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26 February 2007

Dear Ms Morris and Mr Seymour,

**Securities and Exchange Commission Release on Management's Report
on Internal Control over Financial Reporting
File Number S7-24-06**

**Public Company Accounting Oversight Board Proposed Auditing Standard
on An Audit of Internal Control over Financial Reporting that is
Integrated with an Audit of Financial Statements and Related Other
Proposals
PCAOB Rulemaking Docket Matter No. 021**

ACCA (the Association of Chartered Certified Accountants) is the largest and fastest-growing international accountancy body with 296,000 students and 115,000 members in 170 countries. ACCA works to achieve and promote the highest professional, ethical and governance standards and advance the public interest.

ACCA is pleased to comment on:

the Securities and Exchange Commission (SEC) Release Nos. 33-8762 and 34-5476 on Management's Report on Internal Control over Financial Reporting (the SEC's proposals); and

the Public Company Accounting Oversight Board (PCAOB) Rulemaking Docket Matter No. 021 of 19 December 2006 - Proposed Auditing Standard on An Audit of Internal Control over Financial Reporting that is Integrated



with an Audit of Financial Statements and Related Other Proposals (the PCAOB's proposed standard).

We are submitting this single response to both the SEC release and the PCAOB proposed standard as the subject matter 'internal control over financial reporting' is the same in each case. Our comments are confined to the corporate governance and risk management aspects of the documents: we are not commenting on detailed technical auditing aspects of the proposals.

ACCA supports the aims of both proposed documents. We understand this, in both cases, to be ensuring both management and auditors focus on those matters which are most important to assessing the effectiveness of internal control over financial reporting and so allowing the requirements to be simplified and unnecessary procedures eliminated. We particularly welcome the PCAOB's decision to introduce a new audit standard rather than revise the existing one. We also welcome the thrust of the significant changes between the existing standard and the new one.

Last September we submitted our comments to the SEC in respect of its concept release on rule 404. We said we were concerned that, in practice, the internal control evaluation process has become dominated by PCAOB Auditing Standard No2 and the way the audit standard has been applied. We argued this has caused two problems:

1. control evaluation has become over focussed on documenting and evidencing key controls at the expense of a proper evaluation of the control environment.
2. the process has become more expensive than was necessary.

The control environment (as articulated in COSO and other frameworks) is the foundation of all other aspects of control, it was weakness in the control environments at Enron and WorldCom that were their undoing and which brought about the need for the Sarbanes-Oxley Act. Because the control environment includes people factors such as culture and ethics, much of its assessment has to be subjective. It is therefore something that cannot reasonably be comprehensively and totally documented. Nor can such subjective assessment be satisfactorily verified solely by traditional audit methods.

There is a danger with the existing practice that the over reliance on documentation could mean that fundamental weaknesses in the control environment are missed. Further, anecdotal evidence suggests that some



companies which have found it necessary to document thousands of controls are experiencing an adverse reaction from staff who resent burdensome controls: this weakens the control environment.

We recommended that if guidance on assessing internal control is to be issued, it should be brief and keep to high level principles to avoid any risk of it becoming another set of rules. We recommended that such principle-based guidance should emphasise the importance of assessing the control environment and recognise that certain aspects of the control environment, such as culture and ethics, cannot be fully assessed by objective means alone and require subjective, but structured and rigorous, assessment by management. The following considerations are particularly relevant:

- The purpose of internal control is to enable the organisation to operate effectively and have reasonable assurance that significant risks to achieving objectives are identified and managed.
- It follows that internal control should be owned by managers and staff throughout the organisation at all levels rather than by internal or external auditors.
- Too much focus on documentation of, and compliance with, procedures can have unintended consequences and potentially create a culture which is either risk averse and/or inclined to circumvent written rules.
- A structured and facilitated 'self-assessment' approach should be used as part of the evaluation process. Such an approach can be particularly effective in providing assurance on the control environment. It works best when initiated as a top down approach involving managers and staff in constructive face to face communication; it can also lead to improved team working, improved control culture and better operational effectiveness.

Finally we suggested that the PCAOB Auditing Standard No2 should be realigned to become consistent with any revised SEC guidance thereby allowing both management and external auditors to apply reasoned judgement. It should be the SEC guidance, rather than any PCAOB auditing standard, which determines the approach that management follows in order to comply with s404; we are not convinced that this has been so, to date.



