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ICAEW response: 08/07

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Dear Ms Morris and Mr Seymour,

**Securities and Exchange Commission Release on Management's Report on Internal Control over Financial Reporting**

**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**

The Institute of Chartered Accountants in England and Wales (ICAEW) welcomes the opportunity to comment on the SEC and the PCAOB documents published in December 2006 relating to section 404 of the Sarbanes-Oxley Act.

The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular in respect of auditors, is overseen by the Financial Reporting Council (FRC). As a world leading professional accountancy body, the ICAEW provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained.

Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

**Our experience**

The ICAEW is an experienced and significant contributor and commentator on risk management and internal control, as well as on accounting and auditing. Relevant work includes:

- our publication in 1999 of the Turnbull guidance, *Internal Control: Guidance for Directors on the Combined Code*;
- our support to the FRC in the preparation of its 2004 guide *The Turnbull guidance as an evaluation framework for the purposes of Section 404(a) of the Sarbanes-Oxley Act*;
- our project management support to the FRC Turnbull Review Group that produced the revised Turnbull guidance in October 2005;
- our contribution to the March 2005 discussion paper *Risk management and internal control in the EU* and the related follow-up paper of April 2006, published by FEE, the representative body of the European accountancy profession;
- our work on US and UK corporate governance regimes in our *Beyond the Myth of Anglo-American Corporate Governance* thought leadership programme which has included engagement with the SEC and the PCAOB; and
- the ongoing work of expert committees of members in public practice and in business in the areas of PCAOB auditing standards and corporate governance.

We have previously submitted comment letters to the SEC and to the PCAOB in relation to section 404 commencing with a letter to the SEC on 29 November 2002 and a letter to the PCAOB on 21 November 2003 on its proposals for Auditing Standard No. 2 (AS 2). We have consistently expressed concern about the direction taken by the SEC and the PCAOB; the resulting inflated scope of the work of auditors, additional costs and wasteful inefficiencies; and the pervasive impact of AS 2 on the audit methodologies used by the global audit networks. We have also consistently pointed out that not all 'attestations' are 'audits'.

ICAEW members work in SEC registrants and audit firms registered with the PCAOB and in all sectors of the UK and global economies. The ICAEW responds to consultation documents issued by the SEC and the PCAOB because we believe that it is in the public interest for the 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.

We are therefore pleased to submit our comments in this letter on both the SEC and PCAOB documents. The interaction between the two documents is of critical importance and we have paid particular attention to this matter. We have chosen to submit a single letter because we have identified issues that need to be jointly addressed by both bodies and we believe that each body should be aware of what we are saying about the other's document. Supporting this letter are three appendices that cover:

1. comments applicable to both documents;
2. comments on the SEC document and answers to specific questions raised by the SEC; and
3. comments on the PCAOB's proposed auditing standard and answers to specific questions raised by the PCAOB.

## **Our principles**

In preparing this letter, we have applied three overriding principles:

- internal control over financial reporting in any organisation needs to be led from the top of that organisation. In the current US context this means that the focus should be on management;
- whatever work auditors undertake, it must not duplicate the work that management undertakes but must be based on evidence of what management has done; and
- future regulatory efforts should be proportionate and should draw on emerging international best practice in the field of regulation.

In our view, the SEC and the PCAOB documents do not measure up well against these principles and do not present compelling alternatives.

## **There is still much to do**

We are supportive of the SEC and the PCAOB in so far as they want to:

- improve the effectiveness and efficiency with which management and auditors assess a company's internal control over financial reporting (ICOFR) and so lead to cost reductions;
- adopt a top-down, risk-based approach with emphasis on the control environment;
- propose principles-based, high level guidance to enable management and auditors to make judgements based on their knowledge and experience of the business;
- recognise that there is a need for flexibility and discourage a one-size-fits-all checklist mentality; and
- consider issues related to the scalability of the requirements as applied to different companies.

However, whilst we consider the initiatives of the SEC and the PCAOB to be steps in the right direction, we have a number of major concerns about the documents. .

It is assumed that audit costs can be reduced by implementing proposed Auditing Standard No. 5 (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 the changes proposed by the SEC and PCAOB. For example, we are aware that by using different words in its definitions, such as that for material weakness, the PCAOB is attempting to raise the threshold of materiality. However, we note that the words used in the new AS 5 and in the old AS 2 both have their origins in FAS 5. We are therefore sceptical about whether this attempt will be successful and whether in substance much will be achieved.

