm, which we believe is inconsistent with the definitions of an “issuer” and an “audit” in Section 2(a) of the Act. We believe the following clarification will avoid any possible confusion regarding the PCAOB Rule applicability to audits performed by a registered public accounting firm of entities that are not issuers:

A registered public accounting firm and its associated persons shall comply with all applicable professional auditing standards in performing an audit of an issuer.

Ronald S. Boster

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May 12, 2003

We also recommend that the related “note” be expanded to include the definition of “audit” and “issuer.”

Note: Under Section 102(a) of the Act, public accounting firms are not required to register with the Board until 180 days after the date of the determination of the Commission under section 101(d) that the Board has the capacity to carry out the requirements of Title 1 of the Act (the “mandatory registration date”). The Board intends that, during the period preceding the mandatory registration date, this rule would apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms. The term ‘audit’ means an examination of the financial statements of any issuer by an independent public accounting firm in accordance with the rules of the Board or the Commission, for the purpose of expressing an opinion on such statements. The term ‘issuer’ means an issuer (as defined in section 3 of the Securities and Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 781), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

Review of Internal Controls and Section 404 Attestation Standard

We believe it is important for the PCAOB to address the standards for reporting in connection with Section 404 of the Act. The PCAOB has indicated that the adoption of attestation standards for reporting on internal controls under Section 404 is one of three high-priority projects that the Board intends to commence as soon as possible. We strongly encourage the Board to give this project the highest priority, taking precedence over the review of Interim Professional Auditing Standards and the adoption of statutory professional auditing standards.

We agree with the PCAOB’s plan to review both the existing attestation standard (adopted by the PCAOB as part of its Interim Professional Auditing Standards) and the auditing and attestation exposure drafts recently published by the American Institute of Certified Public Accountants (“Exposure Drafts”). We believe the Exposure Drafts represent the best practices developed from a decade of applying the existing standard, which was not originally developed in anticipation of broad-based internal control reporting by all public companies. Upon reviewing both the existing standard and the Exposure Drafts, we believe the Board will find the Exposure Drafts to be an appropriate base from which to develop its standard(s). As soon as possible, the Board should commence its standard-setting process with respect to this topic, make whatever modifications the Board then deems appropriate and in the public interest, and proceed with issuing its proposed standards on internal control reporting.

Ronald S. Boster

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Advisory Groups and Task Forces

Proposed PCAOB Rule 3700 provides for the formation, composition and use of advisory groups in the PCAOB's standards-setting process. We agree with the formation of the advisory group and also believe it would be useful to form, at the Board's discretion, smaller ad hoc task forces to assist in developing or evaluating standards and to provide input to the Board or its staff.

However, we believe it would be helpful if some additional guidelines were included in the final rule regarding: 1) the term of advisory members (e.g., a one-year term and eligibility for re-appointment of three additional one-year terms); 2) whether or not advisory group meetings will be open to the public; and 3) the format (e.g., oral presentation of a summary of the written materials by the PCAOB staff, followed by discussion of each issue presented and questioning the points raised) and expected frequency of such meetings (e.g., at least quarterly).

Further, we believe the final PCAOB Rule 3700 should explicitly provide that the membership of the advisory group at all times should include representatives from the largest registered public accounting firms that audit the financial statements of a significant number of issuers. We support the PCAOB's proposal regarding the composition of the advisory board and we agree with the need for representation of all constituencies involved in the financial reporting process. However, we are concerned about placing specific limits on the representation of any single constituency. The public interest will best be served if the advisory group includes those persons in a position to become aware of emerging auditing issues as they arise, before issues become widespread and before divergent practices become entrenched.

Consideration of International Auditing Standards

The environment for establishing professional auditing standards increasingly involves international audit issues. The International Auditing and Assurance Standards Board ("IAASB") is considering exposure drafts of very significant auditing standards, many of which were intended to converge with auditing standards in the United States and proposed changes thereto. The IAASB is also considering several other significant changes to International Auditing Standards for implementation by 2005.

We urge the PCAOB to consider the changes being made in International Auditing Standards as it conducts its review of existing United States standards and sets future standards, including cooperation and coordination with the IAASB prospectively on the development and convergence of high-quality standards.

Exposure Period

As part of the due process procedures for the adoption of new or amended Professional Auditing Standards, the Board has proposed providing for a public comment period of 21 calendar days. The rule proposal also indicates that a comment period of less than 21 days may be appropriate under relevant circumstances.

Ronald S. Boster

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May 12, 2003

Although we support prompt issuance of new or modified auditing standards with an objective of improving the quality of audits of public companies, we believe that a “normal” comment period of 21 calendar days will not be sufficient to appropriately analyze and comment on far-reaching new or modified standards. Such a period is shorter than the typical comment period for rulemaking by the Securities and Exchange Commission or the Financial Accounting Standards Board. We recommend that the PCAOB consider a standard public comment period of 30 to 60 days, or perhaps longer in certain circumstances. As the Board considers global convergence in the development of auditing standards, a longer comment period might be necessary or desirable to obtain appropriate input from global constituencies.

We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Very truly yours,

The signature is written in a cursive, handwritten style. It reads "Ernst & Young LLP". The "E" is large and loops around the "r". The "n" and "s" are connected. The "&" is written as a simple ampersand. "Young" is written in a similar cursive style. "LLP" is written in a simpler, more upright font at the end of the signature.



May 8, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006

Ladies and Gentlemen:

The Committee on Corporate Reporting (CCR) of Financial Executives International (FEI) wishes to express views on the proposed adoption of Public Company Accounting Oversight Board (PCAOB) Rules 3100 and 3700. FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives, and other senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals, and other documents issued by domestic and international agencies and organizations. This document represents the views of the CCR and not necessarily the views of FEI.

In short, we are very supportive of the PCAOB's proposed process for adopting or amending professional auditing standards. We believe that the PCAOB, its staff, and a broad advisory panel will produce an effective and balanced set of audit standards with diverse representatives as part of the process..

Our specific comments on the proposal are as follows:

- We strongly support the proposal to have a standing advisory panel to assist the PCAOB. The size, qualifications, and representation on the advisory group are also appropriate. We suggest the PCAOB codify the preparer community's right to nominate individuals to the panel, as it is codified for accounting firms, academics and others in Section 3700(c) and consistent with the preparer community's right to participate on the panels themselves which the PCAOB codifies in Section 3700 (b). CCR and FEI would be happy to nominate qualified individuals to represent preparers of financial statements on the advisory panel.
- We agree with the three priorities on the PCAOB's Professional Auditing Standards Agenda, but believe that the first priority should be the review of internal controls and Section 404 attestation standard. We believe that the current lack of clarity on

Public Company Accounting Oversight Board
May 8, 2003
Page 2 of 2

this standard is causing a lot of confusion and inefficiency as management teams strive to meet the pending year-end requirements.

- We support the PCAOB's plan to hold a roundtable discussion on the internal control standard. CCR respectfully requests that we be invited to participate in this discussion.
- We are concerned with the proposed minimum exposure period of 21 days and suggest that a 30 day minimum would be more reasonable, with more time given whenever possible to provide an adequate time frame for reviewers to evaluate and respond to proposed standards. We also recommend that PCAOB releases be listed on the Federal Register and/or that the PCAOB adopt another robust communication process, similar to those of the SEC and FASB, to alert constituents of the release of proposed and final rules.
- We believe that the PCAOB should be required to provide a study of the impact of its proposals on registrants (cost/benefit analysis) similar to the impact studies required to accompany SEC proposals.
- It would be helpful if the PCAOB would describe more clearly the approval process that will apply to its professional auditing standards, involving both the PCAOB and the SEC. It appears that there may be redundant steps (i.e., two comment periods) involved in the process.

* * * *

The Committee welcomes the opportunity to continue an open dialogue on these issues. We would be happy to respond to any questions you may have on our views and to provide recommendations on qualified individuals to participate on both your advisory panel and internal controls roundtable discussion. You can reach me a 989-636-1541.

Sincerely,



Frank Brod
Chair, Committee on Corporate Reporting
Financial Executives International

Grant Thornton LLP
The US Member Firm of
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175 West Jackson
Chicago, IL 60604
312 602-8000



May 12, 2003

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

PCAOB Rulemaking Docket Matter No. 004, *Statement Regarding the Establishment of Auditing and Other Professional Standards*

Dear Board Members and Staff:

Grant Thornton LLP appreciates the opportunity to comment on the proposals of the Public Company Accounting Oversight Board (the Board). We are pleased to submit our general and specific comments on PCAOB Docket Matter No. 004, *Statement Regarding the Establishment of Auditing and Other Professional Standards*.

General Comments

We support the intention of the Board to enhance and preserve the critical aspects of the current standard-setting process including its commitment to:

- Promoting the transparency of the auditing standard-setting process to increase the public's awareness and understanding of the purpose, nature and scope of audits of public companies.
- Soliciting input from a variety of constituencies including the appointment of investors and other financial statement users to the advisory group.
- Maintaining vigilance to (1) assure existing standards are updated regularly to reflect changes in business and the business environment, and (2) identify deficiencies in the current process and propose new criteria, standards, interpretations or other guidance to enhance the standard-setting process.

We also support the three primary objectives of the Board's initial agenda related to the review of the designated interim standards, assessment of standards specifically required by the Act, and a review of the standard(s) for an auditor's attestation relating to internal control pursuant to Section 404(b) of the Act. We have specific comments below related to those objectives.

We do, however, have concerns about the Board becoming a standard setting body, when as we understand it, the primary Board role is to provide a strong, independent body to oversee auditors of public companies. This results in the Board performing a critical activity itself rather than providing oversight. We suggest the Board reconsider whether this approach is in the public interest.

In addition, we have concerns with respect to the formation of the Advisory Group and related Task Forces (as outlined in subheading C.), particularly with respect to (i) the ability of the group to operate in an effective and efficient manner; (ii) the ability of the Board to staff the Advisory Group with qualified persons (that are knowledgeable in the objectives of auditing standards and understand the practical application of the specific auditing procedures) from each of the identified constituencies; and (iii) the lack of specificity related to the operations of the Advisory Group and Task Forces. Additional details about our concerns and specific recommendations are included below.

Specific Comments

Notwithstanding the concerns expressed above, our comments are summarized under the subheadings included in the Board's Release. Our comments are intended to highlight areas of particular concern to us that we believe should be prioritized in the adoption of this process and also to identify areas of omission that we believe the proposed rule should address.

A. Adoption of New or Amended Professional Auditing Standards

The Board's adoption of interim standards effectively incorporated the content of the existing body of literature including standards, interpretations and other guidance (e.g., the AICPA's Accounting and Audit Guides). While the proposed process for developing new or amended standards clearly outlines the Board's authority and required approvals for any changes, it does not directly address the implications to those materials that are not considered "Level 1" auditing standards. Specifically, the release does not address important guidance that resides in the guides and related guidance that has historically been released through journals, SECPS releases, etc. Accordingly, we recommend that the Board consider the nature and future purpose of such guidance, not only in its deliberations in reviewing the existing body of literature, but also the appropriate process for creating, reviewing, and issuing such guidance in the future.

The proposed rulemaking states: "Any registrant that fails to adhere to the Board's Professional Auditing Standards will be subject to Board disciplinary proceedings in accordance with Section 105 of the Act." We believe that the literal interpretation of this rule is extremely proscriptive and does not allow the auditor to exercise necessary judgment with respect to audit risk and materiality. This interpretation might result in potential disciplinary proceedings in cases where a procedure(s) may have been purposefully eliminated as when, in the auditor's judgment, the sum of other procedures effectively mitigated the risk of material financial statement misstatement or when a certain audit procedure was deemed not significant. The ultimate result would likely be the auditors performing procedures unnecessarily with additional cost to issuer and ultimately the investing public. We believe the Board should adopt in its final rule the language included in SAS 95 (AU 150) that requires the auditor to (i) be familiar with all of the standards; (ii) consider audit risk and materiality in determining the appropriate application of the standards in performing specific audit procedures, and (iii) be prepared to justify departures from the standards.

We also note that auditing standards, as currently written, impact or rely on other professions such as actuaries, external legal counsel, and valuation specialists, among others. New or amended standards that might impact the auditor's ability to obtain sufficient appropriate audit evidence from other professionals should be carefully evaluated prior to proposing changes or amendments to the existing literature. As such, we recommend that the Board create standing task forces that liaise with other professions that are key to the preparation of financial statements and the performance of audits, such as the American Bar Association, the American Academy of Actuaries, and others as the Board determines appropriate.

Finally, we believe that there is a potential for confusion and inconsistency in the application of the Board's interim standards, particularly related to standard language in audit and attestation reports. For example, while we believe the Board intended for the report phrase "auditing standards generally accepted in the United States of America" to refer to the Board's Interim Professional Auditing Standards for audits of registrants, there is language in certain review and attestation reports that make reference to the AICPA standards. We recommend that the Board clarify its position on the application of those interim standards and related expectations for report language.

B. Procedure for the Adoption of New or Amended Professional Auditing Standards

We recommend that the Board consider the following comments with respect to clarifying the proposed process and facilitating implementation of new standards:

- Consider whether to maintain interpretive and other guidance using the dual exposure process proposed by the rule (i.e., initial exposure by the Board followed by an exposure period by the Securities and Exchange Commission prior to issuance). We believe this process may delay issuance of guidance or interpretations without significant value-added comments arising from the process. We suggest that for proposed interpretive or other guidance issued outside of the core standards, the Board adopt a process similar to that recently adopted for FASB Staff Positions (FSP) documents (the FSP process is described at www.fasb.org).
- Consider the proposed effective dates for new or amended standards. As the Board is aware, many public accounting firms have an extensive body of developed auditing guidance and other literature, staff training programs, and electronic tools. Changes that are limited to once or twice a year would assist in developing an approach that ensures a consistent application of the required standards over the period under audit, particularly with respect to planning and performing effective reviews of interim information and performing tests of controls throughout the period. Provisions for dealing with emergencies, as described in the proposed rule, would be retained to address critical issues that might arise. This approach will also benefit financial statement preparers as it will limit late requests and other changes in audit approach.

C. Advisory Groups and Task Forces

As noted in our General Comments, our concerns related to the formation and operation of the Advisory Group focus on (i) the ability of the group to operate in an effective and efficient manner; (ii) the ability of the Board to staff the Advisory Group with qualified persons from each of the identified constituencies (that are knowledgeable in the objectives of auditing standards and understand the practical application of the specific auditing procedures); and (iii) the lack of specificity related to the operations of the Advisory Group and Task Forces.

With respect to the selection of group members, we believe that the number of Advisory Group members should be limited to no more than 15 to 18 persons. The potential of up to 30 members, although providing a wide variety of views and opportunities for input, will be unwieldy in practice and not facilitate meaningful discussion and debate in the standard-setting process.

With respect to the composition of the members, we agree with the notion that input from other constituencies is a step forward in expanding both the breadth of input on proposed standards, but also

will, it is hoped, result in more exposure of the audit and attest standards to the public. However, we are concerned that simply appointing key members of other constituencies, although they would be knowledgeable in the financial reporting process, may not immediately result in an upgrade in the standard-setting process. We recommend that nominated members, similar to the requirements set forth for audit committee members in recently issued stock exchange and SEC requirements, be educated in the objectives, key standards, critical auditor judgments and related audit processes. This education may be provided by the Board staff or other means, and will be especially important for those members that do not have experience performing audits.

With respect to the operations of the Board, we recommend that the release be expanded, or alternatively, a separate release be issued to describe and solicit comments on the primary operating principles of the Advisory Group and Related Task Forces. Specifically, we recommend the Board specify (i) who will set and how will a timetable be set for accomplishing the first three agenda items; (ii) how often the Advisory Group will meet, (iii) whether the Advisory Group will appoint a Chairperson, and (iv) whether the Board staff will provide all resources for drafting, editing, monitoring comments, and publishing new and amended standards.

The rule proposal is silent as to the role of topic and industry-specific guidance and the development or updating of those standards and/or other interpretive auditing standards that are specific to an industry. Examples include guidance on auditing derivatives and investments, performing procedures under SAS 70, *Service Organizations*, and issuing reports that may be relied upon in public company audits, and investments company audits to name a few. We recommend that the Board expand this release to address its intentions with respect to the development of such guidance. Alternatively, the Board could issue a separate release that describes the guidance in further detail so as to clarify the process for addressing industry-specific matters.

D. Board Professional Auditing Standards Agenda

We agree with the three proposed projects that the Board expects to address as part of its initial agenda. With respect to review of the Interim Professional Standards, please see our specific comments below in the response to the specific Board requests for comment.

With respect to the assessment of the need to issue specific standards related to the review of internal controls and Section 404 Attestation Standard, we note the urgency of the need to issue final rules on this matter due to the potential September 30, 2003 management and auditor's reporting requirement as set forth in the SEC's proposed rule. We also note the intentions of the Board to issue a separate release to convene a roundtable on this matter in the near future to determine whether a new standard is needed. We assume the unstated alternative choices are that the Board would adopt either the existing standards for reporting on internal control as set forth in the Attestation Standards, or adopt the exposure draft issued by the ASB as part of its body of Professional Auditing Standards. We look forward to the opportunity to participate in such discussions.

Responses to the Board's Questions

The Board solicited comments on the following specific matters:

The Board seeks comment on Proposed Rule 3100 and the related definition. In particular, the Board seeks views on whether there are other standards, in addition to the Board's Professional Auditing Standards, with which the Board should require registered firms to comply.