Although we support the aims of both new documents we are concerned that these aims may not be achieved in practice. Our concerns centre on:

- Inconsistencies in approach and terminology between the two proposed documents. These include:
 - differences in definition; e.g. The SEC's definition of 'Material Weakness' (page 13) is: A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's internal control over financial reporting. The PCAOB defines 'Material Weakness' (paragraph A8) as: A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.
 - the fact that the proposed auditing standard no longer requires an opinion on management's process for assessing internal control;

and

- The PCAOB correctly emphasising the importance of the control environment whereas the SEC seems to down grade its fundamental performance.
- The SEC interpretative guidance being written in a style which may be more suited to the external audit profession and may not be easily understood by managers. Arguably, the SEC rule takes an external audit rather than a management approach.
- An apparent downgrading in the SEC proposal of the fundamental importance of the control environment. Page 26 of the SEC document, says controls such as the control environment may not, by themselves, be effective at preventing or detecting misstatement. While, strictly, this may be true, it is also true to say that ALL the significant cases of significant deliberate misreporting of financial accounts have been a result of failure of the tone at the top, that is a failure in the control environment. The proposed rule could be interpreted as saying it is not essential for management to consider entity level controls of this nature.



- The PCAOB decision to remove the requirement to evaluate management's evaluation process yet retain a requirement to audit internal control seems perverse. In our view the wrong opinion has been dropped. It makes sense for the auditors to base their work on what management is doing. The separate auditor opinion on internal control is likely to mean duplication of effort and may lead to management performing more work than otherwise necessary to satisfy audit requirements. It also means two quite separate costly and time consuming processes will be required to achieve what is essentially the same purpose.

Questions asked by the SEC

We comment below on some of the questions posed by the SEC:

- Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process? Does the proposed guidance allow for management to conduct an efficient and effective evaluation? If not, why not?
- *As we have commented above, we consider the proposed rule to be in a style more suited to external auditors than management. Also, as commented above, we consider that the proposed rule takes fundamentally the wrong approach to the control environment. In spite of the great need for guidance in this area, none is given in how to assess the control environment or any of its vitally relevant components such as culture, tone at the top or processes to prevent management override of controls. Moreover the guidance could be interpreted as meaning that management need not consider the control environment at all as the control environment can not be relied upon to prevent misstatement. While in absolute terms this is true, an effective control environment is the best defence against misstatement and, as COSO says, is the foundation of all other elements of control.*
- Are there particular areas within the proposed interpretive guidance where further clarification is needed? If yes, what clarification is necessary?
- *Yes, as stated above, clarification is required on assessing the control environment and how this relates to assessing other components of control.*
- Considering the PCAOB's proposed new auditing standards, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Considering and Using the



Work of Others In an Audit, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to resolve the incompatibility?

- *Yes, as described in our answer to your first question. By contrast the PCAOB correctly emphasises the control environment and amongst other things requires auditors to 'assess whether sound integrity and ethical values, particularly of top management, are developed and understood'.*
- Are there any definitions included in the proposed interpretive guidance that are confusing or inappropriate and how would you change the definitions so identified?
- *As noted in our general concerns above, there are also inconsistencies in definitions between the two documents.*

Questions asked by the PCAOB

- 3. Will the top-down approach better focus the auditor's attention on the most important controls?
- *It should help to ensure focus on the most important controls*
- 4. Does the proposed standard adequately articulate the appropriate consideration of company-level controls and their effect on the auditor's work, including adequate description of when the testing of other controls can be reduced or eliminated?
- *Provisionally yes, however we are concerned there is a lack of suitable audit procedures and experience to evaluate properly the control environment including 'whether sound integrity and ethical values, particularly of top management, are developed and understood'. In practice this may mean that a proper assessment is not carried out.*
- 5. Does the proposed standard appropriately incorporate risk assessment, including in the description of the relationship between the level of risk and the necessary evidence?
- *Up to a point. However risk assessment could be better addressed if the auditor opinion was on management's assessment rather than on internal control.*

- 7. Is the proposed definition of "significant" sufficiently descriptive to be applied in practice? Does it appropriately describe the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency?
- *No*
- 9. Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statements?
- *In our opinion little or no clarity will be provided by replacement of terms such as "more than remote likelihood" with the term "reasonable possibility"*
- 15. Will an opinion only on the effectiveness of internal control, and not on management's assessment, more clearly communicate the scope and results of the auditor's work?
- *As stated above, we suggest the wrong opinion has been dropped.*

We would be pleased to discuss any aspect of this letter you may wish to raise with us.

Yours faithfully

A handwritten signature in black ink that reads "Paul Moxey".

Paul Moxey

Head of Corporate Governance and Risk Management