Simply stating that proposals are principles-based and risk-based does not mean that this is so or that management and auditor behaviour will be principles-based and risk-based in practice. There are dangers that:

- the expectations created by press releases and the words in the introductory sections of both documents will only be partially met;
- AS 5 will not significantly change auditor behaviour; and
- management will still have look to auditing standards for guidance.

In short, we caution the SEC and PCAOB against 'declaring victory' prematurely and publishing final documents that are substantially the same as the proposals. There is much still to be done not only on AS 5 and the guidance for management, but also on how these documents are interpreted and implemented

## **The SEC and PCAOB documents need further alignment**

The SEC and PCAOB documents are not sufficiently aligned. For example, there are different definitions of material weakness in the two documents. On such a fundamental matter, this is unacceptable. The SEC and PCAOB should adopt one definition of material weakness and the SEC should take direct responsibility for this. We also note that the proposed management and auditor assessment methodologies set out by the SEC and the PCAOB respectively are somewhat different. The SEC's is more high-level and risk-focussed and the PCAOB's is more detailed and control-focussed. We outline these matters and further examples of areas that are not aligned in Appendix 1.

Lack of alignment is likely to cause confusion, misinterpretation, unnecessary cost and unmet expectations of change. More diligence is needed with the SEC and PCAOB working together to inspire greater confidence in the consistency of the documents. In view of the fundamental importance of the issues we highlight, we believe that there should be further public consultation on revisions to the SEC guidance and AS 5.

### **The proposals alone cannot change behaviour fundamentally**

Ultimately, the attitudes and behaviours of individuals working for registrants, auditors and regulatory agencies will determine whether or not the implementation of section 404 is substantially improved. This will depend on people being persuaded and prepared to implement fundamental changes to previous ways of working and methodologies developed under earlier requirements. There is a need for a substantial re-education, re-investment and re-incentivisation. The revised SEC and PCAOB documents have important roles to play in this.

However, the SEC and the PCAOB need to recognise that the guidance and the standard are only parts of a bigger picture. Other factors influencing the behaviour of management and auditors include fears of SEC enforcement actions, adverse PCAOB inspection findings and litigation. Such fears have made management and auditors very cautious in their implementation of section 404. In themselves, the proposed guidance and standard offer only limited incentives to act differently.

The perceived focus of PCAOB inspection reports is on auditor shortcomings, inadequacies in audit work and the under-auditing of financial statements. By contrast, the focus of AS 5 is on preventing the 'over-audit' of internal control over financial reporting. This is evidenced by a significant number of notes referring to the fact that auditors 'need not' or are 'not required to' perform a particular procedure. However, AS 5 cannot prevent auditors from over-auditing in that it does not say that auditors must not perform a particular procedure. It is quite possible that auditors will continue to over-audit despite the changes if their behaviour is being driven by an inspection and enforcement regime that is seen as encouraging defensive auditing.

It is important that the PCAOB sends out a consistent message to auditors. Individual auditor behaviour is likely to be more sensitive to the approach taken by the PCAOB in its inspection and enforcement activities than it is to changes in auditing standards and it is therefore important that one reinforces the other. We do not believe that it will be enough for the PCAOB to say that its inspectors will have regard to the efficiency as well as the effectiveness of the auditor's work. It also needs to be accepted that to be efficient auditors have to make judgements with which inspectors might not agree and which might be seen differently with the benefit of hindsight.

If the inspection and enforcement approach focuses on detailed disclosure errors in published financial statements and compliance with the letter of standards rather than on the manner in which the audit was conducted and the quality of significant audit judgements, then changes to auditing standards will have a very limited effect on auditor behaviour. Another factor which is likely to affect management and auditor behaviour is the elimination of the auditor's opinion on management's assessment.

### **The consequences of separate auditor and management assessments are hard to predict**

The SEC and PCAOB documents provide for separate management and auditor assessments of internal control over financial reporting. This represents an intriguing experiment analogous to requiring management and auditors each to prepare separate financial statements for an issuer. Given the political sensitivity of section 404 and the need to stabilise its implementation, we doubt the wisdom of such experimentation.

It might be argued that there are already separate assessments under AS 2 and that therefore there is little incremental risk. However, there is a major difference. Currently, management has to rely on AS 2 in making their assessment whereas in future management will be able to follow the SEC guidance or another methodology of their choosing. To extend the financial statement analogy, management and auditors would not only prepare separate financial statements but they would also not be required to follow the same GAAP.