We believe the standards as described in the definition of Proposed Auditing Standards as set forth by the Board in Rule 1001 and Rule 3100 are sufficient and complete with respect to the body of literature covered by those standards. We note that the existence and requirements of other standards that impact or require the auditors' assessments of company compliance with laws and regulations such as those in the banking, broker/dealer and insurance industry, for example, should remain in a separate body of literature from the proposed Professional Auditing Standards.

Also with respect to this proposed rule, we note that the summary description included the phrase "...in connection with the preparation or issuance of any audit report for an issuer (as defined in the Act)." A literal reading of the proposed rule might lead to the conclusion that the application of Professional Auditing Standards would be required for performance of any and all audits performed by registered accounting firms and not limited to those engagements for public companies. We also note that for certain situations where the financial statements are not used in SEC filings, "issuers" should be able to engage independent accountants to perform audit and other attest procedures using professional standards other than those of the Board (e.g., an audit and report under International Standards on Auditing for use outside the United States; an agreed upon procedures engagement for private use; or an attest examination report on internet privacy to be published on a web site).

Related to the schedule and procedure for review of the interim standards, the Board requested the following:

The Board invites public comment and suggestions concerning the appropriate priorities for the review of the Interim Professional Auditing Standards and concerning any changes to them that the Board should consider.

The review of the entire body of the adopted Interim Professional Standards is an obviously daunting task. We appreciate the Board's request for feedback with respect to prioritizing such a review. We recommend that the Board consider the blueprint offered by the report issued by the Public Oversight Board's Panel on Audit effectiveness. As the Board is aware, many of the Panel's recommendations were recently incorporated into standards issued (e.g., SAS 99), or are in process or under consideration by the Auditing Standards Board. Specifically, we recommend the Board consider the following in developing its agenda:

- Convergence with International Standards on Auditing—most recently, the efforts to develop a global set of auditing standards resulted in the joint release of several proposed amendments and a continued effort to achieve convergence of U.S. and International auditing standards. The Panel noted this objective as part of its findings. We recommend the Board continue those efforts in developing its agenda, particularly with respect to the recently issued exposure drafts related to materiality and the audit risk model.

Also in this regard, the Board should consider whether it would improve transparency and access to U.S. capital markets if it were to adopt the international auditing standards as its base and focus efforts on any incremental performance and reporting requirements considered to be needed for companies

in the U.S. securities markets. In addition to promoting convergence, this would reinforce the Board as primarily an oversight body, improve the effectiveness of the use of Board resources and reduce the cost of the standards-setting component of the Board's activities.

- Assessing of recently issued accounting standards and current accounting projects. The Panel on Audit Effectiveness cited a need to assess the "auditability" of proposed new accounting standards. We strongly agree with the recommendation and exhort the Board to include in its agenda discussions with accounting standard-setters to discuss mutual cooperation in those assessments.
- Focusing on key problem areas. There have been several articles and studies issued lately with respect to likely areas of fraudulent financial reporting and other financial statement issues that have resulted in restatements. The Panel on Audit Effectiveness focused on many of these areas as well and their findings are well documented. We recommend the Board (i) consider the findings of the Panel and the status of implementation of those related recommendations, and (ii) in their upcoming reviews, focus on the auditors' performance in those areas to assess the auditor's risk assessments and related testing with a view towards identifying possible deficiencies in existing standards. Based on this analysis, the Board can assess whether the standards or the audit execution may be resulting in alleged audit failures. We believe that the Board is in a unique and advantageous position to make this evaluation as a result of its statutory authority. Without such a detailed review and assessment, changes in existing standards would potentially be based on supposition and not facts.
- Promoting applied audit research and incorporate the results in new standards and changes to standards. The findings of applied audit research, including research into auditor behavioral matters, should be incorporated into and underlie the adoption of new standards and changes to standards. We believe the profession needs to grow beyond the era of anecdotal standards setting to a position of standards being established based on empirical evidence. We are not suggesting that auditor judgment is any less essential, but that it should be guided by knowledge of what does and doesn't work well to address an audit risk. We believe the Board's support of applied audit research could result in significant improvements in audit effectiveness.

Concluding Remarks

Overall, we ask the Board to proceed cautiously in amending and adopting new standards. We believe the Board's current and future Professional Auditing Standards will set a standard not just for U.S. Public Company audits, but will also influence performance for U.S. non-public company audits and audits performed under international standards. Finally, as part of the Board's agenda prioritization and ongoing standard-setting process, we urge the Board to work with the accounting educators and accounting firms to assess the potential impact of new standards and the required skillsets to effectively execute proposed new standards and amendments to existing standards.

We would be pleased to discuss any of our comments with the Board or its staff. Please direct any inquiries to Karin French, National Partner in Charge of SEC Regulations, at (703) 847-7533.

Very truly yours,

Grant Thornton LLP



Public Company Accounting Oversight Board
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By E-Mail: comments@pcaobus.org

Düsseldorf, May 12, 2003

Dear Sir(s):

Re: PCAOB Rulemaking Docket Matter No. 004

IDW Comments on the PCAOB Proposals on the Establishment of Auditing and Other Professional Standards and of Interim Professional Auditing Standards

We would like to thank you for the opportunity to comment on the PCAOB Statement Regarding the Establishment of Auditing and Other Professional Standards and the PCAOB Statement on the Establishment of Interim Professional Auditing Standards. The Institut der Wirtschaftsprüfer represents approximately 85 % of the German Wirtschaftsprüfer (German Public Auditor) profession. The German profession seeks to comment on the proposals by the PCAOB noted above because we believe that these PCAOB proposals will affect not only the development of auditing standards in the United States, but also the development of auditing standards on a worldwide basis. Furthermore, increasing numbers of German Wirtschaftsprüfer will be subject to the requirements of the Sarbanes-Oxley Act. Consequently, we will limit our comments on those issues that we believe will affect either the development of auditing

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and related standards on a global basis or the German profession. We will begin our comments with our general views on auditing and related standard setting.

In the past two years, the credibility of financial reporting in capital markets has been seriously called into question. Those involved in the financial reporting process (accounting standard setters, preparers, auditors, auditing standard setters, professional bodies, governments and regulators) in different jurisdictions have attempted to reestablish the credibility of that process by various means. All have recognized the interrelationship among the various parts of that process. Auditing (including attestation and quality control) and ethics (including independence) standards represent only one part of that process.

While the improvement of accounting standards, the preparation of financial statements by management, compliance with professional ethics requirements by both preparers and auditors, and enforcement of professional standards have been regarded as particularly critical areas, serious questions have also been asked about the performance of audits by auditors. However, we suspect that these questions relate primarily to compliance with existing auditing and ethical standards. In our opinion, there is little evidence to suggest that something has been fundamentally remiss with current auditing or ethical standards – whether in the U.S. or internationally. This is not to say that there is no room for considerable improvement in auditing or ethical standards.

Subject to Section 107, under Section 103(a)(1) of the Sarbanes-Oxley Act (SOX), the PCAOB is required to establish by rule and amend or otherwise modify or alter auditing and related standards used by registered public accounting firms in the preparation and issuance of audit reports as required by the SOX or the rules of the SEC, or as may be necessary or appropriate in the public interest or for the protection of investors. It is clear that the intention of the legislator is to provide the PCAOB with primary responsibility for the establishment of auditing and ethics standards for audits of SEC registrants. However, Section 103(a)(3)(A)(i) of the SOX also authorizes the PCAOB to adopt as its rules any portion of any statement of auditing standards or other professional standards that the PCAOB determines satisfy the requirements of Section 103(a)(1) that were proposed by one or more professional groups of accountants that shall be designated or recognized by the PCAOB, by rule, for such purpose. From our point of view, it is also clear that the legislator recognized the professional nature of such standards, and consequently incorporated an adoption mechanism into the SOX. We will define what we mean by “professional nature” below.

Based upon the Statement Regarding the Establishment of Auditing and Other Professional Standards, the PCAOB makes clear that it has chosen not to exercise its

authority to designate a group of accountants or an advisory group as a source of auditing standards. We would have preferred the PCAOB to have chosen to exercise its authority to adopt auditing standards (including any related quality control standards) because of 1. the professional nature of such standards, 2. the current efforts in the profession and among regulators to harmonize these standards on an international basis, and 3. the uniformity of auditing standards for both audits of financial statements of publicly listed entities and such standards for privately owned entities.

The “professional nature” of standards and the involvement of the audit profession

By “professional nature”, we mean that auditing standards do not represent theoretical documents, nor do they regulate a theoretical activity: such standards are applied by practitioners in the field and hence their development must consider the experience of practicing auditors with several years’ experience. We recognize that stakeholders have a legitimate interest in the definition of the subject matter of an audit, in the contents of any report issued based upon the audit, and in the proper performance of such an audit. However, to the extent that stakeholders are not themselves experienced auditors, without the expert guidance of experienced auditors, stakeholders are generally not in a position to judge the auditability of proposed subject matter, the appropriateness of the contents of an audit report to convey the nature of the work actually done, or the proper performance of an audit. In other words, just as a patient has a proper interest in the proper performance of an operation by a surgeon or a legal client a proper interest in the receipt of appropriate legal counsel from his or her lawyer, neither a patient nor a legal client is generally necessarily in a position to judge the appropriate standard for the performance of an operation by a surgeon or appropriateness of legal advice provided by his or her legal counsel, respectively.

We are deeply concerned about the development of auditing standards without substantial audit practitioner input and their issuance without the general agreement of audit practitioners because, in the absence of such input or agreement, there is a danger that auditing standards may represent unreasonable wishes and expectations of stakeholders that do not properly reflect the underlying limitations of auditing procedures and of the audit evidence obtained through the performance of those procedures. In the end, auditing standards developed without substantial audit practitioner input or without the general agreement of audit practitioners may serve only to increase the expectation gap for audits of financial statements, and thereby further undermine the credibility of financial reporting.

For these reasons, we view the current proposal, in which the role of audit practitioners in the development of auditing standards compared to other stakeholders is un-

clear and in which the PCAOB chooses to issue those standards without adoption and without having clearly defined the role of audit practitioners in the development and issuance of those standards, as having the potential to increase the risk of the issuance of dysfunctional auditing standards. Consequently, we consider the nature of the process (and in particular, the nature of the due process) used to develop and issue auditing standards to be crucial to the effectiveness of auditing standards. We will comment on specific matters in the proposed process for setting auditing standards in an Appendix attached to this letter.

International Harmonization of Auditing Standards

Another main reason for us preferring that the PCAOB would have chosen to exercise its authority to adopt auditing standards, rather than developing and issuing such standards itself, is the current efforts in the profession and among regulators to harmonize these standards on an international basis. Under the Constitution of the International Federation of Accountants, member bodies have made commitments to incorporate the principles of the International Standards on Auditing (ISA) issued by the International Auditing and Assurance Standards Board (IAASB) within their auditing standards. Together with member bodies and standard setters from other major industrialized countries, the AICPA has been a leader in the development of the ISA and has been instrumental in the convergence process between the ISA and US GAAS. To this effect, a number of joint projects between the AICPA and the IAASB of international importance for auditing standards (audit risk standards, audit of fair value measurements, etc.) have been undertaken. It would be unfortunate if these efforts were no longer to bear fruit.

Furthermore, the European Commission regards the ISA as the basis for the harmonization of statutory audits within Europe and there is an expectation that the ISA or standards that incorporate the ISA will be applicable for all statutory audits in Europe as of 2005. In addition, the International Organization of Securities Commissions (IOSCO) has begun an endorsement process, whereby the ISA are being reviewed and revised so that they can be an acceptable basis for the audit of financial statements of entities with cross-border offerings of securities. In our view, the importance of international harmonization of auditing standards is bound to the recognition that in today's global capital markets, investors and creditors can and do purchase securities from abroad outside the regulatory reach of their home jurisdictions.

Consequently, as part of its mandate to establish (whether directly or through adoption) auditing and related standards as may be necessary or appropriate in the public interest or for the protection of U.S. investors, we believe that the PCAOB has a responsibility to assist and promote international harmonization and convergence of

auditing standards. In our view, it would have been more convenient for the PCAOB to assist and promote harmonization and convergence through the American profession, which invests considerable time and resources (financial and technical) in these processes. The decision by the PCAOB to not exercise its authority to adopt auditing standards by developing and issuing such standards itself means that continued international harmonization and convergence is predicated upon the PCAOB investing this time and these resources into international standard setting processes and that the PCAOB make a commitment to convergence. It would be rather unfortunate – and, in our view, counterproductive to the PCAOB’s mandate in the long run – if the development and issuance of auditing standards by the PCAOB would lead to a divergence between the ISA and auditing standards worldwide on the one hand and auditing standards applicable to the audit of the financial statements of SEC registrants on the other hand.

The uniformity of auditing standards for all financial statement audits

By having chosen to not exercise its authority to adopt auditing standards by developing and issuing such standards itself, the PCAOB will make efforts to maintain the uniformity of auditing standards for audits of financial statements of privately owned businesses and such standards for SEC registrants more difficult. In our view, while there may be special issues that need to be considered in setting auditing standards for financial statements of SEC registrants, these are not of such a basic nature that they warrant a whole set of separate auditing standards. In other words, an audit is an audit. We note that US GAAP requirements apply, in most cases, to all enterprises that are required or choose to use them, regardless of whether they are privately or publicly owned. Likewise, a single set of auditing standards for all financial statement audits should apply to all financial statement audits.

It should be noted that auditing standards are considered so generic that even the International Organization of Supreme Audit Institutions (INTOSAI) and the World Bank are considering whether audits of financial statements of government bodies should be undertaken in conformity with the ISA. Negotiations between INTOSAI and the IAASB to develop a means of incorporating public sector concerns into the ISA are currently under way. We would consider that a separate set of auditing standards for audits of financial statements of SEC registrants will be redundant, at best, or divergent from other auditing standards, at worst. In any case, to prevent such potential divergence, it would be incumbent upon the PCAOB to become involved in the process by which auditing standards are set generally for all enterprises. Unfortunately, this appears to be beyond the mandate of the PCAOB.

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We hope that you have found our comments useful. If you have any questions about our comments, we would be pleased to be of assistance or to meet with you.

Yours very truly,

Prof. Dr. Klaus-Peter Naumann

CEO, Institut der Wirtschaftsprüfer

Enclosure: Appendix

APPENDIX

Comments on the Proposed Process for Developing and Issuing Auditing Standards

The Role and Composition of Advisory Groups and Task Forces

Appendix 1 of the proposed rule relating to professional auditing standards and advisory groups addresses the formation, composition, membership selection, etc. of such advisory groups. Section C of the Statement also discusses the role of such advisory groups and “task forces” and proposes that each member of the advisory group have expertise in at least one of public company accounting, public company auditing, public company finance, public company governance, investing in public companies and other relevant disciplines. Section C also mentions that the PCAOB expects that the advisory group will have fairly equal representation among these broad groups and that no one group will dominate the advisory group.

In our view, given our comments on the professional nature of auditing standards and the fact that, in both our experience and that of the IAASB, stakeholders generally have only limited interest in the technical details of auditing standards, we believe that a clear majority of an advisory group on auditing standards needs to be audit practitioners. This would ensure sufficient technical input from audit practitioners and that the profession’s concerns about auditability of proposed subject matter, the limitations of audit procedures and resulting evidence, and the reporting of the performance of the audit given these limitations are not “drowned out” in discussion. Since under the Proposal, the PCAOB develops and issues the auditing standards, there is no danger that a clear majority of audit practitioners on an advisory group could “hijack” the process to serve any narrow special interests.

In Section B of the Statement, the advisory group’s role appears to be limited to recommending that the PCAOB propose a new standard or amend an existing standard, commenting on an analysis and evaluation of a proposal by the PCAOB’s staff, advise the PCAOB on proposals or hold hearings, etc. In essence, as mentioned in Section C of the Statement, such expert advisory groups would assist the PCAOB in reviewing existing standards. In our view, such a role for an advisory group is not adequate to ensure that the detailed technical wording of auditing standards is appropriate. We believe that if the PCAOB develops and issues auditing standards, then it will require the assistance of experienced audit practitioners in the drafting process itself.

Given the international impact of the SOX and hence any PCAOB proposals, we suggest that consideration be given to ensuring that audit practitioners from all major industrial nations are represented. As the experience with the other PCAOB proposals shows, the international environment is very complex, and input is required early in the drafting process to ensure that problems in other jurisdictions are appropriately considered.

Exposure Periods

We consider a 21 day exposure period to be inadequate time so that firms and other bodies have the time to consult with members of their technical bodies. In our view, at least a 60 day exposure period is required for new proposals that are urgent. Given the international impact of the SOX on firms outside of the U.S., we believe that a 90 day exposure period may be more appropriate for proposals in general. In any case, we do not believe there is a case for issuing rules without any appropriate due process involving a sufficient exposure period.



**The Institute of
Internal Auditors**

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May 12, 2003

Office of the Secretary
Attention: Mr. Gordon Seymour
Acting General Counsel
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Reference: PCAOB Release No. 2003-005, dated April 18, 2003: *Statement Regarding the Establishment of Auditing and Other Professional Standards*

Dear Mr. Seymour:

The Institute of Internal Auditors (IIA) applauds the commencement of operations of the Public Company Accounting Oversight Board (PCAOB). The formation of the board, with the appointment of Mr. William J. McDonough as board chairman and the selection of Mr. Douglas R. Carmichael as chief auditor, are key steps in launching the new standard-setting board.

