THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

12 July 2007

ICAEW response: 58/07

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington DC 20549-1090
USA

Dear Ms Morris

File No. PCAOB-2007-02: Proposed Auditing Standard on An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements.

The Institute of Chartered Accountants in England and Wales (ICAEW) welcomes the opportunity to comment on the SEC's consultation on the PCAOB's proposed Auditing Standard No. 5 (AS 5) as adopted by the PCAOB on 24 May 2007. In this letter we set out the reservations that we still have about the new prospective regime for the implementation of Section 404 of the Sarbanes-Oxley Act. In the appendix, we provide our responses to the seven questions issued by the SEC on 15 June 2007.

ICAEW members work in SEC registrants and audit firms registered with the PCAOB and in all sectors of the UK and global economies. Since 2002 we have submitted numerous comment letters to the SEC and to the PCAOB in relation to section 404. Most recently our letter dated 26 February 2007 addressed issues raised by the SEC's proposed guidance to management and the PCAOB's proposed AS 5.

The ICAEW responds to consultation documents issued by the SEC and the PCAOB relating to section 404 because we believe that it is in the public interest for US authorities to hear a voice from the accountancy profession outside the United States with direct recent experience of public policy issues related to internal control in listed companies. It is on this basis that we have consistently expressed concern about the direction taken in the interpretation and implementation of section 404, the resulting inflated scope of the work performed by auditors and unnecessary additional costs for issuers.

We readily acknowledge that the SEC and PCAOB documents are now better aligned and welcome the consistent definition of 'material weakness' and the proposed definition of 'significant deficiency'. Furthermore, we applaud the move to encourage the increased use of judgement by auditors. We hope that, in response to predictable requests, the SEC and PCAOB will resist the temptation to provide more guidance and interpretation, especially on the application of monetary criteria to the definitions of material weakness and significant deficiency. To do so could undermine the steps that have been taken to introduce a more principles-based approach to the implementation of section 404.

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Despite the improvements from AS 2 to AS 5, we still have some significant concerns. In summary these relate to:

- the need for changes in attitudes and behaviours;
- the appropriateness of the AS 5 opinion; and
- the international context.

The need for changes in attitudes and behaviours

Whether the implementation of section 404 is substantially improved will in large part depend on the attitudes and behaviours of individuals working for registrants, auditors and regulatory agencies. Fundamental changes to previous ways of working and methodologies are needed within the PCAOB's inspection function as well as in the major audit firms. In addition, fears of SEC enforcement actions, adverse PCAOB inspection findings and litigation have made management and auditors cautious in their implementation of section 404 and have not gone away. It is also a matter of regret that the timescale to implement AS 5 is such that no field testing of proposed AS 5 has been performed to surface and address problems and see how behaviour changes.

We believe that a commitment from the SEC to monitor and review the implementation of its guidance to management and the PCAOB's AS 5 would be helpful in reinforcing public expectations of the need for changes in attitudes and behaviours.

The appropriateness of the AS 5 opinion

Section 404(a) of the Sarbanes-Oxley Act places a clear responsibility on management to assess and report on internal control over financial reporting. Section 404(b) states, in respect of the internal control assessment required of management under section 404(a), that the auditor "….shall attest to, and report on, the assessment made by the management of the issuer." The wording of the Act does not require an audit of internal control over financial reporting.

Whilst we respect the SEC's and the PCAOB's intended clarification of section 404(b) - in conjunction with section 103(a)(2)(A)(iii) – so that the wording in the Act is now interpreted to mean 'the audit of internal control', we remain of the view that:

- there has never been any public justification offered by the SEC or the PCAOB of why the attestation required by the Sarbanes-Oxley Act should take the form of an audit; and
- of the two opinions required by AS 2, the wrong opinion has been eliminated.

The choice of the auditors' opinion required by AS 5 will result in more testing and higher costs than would have been the case if the opinion on management's assessment had been retained and the current opinion had been removed. Such outcomes must be of concern to US authorities as they seek to enhance the effectiveness and reduce the costs of section 404 and to maintain the competitiveness of US capital markets.

We note that on page 169 of the SEC/PCAOB document, the PCAOB states that "to attest to and report on management's assessment, as required by Section 404(b) of the Act, the auditor must test controls directly to determine whether they are effective." It goes on to say that "the auditor audits management's assessment – the statement in management's annual report about whether internal control is effective – by auditing whether that statement is correct – that is, whether internal control is, in fact, effective." We also note on page 12 of its guidance to management that the SEC states that "the Commission believes that an auditing process that is restricted to evaluating what management has done would not necessarily provide the auditor with a sufficient level of assurance to render an independent opinion as to whether management's assessment (that is, conclusion) about the effectiveness of ICFR is correct."

We would understand the concerns of regulators if eliminating the auditor's own assessment meant that there would be no need for auditors to test underlying controls in order to attest to management's assessment. However, we do not believe this to be the case. As part of an audit of financial statements, International Standards on Auditing (ISAs) require auditors to undertake testing of internal controls to enable them to form an opinion on the financial statements. Likewise, if auditors were to express an opinion on management's assessment, they would be expected to perform testing of the underlying controls and could be required to do so.

The international context

We believe that the US is alone in mandating an audit of the effectiveness of internal control over financial reporting as proposed in AS 5 (and its predecessor AS 2) and a related public report.