The SEC and PCAOB are in danger of creating a situation where an issuer could have two different conclusions validly drawn from two different assessment methodologies, one from management and another from the auditor. This possibility is likely to confuse investors and markets. We believe that there should be one approach, and that this would be more efficient and cost effective. Hence, our interest in the further alignment of the SEC and PCAOB documents.

If the SEC and PCAOB documents are not aligned, there will be tensions that have to be resolved because we do not believe that a difference between the approaches taken by management and auditors would be sustainable in the medium term. Either the present situation would reassert itself, with auditors under pressure from PCAOB inspectors holding the whip hand over management, or management's approach would prevail with auditors feeling pressured to acquiesce in the face of public expectations that auditors and auditing standards should no longer drive the section 404 reporting process.

### **The proposals do not appear to reflect Congressional intent**

In attempting to improve the effectiveness and efficiency of implementing section 404, both the SEC and the PCAOB are proposing to change the AS 2 requirements by the elimination of the requirement for the auditor to express an opinion on management's assessment of internal control over financial reporting. AS 5 would only address the auditors' own assessment of the issuer's internal control over financial reporting.

Yet section 404(b) of the Sarbanes-Oxley Act 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." In AS 2 and AS 5, the PCAOB has interpreted section 404(b) as mandating an audit opinion which expresses the auditor's own assessment of the issuer's internal control over financial reporting.

We have two issues with this interpretation:

- Firstly, not all 'attestations' are 'audits'. We first raised this point in our letter to the PCAOB dated 21 November 2003 and have repeated this concern on subsequent occasions, most recently in our letter dated 18 September 2006 to the SEC on its Concept Release. We do not believe that the SEC or PCAOB have satisfactorily set out in print the reasons for their view that an audit is required.
- Secondly, we believe that the SEC and PCAOB should have eliminated the opinion on the issuer's internal control over financial reporting, not the opinion on management's assessment of internal control over financial reporting. They have also failed to provide a proper basis for their action. The subject of the auditors' work specified by the Act is 'the assessment made by the management' not 'the company's internal control over financial reporting' as specified by AS 5. We do not see how these two terms can be equivalent. We note that the wording in the proposed report by the auditors on page A1-38 of AS 5 correctly refers to 'management's assessment' even though this is a source of potential confusion to the reader of the report who might not be aware that AS 5 does not require this assessment to be audited.

These two fundamental issues should be re-examined and debated fully and publicly to confirm whether the SEC and the PCAOB have correctly interpreted Congressional intent.

### **The SEC and the PCAOB should recognise and assert the primacy of management**

Section 404(a) places a clear responsibility on management to assess and report on internal control over financial reporting. Management should understand its responsibilities and ensure, taking professional advice where appropriate, that control systems are working properly to address the significant risks to their company's financial reporting.

The proposed elimination of the auditors' assessment of what management has done reduces the focus on the work of management. We believe that the SEC and PCAOB proposals are therefore at variance with our principles as set out at the start of this letter.

In our letter of 18 September 2006 to the SEC on its Concept Release, we commented that the primacy that should be accorded to management's assessment of the effectiveness of internal control over financial reporting raises fundamental questions about the need for auditors to undertake their own separate audit of the effectiveness of internal control over financial reporting.

We understand that some people may be concerned that if the auditor's own assessment were to be eliminated and the auditor was only required to attest to management's assessment then there would be no need for auditors to test the underlying controls. We do not believe this to be the case. For example, as part of an audit of financial statements, International Standards on Auditing 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 implementation of revised proposals calls for innovative monitoring**

We have previously stated that the proposed AS 5 is only part of a bigger picture. How AS 5 is applied and how PCAOB inspectors undertake their work will be important factors in the future implementation of section 404. At the current time, it is a matter of speculation whether revised proposals will result in an actual reduction in costs and burdens. We would have liked to have seen some proposals for pilot testing to give real world results and evidence. Whilst we recommend that the SEC and PCAOB give consideration to this possibility for all registrants, it may be that such testing may not be feasible.

If this is the case, we strongly suggest that the SEC and the PCAOB put forward innovative ways of monitoring on a real-time basis the future implementation of section 404. Evidence gained should include information on changes in behaviour, costs and burdens that would be useful in assessing the need for a further round of policy reform if there are continuing problems with the implementation of section 404.

Individuals in all registrant companies and audit firms should be able to report to the SEC and PCAOB their views, concerns and real-world experiences of the implementation of section 404 on an on-going basis without the fear of regulatory action. The SEC and PCAOB need to announce their plans for on-going monitoring and soliciting of feedback and state that they will be open to further suggestions for change in the light of experience.