The IIA is pleased to have this opportunity to comment on one of the PCAOB's initial statements, Release No. 2003-005 on the *Establishment of Auditing and Other Professional Standards*. The IIA endorses the PCAOB's methodology for developing an open process for adopting and amending Professional Auditing Standards and in expressing its intent to create a standing advisory group and use other groups and ad hoc task forces in the development of new or amended standards. In addition, the PCAOB's intent to conduct a step-by-step review of the existing standards, which were promulgated by other bodies and currently classified as "Interim Professional Auditing Standards", is a practical and appropriate measure.

Also, we concur with the release's statement that the PCAOB will review both the existing standards and the AICPA's March 18th proposals for amending and adding auditing standards on the external auditor's duties in attesting to the report on a public company's internal controls over financial reporting. The IIA recently provided comments to the AICPA on those exposure draft proposals, a copy of which is attached for your information.

Our Commitment

The IIA can provide the PCAOB and its standing advisory group with specialized knowledge and understanding about the risk exposures and control measures surrounding the preparation of corporate financial reports. We are committed to providing leaders from the internal auditing profession to serve as members of the standing advisory group and as participants at PCAOB-sponsored roundtables and developmental task forces, as appropriate.

The IIA and the Role of Internal Auditors

The IIA looks forward to working with the board's advisory group, task forces, and staff as they work to establish and maintain auditing and related standards that support the integrity and professionalism of the auditors. The IIA is a professional association serving more than 85,000 internal auditors from 140 countries, and its global headquarters is located in Altamonte Springs, Florida. We represent an important constituency within the public company auditing and governance disciplines, and can provide to the PCAOB the profession's leading thinkers and internal auditing executives to serve on your advisory groups and task forces.

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The IIA possesses expertise developed over many years in the auditing of risk management, control, and governance processes of organizations. It has sponsored research and created educational materials on enterprise risk management evaluations, control models and assessment strategies, and the best practices of corporate boards and their audit committees. The IIA has worked with the National Association of Corporate Directors (NACD) on its "Blue Ribbon Commission" recommendations to improve corporate boards and audit committees. The IIA, as a founding member, has partnered with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in conducting the highly credible study titled *Internal Control – Integrated Framework (1992 and 1994)* and the soon-to-be-released Enterprise Risk Management Framework project (expected later this year).

Internal auditors provide essential assurance services to their organizations, especially in testing and evaluating the soundness and effectiveness of internal control processes. Various components of the enterprise's internal control system, when operating properly, provide assurance to management, the audit committee, and board that the accounting statements and accompanying financial and business information are reliable. A significant portion of the annual work plan of an internal audit function is allocated to assessing the company's risk management and control processes, and that plan is coordinated with the audit plan of the external auditor and approved by the audit committee.

An internal audit function of an entity is independent of management. Its charter and policies are approved by the company's audit committee. The charter and policies ensure that the internal auditors will have full access to senior management, audit committee, and board, with unrestricted access to the company's records, personnel, and properties. The chief internal audit executive functionally reports to the entity's audit committee. The internal auditors perform their work in accordance with The IIA's *Standards for the Professional Practice of Internal Auditing* and *Code of Ethics*. (The *Standards* and *Code of Ethics* have been translated into 20 languages.) The work of the internal audit function is subject to periodic quality assessments.

Conclusion

The board and staff members are embarking on an important venture that will have a significant effect on the public's ultimate trust in corporate reports. Both external and internal auditors play vital roles in support of the legal and professional responsibilities of management executives, audit committees, and boards for ensuring that their companies provide truthful, informative corporate reports.

We look forward to working with the PCAOB and are committed to providing internal audit leaders to serve on its advisory group, task forces and roundtables, as appropriate.

Sincerely,



William G. Bishop III, Certified Internal Auditor

Attachment – Comments Provided to the AICPA

cc: Mr. Charles Landes, AICPA



The Institute of
Internal Auditors

William G. Bishop III, CIA
President

Tel: +1 407 937 1200
wbishop@theiia.org

May 12, 2003

Mr. Charles Landes
Director, Audit and Attest Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Landes:

The Institute of Internal Auditors (IIA) agrees that the auditing practices for reporting on the adequacy and effectiveness of an organization's internal controls over financial reporting should be updated to fit with the new laws and regulations. Further, The IIA recognizes the sizeable investment of people and time by the AICPA's Auditing Standards Board and its task force in developing the four exposure drafts of new and amended standards. As the principle voice of the internal auditing profession, The IIA offers unique insights about the complex issues of assessing internal control processes and utilizing the work of internal auditors by external practitioners.

The IIA agrees with the broad tenets of the proposed auditing standards. They are generally consistent with the IIA's professional guidance relating to risk management and control. However, several positions taken in the proposed statements are troublesome, and some issues relating to the assessment process lack adequate guidance. The IIA believes that the proposed amended Statement on Standards for Attestation Engagement (SSAE), entitled *Reporting on an Entity's Internal Control Over Financial Reporting*, and the proposed new Statement on Auditing Standards (SAS), entitled *Auditing and Entity's Internal Control Over Financial Reporting in Conjunction with the Financial Statement Audit*, are deficient and should be enhanced. Our concerns are summarized below and then explained more fully thereafter.

1. The way in which the work performed by internal auditors is presented in the exposure draft is confusing and contradictory. Paragraph 51 identifies the unique role of internal auditors in performing tests on the organization's controls. However, paragraphs 74-76 discuss the use of the tests of "responsible parties" and make the tests and assessments conducted by internal audit indistinguishable from that of management personnel and third parties. The result is that many organizations and practitioners question whether the external auditors can put reliance on the work of internal auditors. The IIA believes that the SSAE should be amended to give greater importance and priority to the work of internal auditors, particularly their normally extensive assessments of the entity's internal controls. The substantial evidence provided by an independent, well managed, and competent internal audit function that performs its activities by the highest professional standards will provide the external auditor with an invaluable understanding of the entity's risk management and control procedures and their effectiveness. In most circumstances, internal audit work on control processes should have greater credibility and higher reliability for the external auditor than other sources of evidence about an organization's internal control system. In addition, the new SAS should contain similar guidance on reliance on the work of the internal auditors that is encompassed in SAS No. 65 (AU §322).

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2. Practical guidance is lacking on attributes of a “significant deficiency” and “material weakness” and the factors to consider in aggregating and mitigating deficiencies. Clarity of the terms and their practical application are essential if the assessment of the organization’s management, work of internal auditors, and attestation by the external practitioner are to be based on mutually acceptable principles.
3. Practical guidance is also essential if the proposed standard is to retain the position that inadequate documentation of the “design” of internal controls may constitute a significant deficiency. The standard must be accompanied by specific criteria for evaluating the design of internal controls and the attributes of proper documentation.

The following section explains more fully our positions.

1. Emphasize that testing by internal auditors can be relied on by the external auditors.

The proposed SSAE in paragraph 74 classifies work performed by internal auditors as one source on which senior management bases its assertion about the effectiveness of internal control. This paragraph makes the internal audit function’s work indistinguishable from the evaluations and tests performed by management and third parties. Some auditors—both internal and external—have read the proposed rules and concluded that the guidance will encourage the external auditors to undervalue the competencies and work quality of internal auditors and to fail to assimilate their considerable knowledge and understanding of the organization’s internal controls. The apparent interpretation of the proposed rules is that the work of the internal audit function has no more value and relevance to the external auditor than any other management group or third party. External auditors will pass over the internal audit function’s accumulated assessments of the enterprise’s internal control processes and re-perform a vast amount of testing.

The IIA believes that interpretation of the proposed rules will lead external audit practitioners to conduct unnecessary and poorly designed tests by failing to study the considerable work of the internal auditors. An important mission of the internal audit function is the testing and assessment of an organization’s risk management and control processes. An internal audit function is a unique organizational unit of an entity; it is independent of management responsibilities and performs objective assessments. The internal audit function and its chief audit executive typically report to the audit committee and have a charter ensuring that the function has full and unrestricted access to records, property, and personnel of the enterprise and may pursue its work plan without management interference.

We strongly recommend that in paragraph 74 of the amended SSAE, the reference to “internal audit” be omitted. Instead, we would add a sentence to the paragraph to state the following: *The use of the work of internal audit function is discussed in paragraph 51 and in the Statement of Auditing Standards No. 65, entitled The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements (AU §322). This will treat the work of internal auditors as a special class of available evidence about the organization’s internal controls. That special status was implicit in the AICPA’s Statement of Auditing Standards No. 65. That standard says that the external auditor should sufficiently review the work of the internal audit function “to identify those internal audit activities that are relevant to planning the audit.”*

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Relevant activities are defined later in the standard as evidence about the design and effectiveness of controls. Using the tests and assessments performed by internal auditors and the information gained about the internal control system will greatly enhance the external auditor's understanding of the adequacy and effectiveness of the system and enable them to design and perform only the needed tests to clarify or resolve significant control issues. The resulting effect would also be lower external audit fees incurred by organizations.

The IIA also believes that the proposed SAS, entitled *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, is generally consistent with the guidance recommended in the proposed SSAE. However, it fails to acknowledge the work of the internal audit function, management, and third parties in providing evidence about the effectiveness of the organization's internal controls over financial reporting, and it does not provide guidance on how that work may influence the testing of controls by the external practitioner. This standard should contain a reference to SAS No 65 (AU §322).

The IIA also requests modification of the final sentence in paragraph 51. It is inappropriate to say: "...the practitioner should recognize that a potential impairment of objectivity may exist when internal auditors perform a monitoring function within the entity's internal control." IIA guidance recommends that internal auditors evaluate the systems of internal control and provide the assessments to management and the audit committee. The results of those engagements are reported to management who retain the responsibility for the adequacy and effectiveness of the internal controls. This evaluation activity by the internal auditors does not impair the objectivity of internal auditors. We recommend that the assertion in paragraph 51 be deleted.

Engagements of internal auditors are conducted in accordance with the globally recognized *IIA Standards for the Professional Practice of Internal Auditing*. Adherence with the *Standards* and *Code of Ethics* is required by all individuals who provide internal audit services. Those Standards (which have been translated into 20 languages) ensure that internal audit work is performed by competent professionals and complies with professional standards and rules of conduct requiring objectivity, due professional care, and periodic quality assessments.

The work plans of the internal auditors and external auditors are normally jointly planned and coordinated, approved by the audit committee, and information about the system of controls and audit findings shared among the audit groups. As a result, duplication of work is avoided and redundant procedures are replaced by more effective and focused tests. Some work performed by the internal and external auditors may be similar in nature dealing with the same or similar processes, but under most circumstances, the work of the internal auditor should be relied upon by the external auditor. The result is that the degree of assurance is not diminished, but the quantity of audit work by the external auditor is reduced and more effective.

If the work of the internal audit function is to be given special credence in the external auditor's assessment of an organization's internal control process, the proposed SSAE should provide examples of ways to encourage the exchange of work between the two audit groups. That coordination should include review of the work plans for the coming year and the scheduling of engagements, access to engagement files and reports of audit findings, sharing of significant audit issues, observed deficiencies and follow-up actions, and regular face-to-face meetings.

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We understand the need for external auditors to test the work of internal auditors to ascertain that the work was conducted in accordance with the IIA's *Standards for the Professional Practice of Internal Auditing*, that internal auditors are competent and properly supervised, and the audit function is organizational independent of management's responsibilities and free of interference from the entity's personnel. Internal auditors typically have unrestricted access to management and the board and to the records, personnel, and properties of the organization. If the external auditor obtained those assurances, the work of the internal auditors should be considered as possessing more credibility than the work of other management personnel for the purposes of this attestation engagement.

2. Expand guidance for applying "significant deficiencies" and "material weaknesses"

The guidance in the proposed statements related to significant deficiencies and material weaknesses is useful. However, as pointed out in COSO's *Internal Control – Integrated Framework Executive Summary*, "[I]nternal control means different things to different people. This causes confusion among businesspeople, legislators, regulators and others." We believe that confusion about the definition and its application still reigns in management, among internal auditors, and in the positions of accounting firms and their partners.

We believe organizations, external auditors, and internal auditors would benefit with the addition of more guidance on what is a significant deficiency, what is a material weakness and how an aggregation of significant deficiencies could aggregate to a material weakness. We believe that additional guidance would help an organization's executive management, internal auditors, external auditors, and audit committees make more consistent decisions.

However, The IIA believes that there are limits to setting detailed definitions and rules that would be applicable to all public companies. The proposed auditing standards should encourage the practitioner to discuss with the audit committee, senior management, and internal audit executive the appropriate definitions of significant deficiency and material weakness for the company and the ways those terms will be applied by both groups of auditors and management. Those discussions should be convened when the audit plans of the external and internal auditors for the coming fiscal year are being reviewed.

3. Provide guidance on what constitutes adequate documentation of the design of controls

The IIA agrees with the premise in paragraphs 15, 16, and 52 that management should identify the controls designed to prevent material misstatements of significant classes of transactions, account balances, and disclosures. We agree that documentation of those controls provides a tool for training and monitoring the effectiveness of the significant internal controls.

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However, we believe it is inappropriate to state in paragraph 16 that “[I]nadequate documentation of the design of controls may result in a significant deficiency or a material weakness...” While some perceived failures in possessing sufficient documentation may constitute a deficiency, it also may not be substantive proof of a deficiency because the forms of documentation are infinite (paragraph 52 lists some examples) and the evidence of control may reside in the entity’s existing culture and common business practices. We suggest modifying the fourth sentence of paragraph 16 to read: “Inadequate documentation of the design of controls *of significant processes, accounts, or groups of accounts* may result in a significant deficiency or a material weakness and may constitute a limitation on the scope of the engagement, *unless alternative forms of evidence or applied business practices are determined.*” (Italics words are suggested inserted phrases.)

We appreciate the opportunity to express our views on these important matters. We welcome the opportunity to discuss any and all issues with your board at any time.

Sincerely,

A handwritten signature in black ink, appearing to read "W. G. Bishop III". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

William G. Bishop III, Certified Internal Auditor

E-mail to: Ms. Julie Anne Dilley jdilley@aicpa.org

**International Federation of Accountants**

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May 12, 2003

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2083

By e-mail to: comments@pcaobus.org

Establishment of Auditing and Other Professional Standards

Throughout its 25-year history, the International Federation of Accountants (IFAC) has focused on developing a common base for worldwide auditing standards in the form of International Standards on Auditing (ISAs). IFAC shares the Public Company Accounting Oversight Board's (PCAOB's) focus on protecting the public interest and believes that requiring the application of a core set of internationally recognized standards, such as the ISAs, can contribute significantly to ensuring the credibility of the information upon which investors and other stakeholders depend. IFAC's comments on PCAOB Release No. 2003-005 "Statement Regarding the Establishment of Auditing and Other Professional Standards" (the Statement) are presented in this context.

IFAC comprises 155 accounting organizations from every part of the globe, representing more than 2.4 million accountants in public practice, education, government service, industry and commerce. As the worldwide organization for the accountancy profession, IFAC develops guidance and standards for accountants in all sectors to encourage them to act with uncompromising integrity in meeting their responsibilities to the public and to assist them in addressing the challenges of globalization. This work has become increasingly critical in today's environment.

This submission provides brief comments on what we see as the key issue with respect to the PCAOB's establishment of Auditing and Other Professional Standards. It also includes some comments on three significant aspects of the due process outlined in the Statement and one drafting issue.

Key Issue

The PCAOB has specifically invited comment and suggestions about priorities for the review of the Interim Professional Auditing Standards. How the PCAOB deals with the review of the Interim Professional Auditing Standards will be strongly influenced by the ultimate model that the PCAOB intends to adopt. In this context, we recommend that the PCAOB seek public comment on the appropriateness of using ISAs as a common base for issuers in the U.S.

ISAs are developed by the International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body under the auspices of IFAC. The IAASB develops standards and guidance for financial statement audits and other assurance or related services pertaining to both financial and non-financial information, and establishes quality control standards covering the conduct and performance of such services.

There are a number of benefits in adopting an internationally consistent approach to Professional Auditing Standards. An international approach, using ISAs as a base, can expedite the process of international convergence – a process that is well underway and increasingly vital to the development of global capital markets and the protection of the public interest. Many IFAC member bodies are already using the ISAs as the basis for some or all of their national standards. Additionally, the European Union plans to adopt the body of ISAs in 2005 for audits of all entities. Using ISAs as a common base, auditors will be required to both:

- (a) perform a financial statement audit in accordance with ISAs¹; and
- (b) perform additional procedures and report on additional matters in response to specific legal, regulatory or other needs established at a national level.

A benefit of this model is that it ensures a nation's unique legal, regulatory and other needs are met.

Due Process

- The Statement notes that the normal exposure period will be “no less than 21 calendar days.” The experience of IFAC Boards, Committees and member bodies has been that a period of considerably longer than 21 days is normally required to allow interested parties to prepare quality submissions, especially in an international environment with geographically and culturally diverse stakeholders.

A longer comment period would be in the best interests of both potential users of PCAOB standards and those who rely on the auditor's work. Given the implications of the PCAOB's rules for registered non-U.S. firms, the international perspective should be considered in the setting of PCAOB standards, particularly the need to consider the potential consequences in a variety of environments.

An abridged form of due process might be appropriate during the transitional phase of reviewing Interim Professional Auditing Standards, all of which have already been subjected to a due process. However, to ensure a robust due process in the longer term, we believe the PCAOB should expose draft standards for a period of no less than 90 days, notwithstanding that there will normally be a further comment period after submission to the SEC.

- The Statement states: “The board may also ask the advisory group² or a task force to advise it concerning the proposal” (emphasis added). We believe due process

¹ Which requires adherence to IFAC's Code of Ethics (including independence requirements) and Quality Control Standards.