The UK Financial Reporting Council considered this matter in 2005, albeit in the context of a wider approach to internal control, as part of a comprehensive and evidence-based review of the Turnbull guidance. Expanding the role of auditors beyond the existing requirements to perform a review was rejected by investors, issuers and auditors for a number of reasons, including cost/benefit considerations. We are also aware that a number of other major countries, such as Japan and Canada, have looked at this matter and not followed the US lead.

In addition, decisions are now being taken to reverse previous requirements that more closely followed US regulation. For example, in September 2006 the Swedish Corporate Governance Board removed the requirements for company boards to report publicly on the effectiveness of internal controls related to financial reporting, and it is no longer mandatory to have an auditor's report on this matter.

In summary the US appears to be alone in pursuing an audit that requires a direct opinion on the effectiveness of controls as well as the requirement for an integrated audit that requires two opinions, one on internal control over financial reporting and the other on the financial statements. ISAs do not provide for a separate opinion on internal control. When considering future prospects of convergence of auditing standards around the world, the US integrated audit represents a major potential barrier.

For the reasons set out above we believe that issues related to the interpretation and implementation of section 404 will not be laid to rest by the approval of AS 5 in its present form. In particular, if AS 5 does not satisfy the expectations of changes in behaviour and costs that have been created in the marketplace, the only course of action would appear to be for Congress to reconsider section 404(b) and the relevant parts of section 103 of the Act.

If you would like to discuss our comments in further detail, please contact me or Jonathan Hunt, Head of Corporate Governance (jonathan.hunt@icaew.com), or Katharine Bagshaw, Manager, Auditing Standards; (katharine.bagshaw@icaew.com).

Yours sincerely

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Commissioners, SEC

Appendix

The SEC's additional solicitation of comments on proposed AS 5

1. *Is the standard of materiality appropriately defined throughout AS5 to provide sufficient guidance to auditors? For example, is materiality appropriately incorporated into the guidance regarding the matters to be considered in planning an audit and the identification of significant accounts?*

   Yes.

2. *Please comment on the requirement in Paragraph 80 that the auditor consider whether there are any deficiencies or combinations of deficiencies that are significant deficiencies and, if so, communicate those to the audit committee. Specifically, will the communication requirement regarding significant deficiencies divert auditors' attention away from material weaknesses?*

   We agree that in order to ensure that the focus is, and remains, on material weaknesses the auditor must not scope the audit to look for deficiencies. Significant deficiencies that are reported should be only those that are identified in the course of an audit that is concerned with material weaknesses. This matter is now better explained in AS 5 and we hope that this is how the standard will be interpreted both by auditors and PCAOB inspectors. Working within the litigious environment of the US, there is nevertheless a risk that the communication requirement regarding significant deficiencies will divert auditors' attention away from the identification, reporting and remediation of material weaknesses. One way to mitigate this risk will be to ensure that auditors' judgements of what constitutes a significant deficiency are not zealously second-guessed by PCAOB inspectors.

3. *Is AS5 sufficiently clear that for purposes of evaluating identified deficiencies, multiple control deficiencies should only be looked at in combination if they are related to one another?*

   Yes. Whilst it is no easy task to consider a combination of deficiencies that are found in the same financial statement account balance or disclosure, we support the clarification in paragraph 69 of AS 5.

4 *Please comment on whether the definition of "material weakness" in Paragraph A7 (which is consistent with the definition that the SEC adopted) appropriately describes the deficiencies that should prevent the auditor from finding that ICFR is effective.*

   Yes.

5. *Is AS5 sufficiently clear about the extent to which auditors can use the work of others?*

   AS 5 represents an improvement over AS 2, but for low-risk areas the standard may yet prove to be too restrictive.

6. *Will AS5 reduce expected audit costs under Section 404, particularly for smaller public companies, to result in cost-effective, integrated audits?*

   It appears to be an assumption that audit costs will be reduced following the implementation of AS 5. We are not convinced that this will always be the case and we are concerned that there may be overly optimistic expectations in the market about the magnitude of cost savings that will arise as a direct consequence of AS 5. We recommend that the SEC keeps this matter under review by monitoring and by consultation with relevant interested parties over the next two or more years.

For smaller issuers that are currently going to be subjected to section 404(a) for the first time in 2007, followed by the full rigour of section 404 in 2008, there is only one certainty; that costs will increase. Whilst these increased costs are unlikely to be as great as they would have been under AS 2, it is not yet possible to determine their magnitude, nor to assess whether they will be an acceptable outcome to smaller filers and their shareholders.

The magnitude of the costs will also be significantly affected by the behaviour of auditors, issuers and regulators. Retaining the auditor's 'audit of internal control' opinion will also increase costs beyond those that would have been expected if it had not been assumed that an attestation must take the form of an audit and if the opinion on management's assessment had been retained. We also note in our letter the somewhat isolated position of the US in respect of the requirement for an integrated audit.

7. *Does AS5 inappropriately discourage or restrict auditors from scaling audits, particularly for smaller public companies?*

It is not possible to make informed comment at this time but it is certainly to be hoped that the more risk-based approach in AS 5 should lead to much better scaling of audits provided that the individuals who implement AS 5 are not overly cautious.