In conclusion, companies need effective systems of internal control over financial reporting, not only for external reporting purposes but also for the purposes of running the business. We suggest that having auditors attest to, but not necessarily audit, management's assessment of the effectiveness of internal control over financial reporting would be more valuable than what is proposed in AS 5.

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](mailto:jonathan.hunt@icaew.com)), or Katharine Bagshaw, Manager, Auditing Standards; ([katharine.bagshaw@icaew.com](mailto:katharine.bagshaw@icaew.com)).

Yours sincerely

A handwritten signature in black ink that reads "Robert Hodgkinson". The signature is written in a cursive, flowing style.

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### General comments on both the SEC and PCAOB documents

#### 1.1 Introduction

The SEC and PCAOB documents need to be aligned to ensure a consistency of approach to the implementation of section 404. The individual documents must also be internally consistent.

A lack of alignment and internal inconsistencies will cause:

- confusion and misinterpretation;
- misaligned methodologies of management and auditors, and
- a consequential and unnecessary waste of time and money.

Depending on the extent of the problem, the issue could lead to the need for increased auditor testing, which could offset potential efficiencies that may result from the PCAOB's proposed auditing standard.

We believe that there are areas where the two documents are not currently aligned and we highlight a number of them below. More diligence is needed with the SEC and PCAOB working together to rectify these matters.

We strongly recommend that the SEC, with its oversight role of the PCAOB, should ensure that the documents should be submitted for a further round of public consultation and should be internally consistent and better aligned.

#### 1.2 Definition of material weakness

There is inconsistency in the definition of material weakness. This is unacceptable. The SEC and PCAOB should adopt one definition of material weakness and the SEC should take direct responsibility for this.

The SEC's definition of 'material weakness' (page 13) is: "A material weakness is a deficiency, or combination of deficiencies, in ICFR 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 ICFR."

The PCAOB defines 'material weakness' (paragraph A8) as follows: "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 SEC's definition is better in that it relates material weaknesses solely to deficiencies in internal control over financial reporting. A 'control deficiency' in the PCAOB's definition is capable of being wider than a deficiency in internal control over financial reporting. The SEC's definition is also better in that it refers to 'a timely basis' which is preferable to having no time constraints. There is no such reference in the PCAOB's definition.

However, we find the SEC's definition to be less satisfactory in that the final sentence ends with the words "by the company's ICFR" (internal control over financial reporting). A material misstatement would not necessarily be indicative of a material weakness where it would be detected on a timely basis by means other than a company's internal control over financial reporting.

### **1.3 The use of judgement in the current US framework**

We applaud the intention to move towards the increased use of judgement by management and auditors in the area of internal control over financial reporting. Sound judgement is a hallmark of good management and experienced professionals and we believe that this is the way forward.

We are aware that senior SEC staff and the Chairman of the FASB have accepted that there is too much complexity in US accounting. One matter that US regulators will have to consider is the practical application of judgement on matters of internal control over financial reporting in the context of a financial reporting framework that is too detailed and complex and not sufficiently intuitive.

There may thus be inherent limitations in the application of judgement to internal control over financial reporting and the SEC may need to consider the implication of being unable fix one part of the financial reporting framework in isolation.

### **1.4 Restatements as a strong indicator of a material weakness in ICFR**

The 'restatement of previously issued financial statements to reflect the correction of a material misstatement' is identified as being a strong indicator of a material weakness. However, this may not fully recognise the possibility of mistakes arising despite the application of sound process and judgement.

Whilst we appreciate that page 45 of the SEC's document states that "the correction of a material misstatement includes misstatements due to error or fraud; it does not include retrospective application of a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle", we ask the SEC and PCAOB to reconsider this whole area.

Perfection cannot easily, if ever, be achieved especially in such matters as accounting standards and internal control over financial reporting especially given the complexity of some parts of US GAAP. There is a perception that every honest mistake in the application of an accounting standard that results in restatement will give rise to a material weakness and a failure of internal control over financial reporting.

For example, consider the complex standard FAS 133, Accounting for Derivative Instruments and Hedging Activities. It is possible that even very well respected and well controlled companies may fall foul of the requirement for a restatement with 20:20 hindsight, even though at the time of preparation of the financial statements the issuer had taken every reasonable step to identify issues and take professional advice on its approach to the application of FAS 133 to specific transactions.