PCAOB - Establishment of Auditing and Other Professional Standards
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would require the advisory group to be consulted in every case, and recommend that Draft Rule 3700 be amended to acknowledge that the advisory group will be involved with all proposals.

- The Statement is silent on whether meetings of the advisory group, and indeed of the PCAOB when proposed standards are discussed, will be open to the public. To ensure transparency, we believe these meetings should necessarily be open to the public.

Drafting Issue

- From an international perspective, there appears to be a problem with Draft Rule 3100, which states: "A registered public accounting firm and its associated persons shall comply with all applicable professional auditing standards". This rule seems to require a registered firm to comply with PCAOB standards on all audits, for instance a registered non-US firm would be required to comply with PCAOB standards even when auditing an organization in their own country which is not a US issuer. This does not appear to be the PCAOB's intention, in which case, the rule would benefit from redrafting to make this clear.

We appreciate the opportunity to comment on this release and will be pleased to assist the PCAOB in ensuring auditing standards can contribute to the restoration of confidence in capital markets. If you have any queries about this submission or want to explore these issues in more depth, please do not hesitate to contact either of us at ph: (212) 286-9655.

Yours sincerely,



René Ricol,
President



Ian Ball
Chief Executive

Cc: Dietz Mertin, Chair IAASB,
Marilyn Pendergast, Chair IFAC Ethics Committee,
Members and Technical Advisers on IAASB and IFAC Ethics Committee,

² The Statement refers in different places to "the advisory group" and "advisory groups". It is assumed the intention of the PCAOB is to have one main advisory group, which may from time to time have sub-groups.



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

May 9, 2003

Dear Mr. Secretary:

PCAOB Rulemaking Docket Matter No. 004

KPMG appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (Board) proposed rule, *Statement Regarding the Establishment of Auditing and Other Professional Standards* (Proposed Rule), which was released April 18, 2003, pursuant to Section 103(a) of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley).

The overarching objective of the provisions of Sarbanes-Oxley is one of furthering the public interest through improving financial reporting, governance, and audit quality. KPMG wholeheartedly supports the efforts of the Board in striving to achieve this objective.

Our comments relate to procedures for adopting or amending Professional Auditing Standards, including the Board's review of Interim Professional Auditing Standards in establishing permanent standards.

Advisory Groups and Task Forces

We are pleased that the Board has elected to convene a standing advisory group to participate in the standards-setting process. We expect that the Board will fully utilize the talents of the various advisory group members and will ensure that participation by the group is substantive to the standards-setting process. In determining the size, composition and operating protocol of the advisory group, we recommend that the Board consider the following:

- A standing advisory group of no greater than 20 members; a group exceeding 20 members generally would not be effective in debating issues and reaching well-reasoned conclusions,
- Individuals from each of the largest auditing firms should be represented on the standing advisory group; the largest auditing firms audit the vast majority of issuers' financial statements,





- Non-U.S. auditors should be represented to give the Board insights into issues that may be unique to areas outside the U.S., and
- Operating policies should be established for the advisory group addressing, among other matters, 1) the process for making recommendations on standards for consideration by the Board, 2) the extent to which deliberations and findings of the advisory group will be made public, and 3) whether the advisory group will participate in the deliberations of all proposed standards.

Procedures for Adopting or Amending Professional Auditing Standards

The Proposed Rule indicates that the development of Professional Auditing Standards should be an open process in which the auditing profession, the preparers of financial statements, the investor community and others have the opportunity to participate. However, the Proposed Rule is not clear regarding the process the Board will adopt to set its agenda and to draft, review and deliberate proposed Professional Auditing Standards.

We believe that three elements are essential to ensuring a transparent process for developing Professional Auditing Standards that will promote public trust:

- The Board's process for developing its agenda should be clearly articulated and communicated to all interested constituencies,
- The Board's deliberations of Professional Auditing Standards should be conducted in a public forum, and
- The exposure process should allow sufficient time for interested parties to evaluate the proposed rules, their impacts, and the practical ramifications of implementation.

We agree that the Board should not be required to notify the recommending party or make a public announcement when concluding that a particular recommendation will not be acted upon, with one exception. We believe that all standard-setting related recommendations to the Board by the aforementioned standing advisory group should, by definition, become an agenda item for the Board to deliberate in a public forum.

Timely, thorough, and open deliberation of auditing, attestation and quality control matters will encourage public participation in the process of establishing and improving these standards. Meetings in a public forum should extend beyond releasing proposed rules for comment and issuing final rules. The deliberations of potential standards prior to exposure should be substantive and be conducted in a public forum. The processes currently used by the Financial Accounting Standards Board and the Emerging Issues Task Force present models for a transparent rulemaking process. These models promote objective decision making, careful consideration of the views of affected constituencies, and evaluation of the expected benefits in relation to expected costs. Where public hearings or roundtables are utilized in the evaluation



process, sufficient notice (30 days would be reasonable) should be provided to allow the various constituencies to plan for effective participation.

The proposed 21-day comment period for proposed standards does not allow sufficient time for interested parties, which will include non-U.S. constituents, to provide meaningful input on those standards. We believe that sixty days represents a more reasonable period for soliciting comments on proposed standards and is consistent with comment periods used by other standard-setting organizations such as the Financial Accounting Standards Board and the International Auditing and Assurance Standards Board. We believe that an open and meaningful due process is essential to ensuring credibility in any standard-setting exercise.

Auditing guidance that is more interpretive in nature might be structured along the lines of FASB Staff Positions with a shorter comment period (e.g., 30 days). Such interpretations would facilitate standard setting where clarification of existing Professional Auditing Standards is needed, but adoption of new Professional Auditing Standards or extensive modification of existing standards is not warranted in the circumstances.

Review of Interim Professional Auditing Standards

The review of each Interim Professional Auditing Standard and the Board's conclusion regarding the adoption of that standard as permanent, with or without modification, or the repeal of that standard, should be subject to the full due process procedures of the Board, including an appropriate comment period. While we believe that the Proposed Rule can be reasonably interpreted that the Board intends to submit the permanent adoption of Interim Professional Auditing Standards to its full due process, we encourage the final rule to be explicit in this regard.

The Board also needs to determine the manner in which it will promulgate permanent Professional Auditing Standards. We recommend that the Board adopt a method similar to that used by the U.S. General Accounting Office (GAO) to promulgate Government Auditing Standards. Under that method, the GAO incorporates by reference the majority of the auditing standards promulgated by the Auditing Standards Board (ASB) and specifies additional requirements and guidance applicable to the audits of Federal organizations, programs, activities and functions, and Federal financial assistance received by others. For example, if the Board intends to modify an existing Interim Professional Auditing Standard, the Board could publish any additional requirements and guidance applicable to the audit of the financial statements of a public company. Not only is this a practical approach, it will significantly enhance the auditing profession's ability to focus on and understand the differences between the auditing standards that have been used for many years and which will apply to the audits of the financial statements of non-public entities and the additional requirements promulgated by the Board.

Implications for Non-U.S. Firms

We encourage the Board to consider how any standards it proposes to adopt impacts non-U.S. firms. Some countries have recently modified local auditing standards to attempt to harmonize with U.S. standards. For example, in the case of Canada, the SEC



continues to accept Canadian generally accepted auditing standards for reporting on Canadian issuers that are eligible for the Multi-jurisdictional Disclosure System (MJDS). We also ask the Board publicly to support initiatives to converge international auditing standards.

Review of Internal Controls and Section 404 Attestation Standard

We support the Board's intention expressed in the Proposed Rule to address as a matter of priority the subject of internal control auditing and reporting. The existing standard (AT501) likely did not contemplate the broad-based, broad circulation and multiple industry reporting that is required by Section 404. We believe the draft standards exposed for comment by the ASB in March 2003 provide much needed guidance for the performance of an audit of an entity's internal control over financial reporting and would significantly strengthen auditor performance in all engagements to report on internal control. We encourage the Board to consider the public interest benefit of incorporating the enhancements in the ASB's exposure drafts into the Board's proposed rulemaking relative to internal control auditing and reporting. With regard to the planned "roundtable meeting" on this subject, we encourage the board to solicit participation from the auditing profession and relevant banking regulatory groups.

* * * * *

KPMG International is a Swiss non-operating association which functions as an umbrella organization to approximately 100 KPMG member firms in countries around the world, to whom it licenses the KPMG name. Each KPMG member firm is autonomous, with its own separate ownership and governance structure. The KPMG member firms do not share profits amongst themselves, and they are not subject to control by any other member firm or by KPMG International.

If you have questions regarding any of the information included in this letter, then please call or write to write to Michael A. Conway, (212) 909-5555, mconway@kpmg.com. or Neil Lerner, + (44) 207 311 8620, neil.lerner@kpmg.co.uk

Yours sincerely,

KPMG

From: HDLewis Family [hdlewis@aristotle.net]
Sent: Sunday, May 11, 2003 5:58 PM
To: Comments
Cc: kwhawkins@ualr.edu
Subject: Docket Matter No. 004

To the Public Company Accounting Oversight Board:

In developing and adopting new auditing standards, I urge the Public Company Accounting Oversight Board (the "Board") not to reinvent the wheel. The process of establishing auditing and other professional standards should begin with a comprehensive review of all currently established GAAS before any attempt at creating new standards is undertaken. It is my understanding that, according to Section 103(a)(3)(B) of the Sarbanes-Oxley Act, the Board "shall adopt existing auditing standards as initial, transitional, or interim standards prior to a determination of the SEC that the Board is capable of carrying out its responsibilities under the Act." It is also my understanding that, since such positive determination has been made, the Board has not determined whether it would be appropriate to include any of the interim professional auditing standards as permanent Board standards and that the Board will establish a schedule for the review of all of the interim professional auditing standards. I recommend that the Board consider each of the interim standards individually before developing any new professional standards. In my opinion, the accounting profession has worked diligently over the years to develop professional standards of independence, technical competence, and due professional care in order to gain public confidence in the profession and positively affect the efficient allocation of resources within the market. Please do not let the recent subjective media exposure that insists that auditing practices have aided in a number of corporate bankruptcies within certain industries induce a complete revocation of the standards that have served the economy relatively well in recent history. Current standards should serve as a foundation for future developments by the Board.

Furthermore, I agree with the comments of Mr. John Corless of CSU-Sacramento that the three general standards and the three fieldwork standards of the ten Generally Accepted Auditing Standards would be a good starting point for establishing new professional standards. In addition, I recommend that the Board utilize two separate advisory boards in the review of interim auditing standards and in the development of future professional auditing standards, one with directed effort towards fieldwork standards and the other toward reporting standards. The separation of advisory functions would afford each panel directed focus and would also expedite the review and development process so that public confidence in the market can be increased and/or restored in a timelier manner.

Thank you for your consideration.

Heath D. Lewis,

Business Manager

Drs. Kumpuris, Davis & Metrailler, M.D., P.A.

Lockheed Martin Corporation
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Rajeev Bhalla
Vice President and Controller

May 12, 2003

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

Via e-mail to comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 004
Proposed Rules of the Board: Part 7 – Establishment of Professional Standards

Lockheed Martin Corporation welcomes the opportunity to provide comments concerning the proposed rules of the Board. Lockheed Martin is a publicly held enterprise with annual revenues of over \$26 billion, and strongly supports efforts to improve the reliability of financial information and restore investor confidence in the marketplace. We are pleased with both the initial actions of the Board and the proposed rules in your recent release, and have one comment for your consideration.

We enthusiastically support the naming of advisory groups to the Board as described in Part 7 of this release, and are heartened that individuals with expertise in public company accounting, finance, and governance are specifically to be included as members as provided under Section 3700 (b). We believe that members from the preparer community can make insightful and valuable contributions to the Board's work, and are gratified that the Board agrees.

We find it inconsistent, then, that the proposed rule does not provide the preparer community with a corresponding voice in recommending individuals to serve on those advisory groups, other than at the discretion of the Board as stated under Section 3700 (c) (8). We believe that public companies, and professional groups of financial executives such as Financial Executives International and the Business Roundtable, are better able to identify quality advisory board candidates from the preparer community than the specific groups listed under Section 3700 (c)

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such as accounting industry groups, accounting firms, and academia. Therefore, we recommend that public company accountants and professional groups of public company financial executives be specifically included in the listed sources of advisory board member recommendations under Section 3700 (c).

Thank you for considering our concerns during the Board's deliberations.

Sincerely,

/s/ Rajeev Bhalla
Vice President and Controller

Message

Page 1 of 3

From: Gagnon, Matthew [Matthew.Gagnon@marriott.com]
Sent: Thursday, April 24, 2003 6:20 PM
To: Comments
Subject: N/A - PCAOB Release No. 2003-006

Per your recent release, 'Establishment of interim professional audit standards'. It appears that we are to expect the Commission's approval of the interim standards no later than April 26, 2003. Based on the definition of the attest standards (rule 3300T), it appears that the standards will include the existing SSAE 10, but not the exposure draft for AT501. Is this assumption correct?

Under either the existing or amended AT501 (assuming proposed amendments are ratified), the standards are silent as to the criteria for the review. Will the PCAOB (the Board) specify the criteria which management and external auditors must apply in their assessments of internal controls required under section 404 of the Act?

As I indicated in an earlier comment to the Board, attached below, I have seen a wide variety of approaches adopted by my peers whose companies are likewise subject to the Act. Over the past month, I have discussed and shared our approach with other large public companies and while some have subsequently altered their approach to incorporate some of our assumptions, others feel it is overkill.

I feel the nature and extent of work we are performing is appropriate based on the conclusions I believe the act requires. At the same time, I do not want to subject my internal clients to an excessive burden, in these difficult times.

I do of course appreciate the magnitude of the effort that the Board is making on a very tight schedule, but I would appreciate any information you can share at this time relative to the criteria you will require as a basis for reporting on internal control over financial reporting.

Regards,

Matthew Gagnon?
IR Audit Director
Marriott International, Inc.
Office: 301-380-2770
Cell: 301-535-6126

From: Gagnon, Matthew [mailto:Matthew.Gagnon@marriott.com]
Sent: Monday, March 17, 2003 11:44 AM
To: 'rsvp@sec.gov'
Subject: Not a candidate. An offer to assist the PCAOB.

I am not a candidate for the chairperson of the Public Company Accounting Oversight Board (PCAOB), but I could not see a better way to get a message to the current members of the board. Please pass this on to the PCAOB's current members for consideration.

Who am I:

I am the Director of Information Resources Internal Audit for Marriott International, Inc., a CPA and a CISA. I have been working in the audit profession for a dozen years for Ernst & Young and for several large US corporations.

As a CPA and an internal auditor, I am bound by professional standards of practice and subject to

a code of ethics. My employer also has a formal ethical conduct policy which requires associates to adhere to high ethical standards as we conduct business to protect other associates, the company and its shareholders.

Having worked with the highest caliber professionals throughout my career, I have seen ethical policy personified in many of my peers, supervisors and executives, but I have not been shielded from the reality that unethical and fraudulent practices are employed by some.

The Problem:

Though I do not believe the propensity to defraud has increased, I do believe that the recent corporate failures help to solidify the case for significant reform of corporate governance and financial reporting that has been building for some time. The Sarbanes-Oxley Act (the Act), appears to provide corporate America and professional auditors a push toward consistent policy and accountability for transparency and reliability of financial reporting, but it is the studies provided for in the act and criteria as yet to be determined by the PCAOB that will be the glue that holds this together.

As you may have guessed, one of my concerns, as I am sure is a concern of my colleagues in the practice of internal auditing, is that the glue with respect to section 404 of the Act will be too inflexible or too weak.

Having participated in many discussions on the subject with the big four accounting firms and internal auditors of other major US corporations, I have heard of many different strategies employed as we prepare for the reporting requirement. Companies' efforts, absent clear direction from the PCAOB, will lead companies to varied solutions many of which may not provide adequate support for required assessments of internal controls. To ensure that companies can develop consistent approaches to meet reporting requirements and have time to implement these approaches, guidance should be provided as soon as reasonably possible.

To ensure that corporations and public auditors develop consistent approaches for compliance with section 404 of the Act, the PCAOB should provide very clear guidance on the criteria to be applied, documentation standards, testing standards, and reporting requirements for the 2003 reporting. As we will learn from this process, the PCAOB would be wise to stress that the requirements will be reevaluated and improved where appropriate for future reports.

The SEC and PCAOB appear to have the attention of the AICPA and its standards boards. I tend to agree that the existing and recently revised standards promulgated by the AICPA provide the basis for effective 'reporting on an entity's internal control over financial reporting', but the interpretation of the standards, and specific criteria for the assessment of internal controls is not clear and those with whom I have had occasion to discuss 404 approaches have various expectations with respect to the ultimate criteria (e.g. pure COSO, COSO with control objectives specified by management, COSO with financial statement assertions (SAS78) for significant financial statement captions, SAS 70 approach limiting scope to control objectives specified by management, etc.).

The Solution:

The apparent imminence of the escalation of the conflict with IRAQ to war, concerns over the US economy and the political pressure I am sure the SEC and PCAOB are exposed to will undoubtedly make for a challenging environment to establish and enforce this significant requirement for US corporations, but be assured, internal auditors are not only bracing for it, we are moving ahead.

To spare the shareholders the cost of inefficient/misdirected efforts to comply with section 404 of the Act, I implore the PCAOB to establish and issue specific guidance for achieving compliance with the Act. I also ask that the PCAOB issue the guidance in an exposure draft to allow management, internal auditors and public accountants ample time to evaluate and challenge the proposed process. Issuing under an exposure draft would enable the PCAOB to issue more timely, while continuing to work internally to improve the process and consider the input of the many professionals that will be affected by this process.

I appreciate your consideration of this input and would welcome the chance to share, with the

Message

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PCAOB, our approach and the status of our efforts to prepare for the requirements of the Act.

Sincerely,

Matthew Gagnon 

**IR Audit Director
Marriott International, Inc.**

Rule 3300T - Interim Attestation Standards Rule 3300T governs the conduct of engagements that (i) are described in the

ASB's Statement on Standards for Attestation Engagements No. 10 (Codification of Statements on Auditing Standards, AT § 101.01), and (ii) relate to the preparation or issuance of audit reports for issuers. Registered public accounting firms involved in such engagements are required to comply with the ASB's Statements on Standards for Attestation Engagements, and related interpretations and AICPA Statements of Position, as in existence on April 16, 2003.

As the Note to Rule 3300T clarifies, the Board intends that, during the period preceding the mandatory registration date, the Interim Attestation Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.



National Association of State Boards of Accountancy

150 Fourth Avenue North ♦ Suite 700 ♦ Nashville, TN 37219-2417 ♦ Tel 615/880-4200 ♦ Fax 615/880/4290 ♦ Web www.nasba.org

May 8, 2003

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

Re: PCAOB Rulemaking Docket Matter No. 004
PCAOB Release No. 2003-005, April 18, 2003
(Statement Regarding the Establishment of Auditing and Other Professional Standards)

Dear Board Members:

We appreciate the opportunity to offer comment to the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") on its proposal regarding the Establishment of Auditing and Other Professional Standards and related proposed Rules that are being considered by the Board for adoption and submission to the Securities and Exchange Commission (the "Commission" or the "SEC").

As the national organization of all U.S. state accountancy regulators, the National Association of State Boards of Accountancy (NASBA) respects the Board's efforts to implement promptly the requirements of the Sarbanes-Oxley Act of 2002 (the "Act") that are entrusted to the Board. NASBA's member boards (the "State Boards") are composed of both licensees and non-licensee public members. As enforcers who are the only authorities empowered to grant or revoke licenses of CPAs (certified public accountants), NASBA's member boards understand the delicate balance between the need for swift discipline and the necessity of procedural fairness.

As before, NASBA's comments here give special attention to facilitating federal/state cooperation.

I. General Comments.

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.

NASBA supports the proposal for the PCAOB's establishing professional auditing standards (to be defined to include auditing standards, standards for attestation engagements, quality control policies or procedures, ethical or competency standards, and independence standards) with input and assistance from one or more advisory groups.

We are pleased to see in footnote 8 of the proposing release that the PCAOB anticipates state accounting regulators will be represented on the advisory group(s). The involvement of state accounting regulators is especially appropriate with respect to ethical, competency and independence standards since state regulators regularly address such matters. Additionally, the public protection efforts at both levels will be enhanced by improved communication among enforcers, harmonization of approaches to shared objectives, and appreciation of procedural, as well as prioritization, differences.

However, as noted below, we do urge that "State regulatory authorities or an association of State regulatory authorities" be included *expressly* among those persons who provide recommendations to the PCAOB of possible advisory group members.

The release notes that the PCAOB plans to publish proposed new or amended professional auditing standards for a comment period normally of at least 21 days. We encourage the PCAOB to consider whether a longer comment period may be appropriate for particular proposals. In making such a determination, the PCAOB could consider the nature, scope and complexity of the proposal, the significance of the proposal, the likely breadth and degree of interest by various groups, and the appropriateness of encouraging comment on the particular proposal by State Boards, which meet only monthly in many states.

II. Comments on Selected Provisions of the Proposed Rules.

Proposed Rule 1001. Definitions of Terms Employed in Rules.

We suggest the addition of definitions of "State" and "State regulatory authority" for use in changes we offer below for proposed Rules 3100 and 3700.

Add a definition of "State" based on the definition in the Act: "The term 'State' means any State of the United States, the District of Columbia, Guam, Puerto Rico, the Virgin Islands, or any other territory or possession of the United States." (Assuming that this definition is included, references in various Rules to "state" would be changed to "State" as appropriate.)

Add a definition of "State regulatory authority" adapted from the definition of "appropriate State regulatory authority" in the Act: "The term 'State regulatory authority' means the State agency or other State authority responsible for the licensure or other regulation of the practice of accounting in the applicable State."

Proposed Rule 3100. Professional Auditing Standards Applicable to Registered Public Accounting Firms. We agree that it is useful to provide expressly that a registered public accounting firm and its associated persons shall comply with all applicable professional auditing standards.

In the proposing release the PCAOB seeks views on whether there are other standards, in addition to its professional auditing standards, with which the PCAOB should require registered public accounting firms to comply. NASBA believes it is fundamental that registered public accounting firms and their associated persons comply with applicable licensing requirements. The failure to adopt such a requirement could undermine the constitutionally preserved ability of each State to protect its citizens from unauthorized practice and from violations of complementary State regulations. Thus, as noted also in Part III below, NASBA urges the PCAOB to require that a registered public accounting firm and each of its associated persons be duly licensed, registered or permitted or otherwise hold valid practice privileges and be in good standing under the laws of each applicable State [defined as noted above] and each other applicable jurisdiction where or with respect to which the activities of the accounting firm or the associated person require the accounting firm or the associated person to be licensed, registered or permitted or otherwise hold valid practice privileges under the laws of the State or other jurisdiction or the rules, regulations or policies of the appropriate State regulatory authority or other jurisdictional regulatory authority.

We believe that, *at a minimum*, the PCAOB should require a registered public accounting firm and each of its associated persons to comply with any applicable *requirements of the Commission for recognition* of the accounting firm or the associated person *by the Commission*, including those set forth in Regulation S-X of the Commission, as it may be amended from time to time.

Proposed Rule 3700(c). Advisory Groups – Selection of Members of Advisory Groups.

NASBA agrees with the proposal that the PCAOB convene one or more advisory groups to assist it in carrying out its responsibility to establish professional auditing standards. NASBA also agrees with the proposal that the PCAOB, at its discretion, select members of advisory groups based upon recommendations provided by a variety of persons or bodies having an interest in the accuracy of public company financial statements. We do believe quite strongly, however, that the list of sources of recommendations should include *express* reference to state accounting regulators. We request that you add to the list: “State regulatory authorities or an association of State regulatory authorities.” We suggest that the term “State regulatory authority” be defined as noted above in our comments on proposed Rule 1001. NASBA and the State Boards have a strong interest in the proper conduct of the public accounting profession, including the proper audit of public company financial statements. We believe that *express* reference to State regulatory authorities or an association of State regulatory authorities would be at least as appropriate as various other categories of recommending persons included in the proposed list. Further, we suggest that “State and federal regulation” might be included in the list of areas of expertise for advisory group members. We strongly believe that state accounting regulators should be represented on the advisory group(s) and are pleased that the PCAOB anticipates this will be the case.

Proposed Rule 3700(e). Advisory Groups – Ethical Duties of Advisory Group Members.

Proposed Rule 3700(e) provides, “Members of an advisory group shall comply with EC 3, EC 8(a) and EC 9 of the Board’s Ethics Code.” The analysis in Appendix 2 of the proposing release

notes that these provisions of the proposed Ethics Code address, respectively, “general ethical principles applicable to service for the Board, disqualification in the case of conflicts of interest, and the non-disclosure of non-public information.”

We suggest that advisory group members also comply with EC 14 [certification] of the proposed Ethics Code, adapted to provide that members of an advisory group agree to comply with [specified provisions of] the Ethics Code at the commencement of their service with the advisory group and shall annually certify in writing their continuing compliance therewith.

We also wonder if consideration might well be given to adapting EC 13 [waiver] for advisory group members. The proposing release notes that the PCAOB contemplates the advisory group “will be comprised of individuals with a variety of perspectives, including practicing auditors, preparers of financial statements, the investor community and others.” Thus there may be a greater likelihood that an advisory group member (distinguished from a PCAOB Board or staff member) may have “a financial interest or other similar relationship which might affect or reasonably create the appearance of affecting his or her independence or objectivity.” The more conscientious the advisory group member (and the more rigorously she or he applies the general principles of EC 3 and the disqualification standard of EC 8(a)), the more likely a possible decision to recuse herself or himself absent a formalized waiver approval process. Such a withdrawal may be appropriate since (compared with the PCAOB and its staff) some element of lessened individual independence and objectivity (or at least the appearance of lessened individual independence and objectivity) may be inherent in the composition of an advisory group intentionally drawn from varied constituencies.

III. Prospective Future Rulemaking by the PCAOB or the Commission.

NASBA urges that care be taken by the PCAOB and the Commission in drafting various regulations so as not to dilute the existing requirement for Commission recognition that a certified public accountant be "duly registered and in good standing as such under the laws of the place of his residence or principal office" and that a public accountant be "in good standing and entitled to practice as such under the laws of the place of his residence or principal office." [Rule 2-01(a) of Regulation S-X; 17 CFR 210.2-01(a)] Accordingly, the current license status of all accountants associated with registered public accounting firms and firms applying for registration (in addition to the firms themselves) should be regularly checked with State Boards directly, or facilitated through NASBA.

NASBA urges that the PCAOB encourage the Commission to add to the requirements of Regulation S-X regarding "Qualifications of Accountants" a requirement for Commission recognition [and/or, as noted above in our comments on proposed Rule 3100, that the PCAOB itself require] that an accounting firm and each of its associated persons be duly licensed, registered or permitted or otherwise hold valid practice privileges and be in good standing under the laws of each applicable State [defined as noted above] and each other applicable jurisdiction where or with respect to which the activities of the accounting firm or the associated person require the accounting firm or the associated person to be licensed, registered or permitted or otherwise hold valid practice privileges under the laws of the State or other jurisdiction or the

rules, regulations or policies of the appropriate State regulatory authority or other jurisdictional regulatory authority.

Conclusion. NASBA appreciates the opportunity to provide these comments. Should you have questions about our thoughts on the proposed Rules or other matters, please contact us. We look forward to ongoing communication and cooperation with the PCAOB and the SEC.

Sincerely,

A handwritten signature in black ink, appearing to read "K. Michael Conaway". The signature is fluid and cursive, with a large, stylized initial "K" and a long, sweeping underline.

K. Michael Conaway, CPA
Chair, NASBA

A handwritten signature in black ink, appearing to read "David A. Costello". The signature is cursive and somewhat stylized, with a prominent "D" and "C".

David A. Costello, CPA
President & CEO, NASBA



May 12, 2003

Office of the Secretary
PCAOB
1666 K Street NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 004

Dear Sir or Madam:

Prescient is pleased to provide comment to the PCAOB's release number 2003-005, "Statement Regarding The Establishment Of Auditing And Other Professional Standards". Our comments are offered in the context of the language contained in Sections 302 and 404 of the Sarbanes-Act of 2002, as well as the AICPA's Auditing Standards Board exposure draft of March 18, 2003.

Inaccurate disclosures occur because Management makes them and auditors attest to them, intentionally or unintentionally. Our company recently provided comments to the Securities and Exchange Commission regarding the Commission's proposed rule regarding internal controls (please see attached). In our comment letter to the SEC, we focused on the accuracy of Management's assertions in their disclosures to the public. But in order to provide a "true" picture to the investing public, the accountability must be shared between issuers and their auditors. Therefore, similar attention should be paid to the tests and tools used by public accounting firms to verify and validate an issuer's financial results and the control systems that produce them. Under the Act, the proposed Commission rules, and the proposed AICPA Standards, the burden is placed almost exclusively at the feet of the issuer.

Both the Sarbanes-Oxley Act of 2002 and the AICPA's standards rely heavily on the Commission on Sponsoring Organization's 1992 report, "*Internal Control – Integrated Framework*". While the COSO Framework is an important and meaningful ingredient in the overall foundation of financial transparency, it is important to note that the COSO Framework was written more than ten years ago. Ten years ago, public companies could not leverage the benefits of today's computer systems. Today's computer systems are relatively inexpensive and allow companies to manage their business processes, controls, results, and disclosures. Therefore, we hope that the PCAOB's efforts will focus beyond COSO and take into account the accelerated velocity of technology. This technology has given issuers access to near perfect information in near real-time, allows them to disclose information in an accurate and timely fashion, and facilitates the validation and verification of mountains of information in seconds.

We applaud the PCAOB's efforts to explore new standards with respect to internal control reporting, and to include interested parties from multiple disciplines in the dialog. We are hopeful that the PCAOB, in your own rulemaking process, will not open up the validation and verification loopholes that the Act sought to close. Closing these loopholes and eliminating linguistic "gray areas" will go a long way toward restoring investor confidence in the capital markets.

Sincerely,

Jonathan Ewert
VP Marketing



April 22, 2003

Jonathan G. Katz
Secretary
U.S. Securities & Exchange Commission
450 Fifth Street NW
Washington, DC 20549-0609
Re: File No. S7-40-02

Dear Mr. Katz:

PRESCIENT is pleased to comment on the Commission's proposed rule regarding internal controls.

Internal controls are at the center of an issuer's ability to disclose financial results to the public in an accurate and timely manner. We applaud the Commission's efforts to restore investor confidence by eliminating the "gray areas" of financial disclosure that have eroded that confidence in the capital markets. Yet despite the Commission's best efforts, the language of the proposed rules leaves important disclosure loopholes untouched.

While many powerful constituencies have vociferously objected to certain sections of the Act and the Commission's proposed rules, the general investing public has remained silent through the process as evidenced by the absence of comments letters. Despite the Commission's best efforts for free and open exchange of information, public investor comment has been muted by the noise of enterprises and organizations that seek to soften the rules to enhance their market position. This is evidence by the conspicuous lack of comment letters from the investing public, in whose interests the law was enacted and on whose behalf the Commission's rules will be enforced. As a result, we believe the proposed rules fall short of their desired effect for transparency, and instead will perpetuate the "shades of gray" the rules seek to eliminate.

Specifically, we point to the language of the proposed rules and the 1992 COSO guidelines on which they are based. At root, disclosure of the "significant deficiencies in the design and operation of internal controls and procedures for financial reporting" is required by management only based on "his or her knowledge" at the time. Regardless of the frequency of testing and certification, this language reopens the loopholes to a sliding scale of accuracy. This sliding scale is not in the best interests of shareholders and the investing public, is certainly not the Commission's intent, and is not consistent with the spirit of the Sarbanes-Oxley Act of 2002. These loopholes become particularly acute in the two most critical areas investors use to evaluate the overall financial health of a business: revenues and expenses.

On the revenue side, much attention has been paid and much progress has been made to clarify the laws, rules, auditing standards, and testing tools. Yet the expense side of the business has been left largely to the discretion of management as part of Management's "Duty Of Care". Sadly, however, many enterprises do not have sufficient financial control systems in place to efficiently and accurately manage the expense side of the ledger. This is true not only of the headline grabbers, but also of the vast majority of public companies. There are several causal factors. Among them are: decentralized decision making, particularly within large companies; the number of disparate vendors required to support an enterprise's needs; the sheer volume of bills an enterprise receives; multiple vendor billing formats and lack of transparency in pricing/consumption; dynamic market pricing conditions; inadequate contract compliance mechanisms and dispute resolution processes; lack of accurate demand forecasting; and more.

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Jonathan G. Katz

April 22, 2003

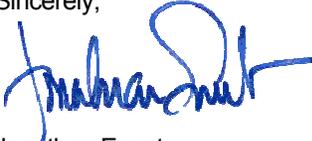
In some major expense categories, more than half of vendor invoices are wrong. Most of the time, these errors are in the favor of the vendor. Overpayment is a direct drain on corporate cash flows and Earnings Per Share. Vendor overpayments indicate that the enterprise has materially deficient internal controls and procedures. Yet because of the sliding scale of accuracy in the Commission's proposed rules, the investing public will continue to rely on Management's assertions that corporate cash flows are under control.

Public companies use public investment dollars similar to the way the government uses the public's tax dollars. We believe that public companies should be held to the same transparency standard as the Federal government. Even its own dealings with vendors, the government has gone to extraordinary lengths to verify and validate that the public's tax dollars are well spent. The Federal Aviation Administration, for example, recently signed a long-term contract to validate and verify each line item of each telecommunications invoice received on a monthly basis. The volume of invoice information received by the FAA dwarfs that of even the largest public company. Verifying and validating expenses is achievable and is neither an operational nor a financial burden.

According to Commissioner Glassman in a speech delivered at the National Economists Club on April 7, the Commission received over 9,000 comment letters and consumed over 4,800 cups of coffee reading and processing each one. To be sure, the Commission's efforts to achieve the goal of financial "transparency" on behalf of the investing public are Herculean in scope and admirable in thoroughness. We hope that the Commission's efforts continue apace after issuance of the final rules.

The proposed rules, as written, simply provide public companies with too many excuses for ineffective controls and too many opportunities to obfuscate the results disclosed to the public.

Sincerely,



Jonathan Ewert
VP Marketing



PricewaterhouseCoopers LLP
400 Campus Dr.
Florham Park NJ 07932
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May 12, 2003

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

Re: PCAOB Rulemaking Docket Matter No. 004, Proposed Rules Relating to Professional Auditing Standards and Advisory Groups

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the proposed rulemaking regarding the establishment of professional standards. We fully recognize and appreciate the authority of the Public Company Accounting Oversight Board (Board or PCAOB) to set such standards, a challenging task. In that connection, we agree with the basic proposal to involve others with an interest and expertise in such standards in the standards-setting process in an advisory capacity.