Where an issuer has tried its best via a clear and robust process to make an appropriate judgement on the application of complex standards and subsequently the SEC staff disagree and force an issuer to make a restatement, then such an honestly made mistake should not lead to the future public reporting of a material weakness in the issuer's internal control over financial reporting.

We suggest that further consideration is given to the area of restatements as a strong indicator of a material weakness in the circumstances we describe. We recognise that the words 'strong indicator' do not mandate a particular treatment. However, in practice, we believe that a risk averse approach by individuals will over-ride the non-compulsory classification and that restatements will automatically give rise to material weaknesses.

## 1.5 A top-down, risk-based approach?

We commend the SEC for its statement on page 16 that “The guidance describes a top-down, risk-based approach to this principle, including the role of entity-level controls in assessing financial reporting risks and the adequacy of controls. The proposed guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement in its financial statements. There is no requirement in our guidance to identify every control in a process or document the business processes impacting ICFR.”

However, as the top-down approach is explained in the guidance, there is progressively more detail and terminology. For example, we move from “financial reporting element” to “characteristics of the financial reporting elements to which the controls relate and the characteristics of the controls themselves” (page 31) to “characteristics of the financial reporting element.....include both the materiality of the financial reporting element and the susceptibility of the underlying account balances, transactions or other supporting information to material misstatement.” (page 33).

The increasing level of detail must not be allowed to blur the overall need for management judgement and a top-down approach so correctly noted by the SEC on page 5 of its document when it states that “Management must bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and that provides reasonable assurance for its assessment”

Although it starts with the same lofty ambition, the PCAOB’s AS 5 appears to have a different interpretation of the risk-based approach. For example, page 19 of its document says that the auditor should “determine the evidence to be obtained based on the risk associated with the control” and in the next paragraph that “...determining that a control presents low risk overall...”. Proposed AS 5 gets into ever-increasing detail with lists of matters that the auditor needs to address.

The wording in the documents is capable of being easily misinterpreted, thus creating confusion as to whether the approach by management and auditors should be an approach that starts with:

- risks; “management to focus on those controls that are needed to adequately address the risk of a material misstatement in its financial statements.” (page 15, proposed SEC guidance); or
- controls; “directing the auditor’s testing to the most important controls; emphasizing the importance of risk assessment” (page 4, proposed AS 5).

The impression given is that there may be two types of ‘risk-based, top-down’ approach. Whichever approach is deemed to be correct, and we prefer that of the SEC, it should be consistent throughout both documents. The danger of inconsistency in the application of an approach to ‘risk’ throughout the SEC and PCAOB proposals could trigger different interpretations.

We ask the question whether in a risk-based approach where the attention is directed to controls that address the risk of a material misstatement in the financial statements, reference should be made to ‘low risk areas’. Whilst we appreciate the curtailment of time and evidence that may be needed for the low risk areas, we question whether this gives the right message to the individuals who will have to implement the guidance.

In the following paragraphs, we highlight a number of areas where further work is needed by the SEC, supported by the PCAOB. We provide a few brief examples to help illustrate our points.

## **1.6 Differing terminology**

Two examples of differing terminology include:

- (a) the proposed SEC guidance refers to controls that address “financial reporting risks” that could result in “material misstatement” whereas AS 5 refers to controls that address “relevant assertions” related to “significant accounts”.
- (b) the proposed SEC guidance refers to “financial statement elements”. It is not clear whether this is the same as the “significant accounts” referred to in AS 5.

## **1.7 Differences in approach exist between the SEC and PCAOB texts**

- (a) The SEC guidance rightly proposes that management need not document every control in an accounting process, needing only to identify the relevant risks. This appears to adopt a top-down, risk-based approach. But AS 5 expects auditors to document walkthroughs of all significant accounting processes. This appears to be a bottom-up approach that does not take account of risk.
- (b) The SEC proposes a framework for assessing deficiencies. Why is this not given equal prominence in AS 5?

## **1.8 Different standards of accountability for management and auditors**

AS 5 requires the auditor to test the design effectiveness of controls by determining whether the company’s controls can effectively prevent or detect errors or fraud that could result in material misstatement. In a corresponding paragraph, the SEC guidance uses the phrase “adequately address the risk of” rather than “can effectively prevent or detect”. This seems to be a different and less absolute requirement.

## **1.9 Specific requirements for auditors that do not exist for management**

AS 5 has specific requirements where, irrespective of the analysis of risk, the auditor is required to perform certain procedures. In areas of high risk, such as the assessment of the control environment, this appears reasonable. However, the requirement to perform walkthroughs of significant processes and to assess the competence of those evaluating controls are just two examples of a greater degree of specificity in AS 5 than might be necessary given the level of risk.

## **1.10 Inconsistencies within a text**

The introduction to AS 5 explains the significant differences between AS 2 and AS 5. Much, but not all, of this text is consistent with the subsequent proposed standard. However, the statement that the proposed standard “requires risk assessment at each of the *decision points* in a top-down approach” (emphasis added in italics) is inadequately explained. AS 5 appears to prompt a continuous stream of decisions, rather than specific “decision points”.

# Comments on the SEC's Release on Management's Report on Internal Control over Financial Reporting

## 2.1 Mixed messages

We note a contrasting approach between:

- comments at the start of the document that set the scene and objectives; and
- subsequent guidance material.

For example, contrast the following two statements:

1. "if management determines that the risks for a particular financial reporting element are adequately addressed by an entity-level control, *no further evaluation of other controls is required.*" (page 16 – introductory comments – emphasis added in italics)
2. "while management ordinarily would consider entity-level controls of this nature when assessing financial reporting risks and evaluating the adequacy of controls, it is unlikely management will identify only this type of entity-level control as adequately addressing a financial reporting risk identified for a financial reporting element." (page 27- part of the guidance).

Mixed messages will lead to different interpretations and confusion and the adoption, as a rational response, of a more cautious response than may be necessary.

## 2.2 SEC's guidance to management is rooted in an auditors' approach

The SEC's proposed guidance is unlikely to resonate well with management as it is not very user-friendly. The approach taken by the guidance and the language it uses are rooted in an auditor's approach to internal control over financial reporting instead of language that may be better understood by management. For example, the proposed guidance makes reference to the 'design' and 'operation' of controls which is perceived as 'auditor' parlance.

## 2.3 Fraudulent financial reporting

The wording in the proposed SEC guidance goes well beyond fraudulent financial reporting to cover misappropriation of assets and corruption. Page 23 states "Management's evaluation of financial reporting risks should also consider the vulnerability of the entity to fraudulent activity (e.g., fraudulent financial reporting, misappropriation of assets and corruption) and whether any of those exposures could result in a material misstatement of the financial statements."

The SEC should carefully consider:

- whether this exceeds the scope of the Sarbanes-Oxley Act; and
- the consequences of this wording and whether an expectations gap will develop giving investors a false sense of security and providing a potential future hostage to fortune.

## 2.4 Balance of the document

We have some concerns that the high-level approach is not consistently implemented throughout the document with the result that, in places, it lapses into a greater degree of detail than may be necessary for high-level guidance.

We assume that IT controls are included in the main body of the proposed SEC guidance (pages 27 and 28) because they have been cited as a problem area over the last two years. Whilst we

understand the need to address these issues, we question whether their inclusion in the main body of the proposed guidance is really the best way to deal with the matter. Will such an approach set a precedent for the future with requests for problem areas that are identified in the next few years to be included in yet more guidance?

Respondents to the SEC's proposed guidance may well request additional guidance in different areas, probably in the form of practical examples. Acceptance of such requests will have the effect of moving away from the concept of management judgement. We hope that the SEC will resist requests for further guidance and will also reconsider the extent of the guidance in the current documents. It is not enough simply to support the provision of guidance by means of a footnote reference to a request for guidance from those commenting on the Concept Release. The SEC should also consider other matters, such as whether guidance adds points of substance and is strictly necessary, whether it will limit the scope for exercising appropriate judgement and whether it will tend to make the document too lengthy and inaccessible for its intended audience to read.

## 2.5 Questions asked by the SEC on the proposed interpretive guidance

*We have chosen not to answer all the questions on pages 49 to 51, pages 53 and 54 and page 60. Unanswered questions are left blank.*