Within the context of that basic support, we have some recommendations for making the standards-setting process optimally effective. We also have identified a number of issues that the proposal does not address, but that are essential to be addressed in the interests of all who rely on the work of the auditing profession for the added credibility that auditors' reports bring to the financial marketplace.

Definition and Applicability of Professional Auditing Standards

Scope of Standards

Proposed Rule 1001(p)(iv) defines "Professional Auditing Standard." The delineation of areas in which standards are to be included within this definition appears to be appropriate. The Board specifically requested comment on whether there are other standards with which the Board should require registered firms to comply. We are not aware of any such standards.

Proposed Rule 3100 states that a registered public accounting firm and its associated persons must comply with "all applicable professional auditing standards." It is not clear what establishes the "applicability" of a professional auditing standard. In particular, the applicability of such standards could be to all professional engagements for which the Board



has issued standards performed by a registered public accounting firm and its associated persons, without regard to whether the client was an issuer or not.

We believe the Board should clarify what clients are covered. We believe that the intention of the Act was to provide oversight over the performance of public accounting firms with respect to issuers, and only that. We do not believe that an extension of the Board's authority to engagements for clients that are not issuers, even if performed by a registered public accounting firm, represents the intention of the Act.

Types of Standards to Be Established

Proposed Rule 1001(p)(iv) does not define what constitutes a "standard." The Interim Professional Auditing Standards adopted give an indication of what the Board intends to include within the concept of standards, but they also raise certain issues.

Specifically, Rule 3200T includes within auditing standards the entirety of generally accepted auditing standards, as described by Statement on Auditing Standard (SAS) No. 95, as amended. This is an appropriate construction for standards to be followed by registered public accounting firms and associated persons, but does not lead to clarity about which standards the Board intends to establish through its standards-setting process. Certainly, we expect that the Board would establish standards equivalent to the category of Auditing Standards in SAS No. 95. The use of the term "standards" in proposed Rule 1001(p)(iv) does not clarify the Board's role in establishing Interpretative Publications. While it may be expected that the Board will issue Auditing Interpretations, it is not as clear whether the Board will issue Guides and Statements of Position, many of which are industry-specific applications of Auditing Standards. (This discussion assumes that the Board will retain the basic structure of the documents contemplated by SAS No. 95.)

We believe that all related authoritative professional literature applicable to covered engagements performed by registered public accounting firms should be created by or under the direction of the same group, to reduce the likelihood that varying interpretations of the intended results will arise. Therefore, we believe the Board should retain authority for all Auditing Standards and Interpretative Publications that relate to the basic standards. However, we are concerned that the Board may not have the resources to issue guidance on applying this material to individual industries. Therefore, since such guidance is very important to effective implementation of the standards, we suggest that the Board consider the alternative of utilizing, under its direct supervision, the existing processes within the American Institute of Certified Public Accountants (AICPA), or appoint its own set of industry-oriented advisory groups, to ensure the continued availability of such industry-specific interpretative guidance.

The last category addressed by SAS No. 95, Other Auditing Publications, are by definition issued by a large number of parties. The Board may well choose to issue some materials that



would fall within this category. However, it is not practical for the Board to assume responsibility for all publications included in this category. This should be clarified in the final version of Rule 3200.

No Implied Private Right of Action

Though Congress did not explicitly create a private right of action for a violation of the Act's provisions, and we do not believe that such a right exists, we recommend that the Board expressly disclaim the Board's intent to create a private right of action, similar to that contained in the recent Final Rule of the Securities and Exchange Commission (Commission) regarding the "Implementation of Standards of Professional Conduct for Attorneys." To avoid any potential confusion, we recommend that the Board state as follows:

- The rules promulgated by the Board and the standards adopted by the Board pursuant to Section 103 of the Act are not intended to, and do not, create a private right of action against any registered public accounting firm or its associated persons based upon compliance or noncompliance with those rules.
- The rules promulgated by the Board and the standards adopted by the Board pursuant to Section 103 of the Act are intended to be enforced only by the Board and by the Commission.
- The ethics standards promulgated by the Board and the ethics standards adopted by the Board pursuant to Section 103 of the Act do not establish a standard of care that is relevant to prove professional negligence.

Applicability to Foreign Registered Public Accounting Firms

Proposed Rule 3100, as written, applies to all registered public accounting firms. However, certain of the Interim Professional Auditing Standards approved by the Board introduce requirements that heretofore have not been applicable to foreign auditors. Specifically, they include the following standards that have only been applicable to members of the AICPA:

- Rule 3400T includes quality control standards based on the ASB's Statements on Quality Control Standards (QC sec. 20-40) and certain membership rules of the AICPA SEC Practice Section. (Some, but not all, of these rules, such as concurring review requirements, have been applicable to foreign auditors.)
- Rule 3500T includes ethics standards based on Rule 102, and interpretations and rulings thereunder, of the AICPA's Code of Professional Conduct.
- Rule 3600T includes independence standards based on Rule 101, and interpretations and rulings thereunder, of the AICPA's Code of Professional Conduct, to the extent that they are more restrictive than the rules of the Commission.

We believe that the Board should specify that these Interim Professional Auditing Standards are not applicable to registered public accounting firms and their associated persons, when the firm is domiciled outside the United States, pending a further study of their applicability.



In addition, we are aware of a special arrangement the Commission has with respect to Canadian auditors whereby auditing standards generally accepted in Canada are deemed acceptable to the Commission when the auditor's report is included in a form filed under the Multijurisdictional Disclosure System (MJDS). We believe that the Board should specifically incorporate this arrangement in its application of Rule 3100 to the auditing standards to be followed by such firms.

The Standards-Setting Process

The only specific rule relating to the establishment of professional standards included in the rulemaking is proposed Rule 3700, Advisory Groups. However, the Statement accompanying the proposed rules includes additional discussion on the process that the Board intends to follow in its standards-setting. Therefore, we have not limited our comments to just proposed Rule 3700.

Composition of Advisory Groups

Proposed Rule 3700 appropriately, and consistent with the Sarbanes-Oxley Act of 2002 (Act), allows for the appointment of **one or more** advisory groups. However, the accompanying Statement, in places, implies that the Board may only appoint one such advisory group. We strongly encourage the Board to have separate advisory groups for each of the various types of standards to be established, that is, (i) auditing and attestation standards, (ii) quality control standards, and (iii) ethics and independence standards. Experience has shown that those with expertise in auditing may not have a similar degree of expertise in ethics and independence, and so forth.

We also note the intention of the Board, as presented in the Statement, to have representative complements of individuals from various backgrounds, with the intention of relatively equal representation from the accounting/auditing, finance, and investment fields. We understand the desire to have broad involvement of various groups in these endeavors. However, we believe that it is essential to involve, in a significant way, people with a deep understanding of how the standards are, or would be, implemented in practice, that is, auditors in public practice.

We also are aware of comments in various public forums to the effect that the time commitment expected of advisory group members, in at least some areas, will be significant. Given the nature of the subject matter to be addressed by these advisory groups, it may be difficult to attract sufficient candidates from the finance and investment fields to balance the number of accounting/auditing experts needed to effectively operate the advisory group. We encourage the Board to not set rigid requirements for proportional participation so that it not impede its ability to attract the necessary expertise and talent for its tasks.



Proposed Rule 3700 contains no indication of the length of service of advisory group members, or how the Chair of such groups would be selected. We recommend that the Chair of an advisory group be selected from among its volunteer members, and not be a Board staff person (or a Board member) to ensure that the advisory group is not encumbered in providing advice to the Board. Furthermore, we suggest that the members of an advisory group (as compared to an ad hoc task force) be appointed for a set term of, say, three years, and that the expirations of terms be staggered so that there is always a reasonable continuity of membership from year to year.

Ethics Obligations of Advisory Group Members

Proposed Rule 3700 appropriately requires that advisory group members participate on a personal basis, and that the members comply with certain specified ethical duties. However, we have the following observations and recommendations with respect to the provisions of the Board's Ethics Code cited in section (e) of the Rule, based on the proposed Ethics Code included in PCAOB Rulemaking Docket Matter No. 003:

- EC 8(a) required recusal in the event of "a financial interest or other similar relationship which might affect or reasonably create the appearance of affecting his or her independence or objectivity with respect to the Board's function or activities." However, it needs to be recognized that advisory group members all have other vocations, and they will need guidance on how this rule applies to their participation. They are not likely to be able to adhere to this rule in the same way that Board members and professional staff can.
- EC 9 limits the dissemination of information to which advisory group members may have access. However, we understand that advisory group members will be expected to use support personnel they have in their respective organizations to assist in the Board's activities, a common occurrence by volunteers assisting professional organizations. If they are precluded from sharing agenda materials with these support personnel, their contribution may not be maximized. This should be clarified.
- We suggest that the Board consider including EC 10 (restrictions on speaking for the Board) and EC 14 (annual compliance certification) as applicable to advisory group members.

Other Standards-Setting Processes

The Statement accompanying the proposed rules refers to the following aspects of the standards-setting process:

- The Board will determine its own standards-setting priorities, and also will consider proposals submitted by others (and, in fact, encourages such submissions).
- The Board will utilize advisory groups, subgroups thereof, and/or ad hoc task forces to assist its staff in developing standards.
- The Board will solicit public comment on its proposals, and may convene hearings or roundtable meetings to obtain such input.



- Proposals for new standards will be published for comment, for a period of no less than 21 calendar days, unless the Board determines that a shorter period is necessary or appropriate under the circumstances or unless the Board determines that an emergency exists that would preclude a public comment period.
- After considering such input, the Board will consider the proposal and, by majority vote, determine whether to approve the standard.
- Any standard so approved requires approval by the Commission, which is also required to publish the Standard for comment. (We understand that the Commission normally permits a comment period of at least 30 days.)

We recognize that the Board needs some flexibility in the process used to develop proposals for standards. However, we believe that such activities need to be conducted within the broad principles of “sunshine” and due process. Therefore, we urge the Board to ensure that such activities take place with these principles in mind.

With that in mind, we have some recommendations about the processes set forth above:

- It is not clear whether the Board intends for its standards-setting meetings, including meetings of advisory groups, to be open to the public. Consistent with its present conduct of its affairs, we believe the Board should make it clear that all meetings at which proposed standards are discussed should be open to the public.
- We observe that a majority vote is anticipated for approval of a standard. We believe that a similar vote should be required for approval of a proposal released for public comment.
- Experience has shown that a comment period of 21 days is too short. We encourage the Board to allow a minimum of 30 days for proper consideration by commenters and, for more complicated proposals, to allow an exposure period of at least 60 days.

Review of Interim Professional Auditing Standards

The Statement accompanying the proposed Rules invites suggestions concerning priorities for the Board’s review of the Interim Professional Auditing Standards and any changes to them that the Board should consider. Based on our understanding of the content of the Interim Professional Auditing Standards, as discussed above, we have the following suggestions:

- Auditing standards
 - The Auditing Standards Board (ASB) proposed, last October, a significant series of revisions to current auditing standards around the subject of risk assessment. These revisions were developed jointly with the International Auditing and Assurance Standards Board (IAASB), and are a key element in the longer-term initiative to achieve greater convergence of U.S. and international auditing standards, within the overall goal of one set of global auditing standards. (We understand the ASB intends to submit to the Board a modified version of this proposal, to reflect comments received on its proposal. Comments were due to the ASB by April 30, 2003.) We



- understand the IAASB may approve the final revisions to international standards on auditing as early as September 2003. We urge the Board to take expeditious action to integrate these revisions into auditing standards to be used in the U.S.
- A companion proposal to the proposed revision to AT 501 (discussed below) would establish an auditing standard requiring that an audit of internal control over financial reporting be performed in conjunction with an audit of financial statements for a public company, to effect the requirement of Section 103(a)(2)(A)(iii) of the Act. We encourage the Board to utilize this material in developing their response to this Section of the Act. (We understand the ASB intends to submit to the Board a modified version of this proposal, to reflect comments received on its proposal. Comments are due to the ASB by May 15, 2003.)
 - The ASB proposed, earlier this year, a new standard relating to requirements for a reviewing partner and a series of amendments to existing standards (including a requirement for retention of audit documentation) responsive to various provisions of the Act. Among other things, these revisions would effect the requirements of Sections 103(a)(2)(A)(i) and (ii) of the Act. We encourage the Board to utilize this material in developing their response to these Sections of the Act, as well as to enhance the auditing standards for the other items contained therein. (We understand the ASB intends to submit to the Board a modified version of this proposal, to reflect comments received on its proposal. Comments are due to the ASB by May 15, 2003.)
 - We are aware that the ASB has identified a number of other areas where existing auditing standards might be enhanced or improved, and that the ASB will be submitting recommendations to the Board in these areas. We encourage the Board to consider these recommendations. We believe that all of these matters relate to audits of issuers (as well as other entities), and therefore should be considered by the Board.
- Attestation standards
 - The ASB proposed, earlier this year, a revision of AT 501, *Reporting on an Entity's Internal Control over Financial Reporting*. These revisions were intended to clarify and expand the existing guidance to strengthen performance requirements for, in particular, the attestation required pursuant to Section 404 of the Act. While the Board has indicated its plan for addressing this area of standards, we believe this needs to be among the highest priorities of the Board in the near term. We are supportive of the ASB's proposal. (We understand the ASB intends to submit to the Board a modified version of this proposal, to reflect comments received on its proposal. Comments are due to the ASB by May 15, 2003.)
 - We do not believe there are any other aspects of the attestation standards that require immediate attention.
 - Quality control standards
 - The AICPA is close to finishing a revision to its *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing*



Practice. This Guide is applicable to auditors of both public and nonpublic entities, and is not an authoritative portion of the quality control standards adopted by the Board as part of Rule 3400T. Still, we encourage the Board to endorse this Guide.

- Ethics and independence standards
 - The AICPA's Professional Ethics Executive Committee (PEEC) has outstanding an exposure draft of proposed revisions to various aspects of the AICPA's independence rules that would amend three interpretations to Rule 101 of the AICPA's Code of Professional Conduct. The interpretations are Interpretation 101-3, *Performance of non-attest services*, 101-5, *Loans from financial institution clients*, and 101-13, *Extended audit services*. The proposed revisions of Interpretations 101-3 and 101-13, in particular, would tighten the current restrictions applicable to the provision of certain non-audit services. In addition, the PEEC is in the process of amending ethics ruling no. 91, *Member leasing property to or from a client*. We encourage the Board to include in its professional auditing standards any final revisions to the existing AICPA independence rules that it previously adopted on an interim basis. This is particularly important given that certain of the proposed amendments would institute requirements that are not presently contained in the independence rules of the Commission or the Independence Standards Board (ISB) and would tighten the current requirements of the existing AICPA rules.
 - During its existence, the ISB issued three independence standards and three independence interpretations. ISB Standard No. 2 was superseded by the Commission's 2000 independence rule. However, that standard is still on the ISB's website, although it contains a notation stating that it will never become effective because of comprehensive revisions made by the Commission to its rules on the same subject. We urge the Board to make clear that ISB Standard No. 2 is not among the Board's Interim Professional Auditing Standards. In addition, certain aspects of ISB Standard No. 3 were effectively superseded by the Commission's 2000 and 2003 independence rules. To avoid lending renewed authority to those aspects of ISB Standard No. 3, we recommend that the Board clarify that it is adopting on an interim basis only those aspects of ISB Standard No. 3 that were not effectively superseded by the Commission's rulemaking.

* * * * *

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the staff may have. Please do not hesitate to contact Raymond J. Bromark (973-236-7781) or James S. Gerson (973-236-7247) regarding our submission.

Sincerely,

/s/ PricewaterhouseCoopers LLP

From: PLShillam@cs.com
Sent: Friday, May 09, 2003 8:19 PM
To: Comments
Subject: PCAOB Rulemaking Docket No. 004

I am concerned that the adoption of Professional Auditing Standards that are applicable to registered public accounting firms may give rise to double standards - those adopted by the Auditing Standard Board and those promulgated by the PCAOB. This will cause confusion with investors.

The issue will be akin to the Big-GAAP/Little-GAAP issue that has been bantered about for years in the accounting profession. Now, we will have Auditing Standards and Professional Auditing Standards. Additionally, there exists Government Auditing Standards. I fear to think where we are going.

Do we really need a quasi-government agency establishing auditing standards or would it be more efficient and effective to have the PCAOB have a proactive role in the standard setting process? The legislation does not mandate that the PCAOB establish a "standard setting" organization. It does require that the PCAOB by rule standards relating to the preparation of audit reports.

There currently exists standard setting bodies that the PCAOB could, through existing exposure processes, influence the direction and content of the existing standards without introducing another layer of governance.

I encourage the Board reconsider its decision to usurp the function being performed by existing standard setting bodies and find a way to work with them to achieve the objectives defined in the Act.