	<u>Question</u>	<u>Comment</u>
1	<p>Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process?</p> <p>Does the proposed guidance allow for management to conduct an efficient and effective evaluation?</p>	<p>Generally yes. The guidance is a step forward, but, as we state in our letter of 26 February 2007, we have a number of concerns and believe that there is still much to do.</p> <p>Overall, we commend the SEC on its intention to adopt a generally high-level and principles-based approach for the preparation of its proposed interpretive guidance for management.</p> <p>In Appendix 1.5 we refer to the top-down, risk-based approach and, in particular, the risk that detail might blur the overall need for management judgement.</p> <p>It is not possible to say at this time. The acid test is whether expectations of change will be met. We refer to our letter of 26 February 2007 in which we point out that the proposals alone cannot fundamentally change behaviour.</p>
2	<p>Are there particular areas within the proposed interpretive guidance where further clarification is needed? If yes, what clarification is necessary?</p>	<p>Points requiring greater clarity are set out in our letter of 26 February 2007 as well as in our comments on alignment with the PCAOB standard in Appendix 1 and in all comments in Appendix 2. However, as stated in Appendix 2.4 we are very wary of calls for further clarification where this does not add points of substance and merely limits the scope for exercising appropriate judgement and makes the document too lengthy and inaccessible.</p>
3	<p>Are there aspects of management's annual evaluation process that have not been addressed by the</p>	<p>No. Respondents to the SEC's proposed guidance may well request additional guidance in different areas, probably in the form of practical</p>

	<p>proposed interpretive guidance that commenters believe should be addressed by the Commission? If so, what are those areas and what type of guidance would be beneficial?</p>	<p>examples. Acceptance of such requests will have the effect of moving away from the concept of management judgement. We hope that the SEC will resist requests for further guidance.</p>
4	<p>Do the topics addressed in the existing staff guidance (May 2005 Staff Guidance and Frequently Asked Questions (revised October 6, 2004)) continue to be relevant or should such guidance be retracted? If yes, which topics should be kept or retracted?</p>	<p>The May 2005 documents should be retracted.</p>
5	<p>Will the proposed guidance require unnecessary changes to evaluation processes that companies have already established? If yes, please describe.</p>	<p>We hope that unnecessary changes will not happen, but this depends on how the new requirements are implemented.</p> <p>The Commission should accept that some companies may have changes to make to previously established processes. However, costs that have already been incurred are sunk costs and should not be taken into account when deciding on future regulatory policy.</p> <p>We are concerned that the SEC and PCAOB documents are not aligned. A lack of alignment and internal inconsistencies will cause confusion and misinterpretation, misaligned management and auditor methodologies and a significant consequential waste of resources.</p> <p>Much work is needed to rectify these matters.</p>
6	<p>Considering the PCAOB's proposed new auditing standards, <i>An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements</i> and <i>Considering and Using the Work of Others In an Audit</i>, 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?</p>	<p>See Question 5 above, matters raised in our letter of 26 February 2007 and Appendix 1.</p>

7	<p>Are there any definitions included in the proposed interpretive guidance that are confusing or inappropriate and how would you change the definitions so identified?</p>	<p>See Appendix 1.2 and 1.4.</p> <p>In particular, there are differences in the wording of the definitions proposed by the SEC and the PCAOB. On a matter as fundamentally important as this there should be no inconsistency.</p> <p>The definitions throughout the guidance appear to use language that is more commonly used by auditors than by management.</p>
8	<p>Will the guidance for disclosures about material weaknesses result in sufficient information to investors and if not, how would you change the guidance?</p>	<p>In principle, yes but in practice we are concerned that legal advice will limit the usefulness of disclosures to investors.</p> <p>On the issue of material weaknesses, we refer to Appendix 1.2 and 1.4.</p>
9	<p>Should the guidance be issued as an interpretation or should it, or any part, be codified as a Commission rule?</p>	<p>The document should be issued as interpretive guidance and not as a rule.</p>
10	<p>Are there any considerations unique to the evaluation of ICFR by a foreign private issuer that should be addressed in the guidance?</p> <p>If yes, what are they?</p>	<p>Yes. We agree that the management of FPIs that file financial statements prepared in accordance with home country generally accepted accounting principles or IFRS with a reconciliation to U.S. GAAP should plan and conduct their evaluation process based on their primary financial statements (i.e., home country GAAP or IFRS) rather than the reconciliation to U.S. GAAP(footnote 47).</p> <p>We also support the SEC's reference in footnote 16 to frameworks used in other countries, for example the Turnbull guidance adopted in the UK.</p>
11	<p>Should compliance with the interpretive guidance, if issued in final form, be voluntary, as proposed, or mandatory?</p>	<p>Voluntary, as proposed.</p>
12	<p>Is it necessary or useful to amend the rules if the proposed interpretive guidance is issued in final form, or are rule revisions unnecessary?</p>	<p>-</p>
13	<p>Should the rules be amended in a different manner in view of the proposed interpretive guidance?</p>	<p>-</p>