Respectfully,

Paul L. Shillam, CPA, CMA
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COMPLIANCE WITH AUDITING AND
 RELATED PROFESSIONAL PRACTICE
 STANDARDS

ADVISORY GROUPS

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) PCAOB Release No. 2003-009
) June 30, 2003
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) PCAOB Rulemaking
) Docket Matter No. 004
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Summary: After public comment, the Public Company Accounting Oversight Board ("Board" or "PCAOB") has adopted a Rule relating to compliance with the Board's auditing and related professional practice standards and a Rule relating to the formation of advisory groups. Specifically, the Board has adopted Rule 3100, and a related definition that would appear in Rule 1001, and Rule 3700. Rule 3100 generally requires all registered public accounting firms to adhere to the Board's auditing and related professional practice standards in connection with the preparation or issuance of any audit report for an issuer (as defined in the Sarbanes-Oxley Act of 2002 (the "Act")) and in their auditing and related attestation practices. Rule 3700 governs the formation, composition and role of one or more advisory groups to assist the Board in formulating new auditing and related professional practice standards for registered public accounting firms. The Board will submit these Rules to the Securities and Exchange Commission ("Commission" or "SEC") for its approval pursuant to Section 107 of the Act. These Rules will not take effect unless approved by the Commission pursuant to Section 107 of the Act. This Release also provides additional guidance regarding the number, size and composition of advisory groups and addresses certain qualifications that the Board may consider in selecting advisory group members and the terms and conditions of membership. Further, it provides guidance about the advisory group meetings, agendas, role of members and procedures that the Board believes is important to the functioning of advisory groups.



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Public

Comment: The Board released for public comment proposed Rules on the establishment of auditing and other professional standards on April 18, 2003. The Board received 22 letters of comment.

Board

Contacts: Gordon Seymour, Acting General Counsel (202/207-9034; seymourg@pcaobus.org), Thomas Ray, Deputy Chief Auditor (202/207-9112; rayt@pcaobus.org), or Mary M. Sjoquist, Special Counsel to Board Member Gradison (202/207-9084; sjoquistm@pcaobus.org).

* * * * *

Section 103(a)(1) of the Act directs the Board to establish auditing and related attestation standards, quality control standards, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by the Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors. Similarly, Section 103(b) authorizes the Board to establish such rules as may be necessary or appropriate to implement the auditor independence requirements in, or as authorized under, Title II of the Act. While Section 103(a)(4) directs the Board to convene such expert advisory groups as may be appropriate to aid in standards-setting, it nevertheless affords the Board considerable discretion in determining the procedures by which it will develop and adopt auditing and related professional practice standards.^{1/}

^{1/} The auditing and related attestation standards, quality control standards, and ethics standards over which the Board has authority under Section 103(a) of the Act, and the independence rules the Board is authorized to adopt under Section 103(b), are collectively referred to in this Release as "auditing and related professional practice standards." This term is defined in Rule 1001(a)(viii). The Board's proposed Rules and Release used the term "professional auditing standards." As discussed in more detail in Appendix 2 to this Release, because a number of commenters found this term confusing, the Board has decided to use the term "auditing and related professional practice standards" (hereinafter, "Standards").



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This Release announces the adoption of Rule 3100 (and a related definition) and Rule 3700. Rule 3100 requires all registered public accounting firms to adhere to the Board's auditing (and related attestation), quality control, and ethics standards, and its independence standards. Rule 3700 addresses the formation, composition, and other basic matters concerning advisory groups, which may be convened to aid in the Board's standards-setting process. In addition, as set forth in more detail below, the Board has determined to convene, at this time, one standing advisory group (the "SAG") to assist it in performing its standards-setting responsibilities.

Section A of this Release discusses the adoption of Rule 3100. Section B discusses the adoption of Rule 3700, and the establishment of the SAG and ad hoc task forces. The text of Rule 3100 (and a related definition) and Rule 3700 and a detailed discussion of the Rules are provided in Appendices 1 and 2 hereto, respectively.

The Board has reviewed all of the public comments received on the Rules as proposed in Release No. 2003-005. In response to these comments, Rule 3100 (and a related definition) and Rule 3700, as finalized, both clarify and modify certain aspects of the proposed Rules. Most importantly, the revisions to the original proposal are as follows –

- Instead of using the term Professional Auditing Standards as originally proposed, the defined term in Rule 1001 has been changed to Auditing and Related Professional Practice Standards;
- Rule 3700(c), Selection of Members of Advisory Groups, has been revised to clarify that the Board will accept nominations to the SAG, including self-nominations, from any person or organization rather than including a non-exclusive list of specific groups; and
- Rule 3700(e), Ethical Duties of Advisory Group Members, has been revised to make EC10 of the Board's Ethics Code applicable to members of the SAG with respect to any private publication or public statement



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about the Board or any advisory group or any of the activities of the Board or any advisory group.^{2/}

A more detailed analysis of the Board's response to the comments on the proposed Rules is included in Appendix 2. The Board's Rules will be submitted to the Commission for approval. Pursuant to Section 107 of the Act, Board Rules do not take effect unless approved by the Commission.

A. Compliance with the Board's Auditing and Related Professional Standards

Section 103(a) of the Act directs the Board, by rule, to establish auditing and related attestation standards, quality control standards, and ethics standards "to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by [the] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." Section 103(b) of the Act also directs the Board to establish independence standards to implement, or as authorized under, Title II of the Act.^{3/}

^{2/} See PCAOB Release No. 2003-008 (June 30, 2003) which includes the entire text of the Board's Ethics Code.

^{3/} See also Report of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, on S. 2673, S. Rep. No. 107-205 (July 26, 2002) ("The Committee has concluded that the Board's plenary authority in this area is essential for the Board's effective operation, a position taken during the hearings by a number of witnesses..."). Board Rules adopting or modifying auditing and related professional practice standards require approval by the Commission. In addition, the Board recognizes that the Commission may also establish professional standards applicable to accountants that practice before it and audit reports filed with it and that the Commission has the authority to institute proceedings to amend the Board's Rules, including those that establish auditing and related professional practice standards. See Sections 2(a)(10), 3(c)(2), and 107(b)(5) of the Act.



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As a corollary to the Board's exclusive, statutory authority to establish and amend Standards, all public accounting firms that are registered with the Board must comply with the Board's Standards. While this requirement is implicit in the Act, the Board has codified the obligation of registered firms to comply with the Board's Standards in Rule 3100. Any registered public accounting firm or person associated with such a firm that fails to adhere to applicable Board Standards may be the subject of a Board disciplinary proceeding in accordance with Section 105 of the Act.^{4/} In general, the Board's Standards will apply to registered public accounting firms and their associated persons in connection with their audits of (and related attestations concerning) the financial statements of issuers, as defined in Section 2(a)(7) of the Act, and those firms' auditing and related attestation practices. A number of commenters suggested that this Rule was either beyond the Board's authority or would create the impression that it applied to areas outside the Board's authority. To address these concerns, commenters suggested adding language about the scope of the Board's authority to Rule 3100. After considering these comments, the Board has decided to adopt the Rule as proposed.

The Board recognizes its responsibility to oversee the audits of issuers, as that term is defined in the Act, and does not intend to suggest that registered public accounting firms and their associated persons must comply with the Board's Standards in auditing non-issuers. Rule 3100, however, requires registered public accounting firms and their associated persons to comply with all *applicable* Standards. Accordingly, if the Board's Standards do not apply to an engagement or other activity of the firm, Rule 3100, by its own terms, does not apply to that engagement or activity.

Authorities other than the Board may nevertheless require that accounting firms or individual auditors comply with the Board's Standards in the conduct of audits of (or

^{4/} In addition, the Act provides that any violation of the Board's Rules is to be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq., or the rules and regulations issued thereunder, and any person violating the Board's Rules "shall be subject to the same penalties, and to the same extent, as for a violation of [the Exchange] Act or such rules or regulations." Section 3(b)(1) of the Act.



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attestations concerning) the financial statements of non-issuers.^{5/} In that event, those authorities may enforce the Board's Standards pursuant to their own processes.

B. Establishment of Advisory Groups and Ad Hoc Task Forces

While the Board will, by rule, establish Standards, it recognizes that the development of such Standards should be an open, public process in which investors, the accounting profession, the preparers of financial statements, and others will have the opportunity to participate. To this end, as discussed in PCAOB Release No. 2003-005 (April 18, 2003), the Board intends to provide for a public comment process on proposed standards.^{6/} The Board's staff will, of course, be actively involved in the standards-setting process, but the Board also encourages proposals and recommendations on its standards-setting agenda and standards development projects from the public. Moreover, in order to obtain the advice of a broad range of experts, the Board has determined to form an advisory group, the SAG, which may be divided into sub-groups by the Board if the need for specialized advice arises. Finally, the Board may also establish one or more ad hoc task forces to assist the staff with the drafting of technical language, among other things.

1. Authority

Section 103(a)(4) of the Act provides that the Board shall "convene, or authorize its staff to convene, such expert advisory groups as may be appropriate... to make recommendations concerning the content (including proposed drafts) of auditing, quality control, ethics, independence, or other standards required to be established under this

^{5/} Cf. Section 209 of the Act (stating that "[i]n supervising nonregistered public accounting firms and their associated persons, appropriate State regulatory authorities should make an independent determination of the proper standards applicable...").

^{6/} In response to PCAOB Release No. 2003-005, the Board received several comments relating to the process by which the Board will establish standards. While this release is intended to address only the adoption of Rules 3100 and 3700, the Board will nevertheless take these comments into consideration in its standards-setting work.



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section." The Board has decided initially that it is likely to exercise this authority by convening the SAG to participate in the standards-setting process. Rule 3700 addresses the formation, composition, and other basic matters concerning advisory groups, including the SAG.

2. Role, Size and Composition

The role of the SAG will be to assist the Board in *reviewing* existing Standards, in *evaluating* proposed Standards recommended by Board staff, Board-formed technical task forces or others and *recommending* to the Board new or amended Standards. The role of the SAG will not ordinarily include technical drafting (which will be performed by the Board's staff, with the assistance of ad hoc task forces, when necessary). Instead, the Board will look to the SAG to provide advice and insight as to the need to formulate new Standards or change existing Standards and opinions on the impact of proposed new or changed Standards.

The Board contemplates that the SAG initially will have approximately 25 members. As noted above, the Board may, based on the circumstances of particular projects, prior to or after the formation of the SAG, form ad hoc task forces of specially qualified persons selected by the Board to assist it with specific projects. Members of any appointed ad hoc task force may or may not be members of the SAG.

The SAG will be composed of individuals with a variety of backgrounds, including practicing auditors, preparers of financial statements, investors (both individual and institutional), and others.^{7/} In order to achieve this diversity, the Board expects that no one field of expertise will predominate among the SAG membership. Although SAG members may be employed or otherwise affiliated with particular organizations, the Board expects SAG members to serve in their individual capacities and not to serve as representatives of particular interests, groups or employers.

^{7/} The Board also anticipates appointing individuals from academia and state accounting regulators, among others, to the SAG.



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3. Nominations of SAG Members

In determining appointments to the SAG, the Board intends to solicit nominations, including self-nominations. Interested parties will have 45 days from the date of the Board's Notice ("Notice") to the public to submit nominations on a form which will be provided in the Notice. Interested parties who have submitted nominations prior to the publication of the Notice, will be sent nomination forms for completion at the time of publication of the Notice.

4. Qualifications

In evaluating nominations for the SAG, the Board will seek individuals with an interest in the quality of the audits of public companies. The Board may also consider certain factors in determining SAG appointments including but not limited to the following –

- (a) SAG members will be individuals of integrity, with an understanding of the responsibilities for and the nature of financial disclosure required under the securities laws and the obligations of accountants with respect to the preparation of and issuance of audit reports with respect to such disclosures; and
- (b) SAG members will have a working knowledge of one or more of the following subjects and a general understanding of the remaining subjects –
 - generally accepted auditing standards (as developed by previous auditing standards setting bodies and adopted by the Board as Standards and, in the future, as set from time to time by the Board);
 - generally accepted accounting principles;
 - the creation, audit or analysis of public financial statements;
 - public company corporate governance; and



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- other fields that the Board deems to be relevant.

5. Term

Unless the appointment is revoked for cause, as determined by the Board, or unless the SAG member voluntarily resigns from the SAG, membership on the SAG will be for a term of two years; provided, however, that approximately 50 percent of the initial members will be appointed for a three-year term to assure continuity. Members will not be limited in the number of terms that they may serve.

6. Conditions of Membership

Rule 3700(d) specifically states that members of the SAG will serve in their individual capacities and therefore may not delegate their duties, including attendance at meetings, as SAG members. In addition, each appointee to the SAG shall agree in writing to the following "conditions of membership" in order to avoid potential conflicts of interest and to assure that the Board's standards-setting agenda is met –

- to serve on a voluntary basis without compensation from the Board;^{8/}
- to seek constructive resolutions to issues raised by the Board for the SAG;
- to act in the public interest in his or her individual capacity and not as a representative of any constituency;
- to attend at least 75 percent of all SAG meetings;^{9/}

^{8/} SAG members shall be entitled to reimbursement for documented reasonable travel expenses relating to participation in official SAG meetings or other SAG activities.

^{9/} Attendance may be in person or by telephone or teleconference. SAG members who fail to participate in the minimum number of meetings shall be subject to removal by the Board unless excused from attendance by the Chair of the SAG for good reason.



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- (e) to agree to spend, at an expected minimum, between 50 and 100 hours per year on SAG matters or such reasonably greater amount of time as may be necessary to achieve the goals of the SAG and the Board;^{10/}
- (f) to refrain from using his or her position on the SAG to influence Board members or Board staff on matters directly affecting that SAG member or his or her employer, business partners or clients;^{11/}
- (g) to recuse himself or herself, or otherwise withdraw from, consideration of any matter before the SAG or the Board directly affecting such SAG member, his or her employer, business partners or clients. If recusal or withdrawal is not practical in either such member's or the Board's opinion, such SAG member shall resign from the SAG;^{12/}

^{10/} During the first year of the SAG, members may expect to spend more than the minimum number of hours on SAG matters.

^{11/} SAG members are not precluded from appearing or practicing before the Board regarding matters generally affecting all issuers or registered public accounting firms, including, indirectly, the member, his or her employer, business partners or clients. Accordingly, a SAG member who is employed by a registered public accounting firm would be permitted to be involved in preparing a comment on a Board rule proposal that generally affects all issuers or registered public accounting firms.

^{12/} Matters generally affecting issuers or registered public accounting firms, even though affecting the SAG member, his or her employer, business partners or clients, shall not require the member to recuse or withdraw him or herself from consideration of the matter or to resign from SAG. The Board expects that most standards-setting projects will affect issuers (or categories of issuers) and registered public accounting firms and their associated persons in a generally similar manner; however, if a standard would have a unique or disproportionate effect on a particular issuer or firm, a SAG member employed by that issuer or firm would be required under Rule 3700 to recuse himself or herself.



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- (h) to be bound by EC3, EC8(a), EC9, and, with respect to any private publication or public statement regarding the Board or the SAG or any of the activities of the Board or the SAG, EC10 of the Board's Ethics code;^{13/}
- (i) to annually certify his or her continuing compliance with "the conditions of membership;" and
- (j) to agree to any such other provisions that the Board may deem necessary to avoid even the appearance of a conflict of interest.

7. Meetings and Board Relations

The Board has determined that the first Chair of the SAG will be the Board's Chief Auditor and Director of Professional Standards who will be a non-voting member of the SAG. The Board will approve the agenda for all annual, semi-annual or quarterly SAG meetings as set forth below. Agenda items may also be added where the Board determines that the assistance of the SAG is required in response to emerging issues or problems. The Chair will be responsible for preparing the meeting agenda, organizing and overseeing meetings, conference calls and related activities, acting as the general liaison to the Board and finalizing all submissions to the Board based on the SAG recommendations.

The SAG will hold an annual meeting to discuss the agenda presented to the SAG on the annual standards-setting process and related matters. The SAG will also hold a semi-annual meeting. Both the annual and the semi-annual meetings will be open to the public. Meetings of the SAG may also be held, at the direction of the Board or the Chair, during the intervening quarters. In addition, at the direction of the Chair, monthly meetings of the SAG may be held, by video or teleconference, for the Board's staff to report on new issues raised by the Board for the SAG's consideration and to

^{13/} In PCAOB Release No. 2003-008 (June 30, 2003), the Board clarified that for purposes of applying EC8(a) to SAG members, the SAG members shall not be considered to lack independence or objectivity with regard to SAG matters merely because they (or their employer, business partners or clients) are subject to the direct or indirect oversight of the Board.



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discuss the status of pending issues. Final decisions on recommendations to the Board and related activities will be conducted at the annual, semi-annual, or other open meeting of the SAG.^{14/} The meetings held in the quarters between the annual and semi-annual meeting, if any, and the monthly meetings will not generally be open to the public.

If so directed by the Chair of the SAG, the SAG may convene hearings, roundtable discussions or other fact-finding activities designed to assist the SAG in the development of recommendations on new or amended Standards or other recommendations to the Board.

Decisions on whether a recommendation should be made to the Board will be by a majority of the SAG members present in person or by video or teleconference. Recommendations from the SAG will be presented to the Board at an open meeting of the Board. Such recommendations will be provided in writing, including dissenting opinions, if any, by SAG members. The Board retains the exclusive authority to adopt, modify, or reject any SAG recommendation, in its sole discretion, in order to protect investors by improving the fairness and reliability of corporate disclosures as set forth in the Act.

^{14/} The Board expects the SAG to make decisions in an efficient and speedy manner. To this end, the SAG need not defer decisions on recommendations for the annual or semi-annual open meetings. Rather, at the direction of the Chair, the SAG may make decisions on recommendations at any meeting, so long as it is open to the public in some manner, including, at the direction of the Chair, telephonically.



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* * *

On the 30th day of June, in the year 2003, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Acting Secretary

June 30, 2003

APPENDICES –

1. Rules Relating to Auditing and Related Professional Practice Standards and Advisory Groups
2. Section-by-Section Analysis of Rules Relating to Auditing and Related Professional Practice Standards and Advisory Groups



**Appendix 1 – Rules Relating to
Auditing and Related Professional Practice Standards and Advisory Groups**

RULES OF THE BOARD

SECTION 1. GENERAL PROVISIONS

Rule 1001. Definitions of Terms Employed in Rules.

When used in the Rules, unless the context otherwise requires:

(a)(viii) Auditing and Related Professional Practice Standards.

The term "auditing and related professional practice standards" means the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of the Act), and any other professional standards, that are established or adopted by the Board under Section 103 of the Act.

SECTION 7. PROFESSIONAL STANDARDS

Part 1 – General Requirements

Rule 3100. Compliance with Auditing and Related Professional Practice Standards.

A registered public accounting firm and its associated persons shall comply with all applicable auditing and related professional practice standards.



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Part 7 – Establishment of Professional Standards

Rule 3700. Advisory Groups.

(a) Formation.

To assist it in carrying out its responsibility to establish auditing and related professional practice standards, the Board will convene one or more advisory groups, in accordance with Section 103(a)(4) of the Act.

(b) Composition.

Advisory groups, in combination or as sub-groups designated by the Board within one advisory group, will contain individuals with expertise in one or more of the following areas –

- (1) accounting;
- (2) auditing;
- (3) corporate finance;
- (4) corporate governance;
- (5) investing in public companies; and
- (6) other areas that the Board deems to be relevant to one or more auditing or related professional practice standards.



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(c) Selection of Members of Advisory Groups.

Members of advisory groups will be selected by the Board, in its sole discretion, based upon nominations, including self-nominations, received from any person or organization.

Note: The Board will announce, from time to time, periods during which it will receive nominations to an advisory group. During those periods, nominations may be submitted by any person or organization, including, but not limited to, any investor, any accounting firm, any issuer, and any institution of higher learning.

(d) Personal Membership.

Membership in an advisory group will be personal to the individuals selected to serve on the advisory group. A member's functions and responsibilities, including attendance at meetings, may not be delegated to others.

(e) Ethical Duties of Advisory Group Members.

Members of an advisory group shall comply with EC3, EC8(a), EC9, and, with respect to any private publication or public statement about the Board or any advisory group or any of the activities of the Board or any advisory group, EC10 of the Board's Ethics Code.

(f) Ad Hoc Task Forces.

The Board may, in its discretion, establish ad hoc task forces. The membership of such task forces may include, but is not limited to, advisory group members. To the extent not otherwise required, members of ad hoc task forces shall comply with paragraph (e) of this Rule.



Appendix 2 – Section-by-Section Analysis of Rules Relating to Auditing and Related Professional Practice Standards and Advisory Groups

Rules Relating to Auditing and Related Professional Practice Standards

The Rules relating to auditing and related professional practice standards consist of Rule 3100, plus a new definition that appears in Rule 1001. Each of the Rules, and the new definition, is discussed below.

Rule 1001 – Definitions of Terms Employed in Rules.

Rule 1001 contains definitions of terms used in the Board's Rules.

Auditing and related professional practice standards

Rule 1001(a)(viii) defines "auditing and related professional practice standards" as the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of the Act), and any other professional standards, that are established or adopted by the Board under Section 103 of the Act.

The Board had proposed to use "professional auditing standards" as the term defined in this provision. Several commenters expressed concern that characterizing attestation, quality control, ethical, and independence standards as "professional auditing standards" would confuse people as to the defined term's meaning. To address these concerns, the Board has chosen to use the term "auditing and related



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professional practice standards" as the defined term for the standards established or adopted by the Board under Section 103 of the Act. The Board has used the longer term "auditing and related professional practice standards," rather than the shorter "professional standards," because the term "professional standards" is defined otherwise in Section 2(a)(10) of the Act. The term "auditing and related professional practice standards" is similar to that portion of the definition of the term "professional standards" that appears in Section 2(a)(10)(B) of the Act. (Hereinafter in this Section-by-Section Analysis, auditing and related professional practice standards shall be referred to as "Standards.")

In addition, the Board's proposed definition was based on a portion of the definition of "professional standards" in Section 2(a)(10)(B) of the Act. For purposes of clarity, the Board has modified this definition slightly to track more closely the description of the standards the Board will set in Section 103(a)(1) of the Act. The definition still includes any other type of standard provided for in the definition of "professional standards" in Section 2(a)(10)(B) of the Act that the Board establishes or adopts under Section 103 of the Act. Accordingly, the definition, as revised, covers the same scope of standards as the Board's proposed rule.



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Rule 3100 – Auditing and Related Professional Practice Standards Applicable to Registered Public Accounting Firms.

Rule 3100 provides that a registered public accounting firm and its associated persons must comply with all applicable Standards.^{1/} This Rule is intended to codify the obligation of registered public accounting firms and their associated persons to comply with applicable Standards and to ensure that the Board's Standards are enforceable.

A number of commenters suggested that this Rule was either beyond the Board's authority or would create the impression that the Rule applied to areas outside the Board's authority. To address these concerns, commenters suggested adding language about the scope of the Board's authority to Rule 3100. After considering these comments, the Board has decided to adopt the Rule as proposed.

The Board recognizes its responsibility to oversee the audits of issuers, as that term is defined in the Act, and does not intend to suggest that registered public

^{1/} The Board's proposed rule included a note to clarify that proposed Rule 3100 was intended to apply to those public accounting firms that will be required to register with the Board immediately after the applicable date in order to continue to participate in the audits of issuers after such date. For U.S. public accounting firms the applicable date is October 22, 2003. Because of the approaching registration deadline, and because the Board's Interim Auditing Standards, as approved by the SEC, currently require these public accounting firms to comply with them, the Board has deleted the note as unnecessary.



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accounting firms and their associated persons must comply with the Board's Standards in auditing non-issuers. Rule 3100, however, requires registered public accounting firms and their associated persons to comply with all *applicable* Standards. Accordingly, if the Board's Standards do not apply to an engagement or other activity of the firm, Rule 3100, by its own terms, does not apply to that engagement or activity.^{2/}

Finally, one commenter suggested that Rule 3100 also require registered public accounting firms and their associated person to be duly licensed, registered or permitted or otherwise to hold valid practice privileges and be in good standing under

^{2/} For example, the Board's Interim Auditing Standards provide that, "[i]n connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003 (Codification of Statements on Auditing Standards, AU § 150 (AICPA 2002))." See Rule 3200T. The term "audit report" is defined in the Act and the Board's Rules to mean the audit of an issuer. See Rule 1001(a)(vi), adopted by the Board in PCAOB Release. No. 2003-007. Moreover, the Board notes that it would not be a correct description of its authority to say, as one commenter suggested Rule 3100 provide, that "A registered public accounting firm and its associated persons shall comply with all applicable professional auditing standards *in performing an audit of an issuer.*" Particularly with respect to the quality control standards the Board is authorized to establish, the Board may adopt standards that, while related to registered public accounting firms' audit practices, must be complied with other than in the course of performing an audit. Cf. Section 103(a)(2)(B) of the Act (requiring the Board to include, among the "quality control standards that it adopts with respect to the issuance of audit reports, requirements... relating to... hiring, professional development, and advancement of personnel").



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the laws of each applicable state. Registration with the Board does not supersede state registration or licensing requirements and the Board expects registered public accounting firms and their associated persons to comply with state and other applicable legal requirements. Rule 3100, however, is merely intended to codify the obligation of registered public accounting firms and their associated persons to comply with Board Standards and to ensure that the Board's Standards are enforceable. Accordingly, the Board has decided not to amend the Rule as proposed to reflect this suggestion.

Rules Relating to Advisory Groups

Rule 3700 – Advisory Groups.

Rule 3700 addresses certain basic matters concerning the formation and use of advisory groups in the Board's standards-setting process.^{3/} The Rule provides that the Board will convene one or more advisory groups, as contemplated in Section 103(a)(4) of the Act. Any advisory group will consist of individuals with expertise in certain, specified areas relevant to the Board's standards-setting responsibilities. Members of an advisory group will be selected by the Board. In addition, the Rule provides for the

^{3/} The Rule does not address the use of an advisory group for matters other than standards-setting.



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Board to establish ad hoc task forces.^{4/} While such task forces may include advisory group members, a task force may consist totally or partially of non-advisory group members who are persons with specialized experience in the standard-setting project under study. To the extent persons who serve on such task forces are not advisory group members or professional staff of the Board, they must comply with the ethics provisions applicable to advisory group members under Rule 3700(e).

The Rule further provides that membership on an advisory group will be personal to the individuals selected and that the functions of an advisory group member, including attendance at meetings, may not be delegated to others. This provision is based on a comparable provision in the Financial Accounting Standards Board's Rules governing the members of the Financial Accounting Standards Advisory Council.

Finally, Rule 3700 provides that members of a Board advisory group must comply with certain provisions in the Board's Ethics Code. Specifically, the Rule makes advisory group members subject to EC3, EC8(a) and EC9, and, to the extent applicable, EC10. These provisions of the Board's Ethics Code address, respectively,

^{4/} Such task forces may be formed without regard to the procedures for the formation, composition, and selection of advisory group members under Rule 3700(a)-(c).



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general ethical principles applicable to service for the Board, disqualification in the case of conflicts of interest, the non-disclosure of non-public information, and speaking for the Board when not authorized to do so by the Board.^{5/}

Commenters suggested that it might be appropriate to establish more than one advisory group since expertise is likely to be required in more than one specialized area. The Board is aware that it may need advice in one or more specialized area. However, the Board has determined to form only one standing advisory group (the "SAG"). This group, however, may, at the Board's direction, form specialized sub-groups as needed. In addition, the Board may form ad hoc task forces to work with Board staff in formulating Standards in specialized areas which may then, in the Board's discretion, be added to the SAG's agenda for discussion at SAG meetings.

In addition, Commenters recommended adding other specific groups from which nominations could be received to the groups identified in Rule 3700(c) as proposed. After careful consideration of these comments, the Board has determined that Rule 3700(c) should reflect the Board's intention to accept nominations from all sources. Accordingly, Rule 3700(c) has been revised to state that the Board will accept

^{5/} See PCAOB Release No. 2003-008 (June 30, 2003) for the text of the Ethics Code adopted by the Board.



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nominations from any person or organization, including self-nominations. A note to this part of Rule 3700 provides that the Board will announce, from time to time, periods during which it will receive nominations for an advisory group.

With respect to qualifications of the advisory group members, one commenter suggested that all members have qualifications similar to those "requirements set forth for audit committee members in recently issued stock exchange and SEC" rules or proposed rules. The New York Stock Exchange ("NYSE") proposed listing requirements require that all members of audit committees of listed companies be financially literate. In addition, at least one member of the audit committee must meet the definition of an "audit committee financial expert."^{6/} The NASDAQ Stock Market ("NASDAQ") proposed rules regarding qualifications for service on audit committees require that all audit committee members must be able to read and understand financial statements including a company's balance sheet, income statement, and cash flow statement and that the audit committee have at least one member who meets the

^{6/} See SEC Release No. 34-47672; File No. SR-NYSE-2002-33 (April 11, 2003).



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definition of an "audit committee financial expert."^{7/} After considering this comment, the Board has decided to adopt the Rule as proposed by the Board. While Rule 3700 does not specifically state the qualifications each member must have, the Rule does set forth the types of expertise that the Board will look for in advisory group members. In addition, as noted in Section C.4. of this Release, the Board may also consider certain specific qualifications in selecting nominees to the SAG. The Board believes that it will likely select members who, at a minimum, would meet the general qualifications set forth for "all" audit committee members in the proposed Rules of the NYSE and NASDAQ while providing the Board with the flexibility to select members from a broad spectrum of backgrounds to assist it in meeting the requirements of the Act. SAG members will be selected based upon qualifications which will be elicited from them on a nomination form and through the evaluative process.

Furthermore, commenters suggested that the composition of the SAG be flexible because the Board may find that it is unable to attract a sufficient number of qualified members from fields such as finance and investment. In response to this concern, it should be noted that, the Board expects that the SAG will be broadly representative and

^{7/} See SEC Release No. 34-47516; File No. SR-NASD-2002-141 (March 17, 2003).



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that no one field of expertise will predominate among the SAG membership. Other concerns regarding composition related to assuring that the SAG have a sufficient number of members with technical expertise including requiring a majority of members to be practicing auditors. Although the Board certainly intends that the SAG have practicing auditors among its members, the Board believes that it is important that the SAG be able to provide advice in a broad range of areas, including technical auditing expertise, and that technical expertise in particular areas may be obtained by forming ad hoc task forces, as needed and as appropriate for particular standards-setting projects. Other commenters recommended that –

- (a) the four largest auditing firms be represented on the SAG;
- (b) non-U.S. auditors be represented;
- (c) the number of members associated with a single firm, company or association be limited;
- (d) membership be dispersed among those affiliated with firms, companies and associations of various sizes; and



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- (e) there be a balance between financial information suppliers (representatives of public companies and auditors) and financial information users (equity and debt investors).

As noted above, the Board recognizes the need to have diversity on the SAG and in selecting members will keep diversity in mind while assuring that no one expertise will predominate among the SAG membership.

With respect to the actual functions of the SAG, one commenter, suggested that the SAG be involved in all standards-setting proposals while another commenter recommended that the actual drafting of the Standards fall within the SAG's authority. In order to maintain flexibility in the rulemaking process, the Board has determined not to revise the proposed Rule to reflect these comments. Although the SAG is likely to be involved in the Board's standards-setting process as discussed in the Release, the Board does not intend to make SAG involvement mandatory to every standards-setting project. In addition, the actual drafting of the Standards is likely to be done by the Board's staff assisted by ad hoc task forces where necessary.

Another comment related to recommending that the SAG work toward "harmonizing" international standards. Neither Rule 3100 nor 3700 is intended to



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address substantive standards-setting issues. Rather the Board intends to address such issues, including cooperation with standards-setters in other jurisdictions, in the future.

Commenters also made recommendations regarding SAG procedural matters. These commenters suggested that the Board address –

- (a) the process for making recommendations on Standards for consideration by the Board;
- (b) whether or not SAG meetings would be open to the public;
- (c) the format and the frequency of the meetings;
- (d) the process by which the Board will set the SAG's agenda;
- (e) the appointment of a Chair for the SAG;
- (f) whether the Board will provide all resources for drafting, editing, monitoring comments and publishing new and amended Standards;
- (g) the term of appointment to the SAG; and
- (h) an avenue for minority viewpoints to be expressed in any report or recommendation to the Board.



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With the exception of the comment on resources for drafting and publishing new Standards, the Board has addressed all of these comments in Section B.7. of the Release. In summary, the SAG will hold an annual meeting and a semi-annual meeting. Additional meetings may be held in the intervening quarters. Monthly telephonic meetings are also expected to be held at the discretion of the Chair. The annual and semi-annual meetings, and any meeting at which the SAG makes a final decision on a recommendation to the Board, will be open to the public. Agenda items for the SAG will be driven in part by the schedule to be set by the Board for the review of the Interim Auditing Standards. Other agenda items will be added by the Board where the Board determines that a response to emerging issues or problems connected with audits needs to be addressed. The Board has determined that the first Chair of the SAG will be the Board's Chief Auditor and Director of Professional Standards. All SAG members will be appointed for two-year terms except that approximately one-half of the appointees initially appointed to the SAG will be appointed for a three-year term to assure continuity. There will be no limits on the terms that a member of the SAG may serve. The Board anticipates that drafting, editing, monitoring comments and publishing, will be conducted by the Board and its staff. To the extent that the SAG is



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specifically authorized by the Board to undertake any of these functions and the expenses have been preapproved by the Board or a staff member delegated by the Board, the Board will cover the SAG's costs.

In response to the issue of whether the SAG's meetings will be open to the public and in order to assure that the public is informed of the SAG's operations, the Board has determined that the annual and semi-annual meetings of the SAG will be open. In addition, decisions on making recommendations to the Board will only be made at an open meeting of the SAG. All recommendations to the Board by the SAG will be presented to the Board in open public meetings of the Board and such presentations will include the presentation of minority views of the SAG members. Finally, it should be noted that Board standards-setting proposals will be subject to the public comment process before being adopted by the Board.

With respect to Rule 3700(e) relating to the ethical duties of the SAG members, one commenter recommended that the SAG members be subject to Section EC14, the certification requirements, of the Ethics Code. In response to this comment, the Board has added to its "conditions of membership" described in Section C of the Release, a requirement that members of the SAG shall annually certify their continuing compliance



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with the "conditions of membership." A second commenter recommended that both Rule 3700(e) and EC8(a) of the Ethics Code be clarified to confirm that being a practicing auditor does not, in and of itself, constitute a financial interest requiring recusal. Section EC8(a) of the Ethics Code has been revised to add an explanatory note that clarifies this issue.^{8/} A third commenter recommended that members of the SAG be prohibited from "unauthorized" speaking for the Board. In response to this comment, the Board has revised Rule 3700(e) to make EC10 of the Board's Ethics Code applicable to any private publication or public statement by an advisory group member with regard to the Board or the advisory group or any of the activities of the Board or the advisory group. Finally, a fourth commenter recommended that a member of the SAG be permitted to share SAG material with support personnel within the member's home organization who are assigned to assist the member in his or her duties. The Board has not added a provision to address this concern. The Board believes that SAG members will normally be able to perform their responsibilities without needing access to non-public Board information. To the extent that it may be appropriate, from time to time, to permit non-public standards-setting information to be

^{8/} See PCAOB Release No. 2003-008 (June 30, 2003).



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shared with individuals outside the SAG, including to permit SAG members to consult technical experts who are not employees or staff of the Board, the Board may require that such individuals agree to the confidentiality provisions under Section EC9 of the Ethics Code.