14	Is it appropriate to provide the proposed assurance in Rules 13a-15 and 15d-15 that an evaluation conducted in accordance with the interpretive guidance will satisfy the evaluation requirement in the rules?	Yes.
15	Does the proposed revision offer too much or too little assurance to management that it is conducting a satisfactory evaluation if it complies with the interpretive guidance?	Despite the safe harbour that may be provided, if auditors are still required to form their own opinion on the issuer's internal control over financial reporting and to work to a more detailed, non-aligned standard which a high level of detail, management will still look to the auditing standard for guidance.
16	Are the proposed revisions to Exchange Act Rules 13a-15(c) and 15d-15(c) sufficiently clear that management can conduct its evaluation using methods that differ from our interpretive guidance?	Yes.
17	Do the proposed revisions to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X effectively communicate the auditor's responsibility?  Would another formulation better convey the auditor's role with respect to management's assessment and/or the auditor's reporting obligation?	See the comments in our letter of 26 February 2007 on the proposed elimination of the requirement on the auditor to evaluate management's assessment.  We strongly believe that the SEC and PCAOB have proposed the elimination of the wrong auditors' opinion. We believe that the SEC and PCAOB should re-examine their decision.  Yes. The auditors' opinion on management's assessment currently proposed for elimination should be retained and the other opinion required by AS 2 should be eliminated.
18	Should we consider changes to other definitions or rules in light of these proposed revisions?	If this question is aimed at definitions of material weakness, see Appendix 1.2.
19	The proposed revision to Rule 2-02(f) highlights that disclaimers by the auditor would only be appropriate in the rare circumstance of a scope limitation. Does this adequately convey the narrow circumstances under which an auditor may disclaim an opinion under our proposed rule? Would another formulation provide better guidance to auditors?	-

20	We request comment on the nature of the costs and benefits of the proposed amendments, including the likely responses of public companies and auditors concerning the introduction of new management guidance.	It is clear where the costs are, it is less easy at this stage to assess the benefits. We have concerns around expectations of cost reductions as noted in this letter.  We recommend that the SEC keeps these matters under constant review, gathering information on the costs of implementation. We refer to this matter in our letter of 26 February 2007 under the heading of ' <i>The implementation of revised proposals calls for innovative monitoring</i> '.
21	We seek evidentiary support for the conclusions on the nature and magnitude of those costs and benefits, including data to quantify the costs and the value of the benefits described above.	-
22	We seek estimates of these costs and benefits, as well as any costs and benefits not already identified, that may result from the adoption of these proposed amendments and issuance of interpretive guidance.	-
23	With increased reliance on management judgment, will there be unintended consequences?	See comments in our letter of 26 February 2007 on ' <i>The consequences of separate auditor and management assessments are hard to predict</i> ' and ' <i>The proposals do not appear to reflect Congressional intent</i> '.
24	We also request qualitative feedback and related evidentiary support relating to any benefits and costs we may have overlooked.	-

### **Comments on the PCAOB's proposed auditing standard – an audit of internal control over financial reporting that is integrated with an audit of financial statements**

#### **3.1 Overall comments**

AS 5 represents an improvement on AS 2. However, there are a number of important issues that will need to be addressed by the PCAOB and the SEC. These major issues include:

- alignment between the SEC and PCAOB documents;
- risk vs. control-based approaches;
- the level of detail in guidance that reduces the need for professional judgement; and
- a proposed auditing standard that is less focussed on the higher level issues than the SEC's guidance to management.

We stress the importance of auditor and PCAOB inspector behaviour in the success or otherwise of AS 5 in the implementation of section 404 of the Sarbanes-Oxley Act. Changing behaviour in an environment where litigation and fear of PCAOB inspections promotes conservatism will not be a short-term or an easy task. If there is to be success in meeting the expectations for change that now exist in the marketplace, the PCAOB and the SEC will need to carry out a careful examination of the issues raised by the consultation on AS 5.

#### **3.2 Management assessment**

Page 16 of AS 5 contains some apparently contradictory statements. Firstly, the PCAOB states that it "believes that the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process".

Later on the same page it states that "an auditor still would need to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which he or she will use the work of others. The extent of work necessary for these purposes, however, should be limited."

While these statements might be capable of being reconciled to each other using sophisticated technical arguments, they are most readily construed as contradicting each other. We also question the validity of the first statement and ask whether an auditor can perform an effective audit of internal control without performing an evaluation of the quality of management's evaluation process. We believe that the starting point for an auditor's evaluation of an organisation's controls is to understand the process used by management in carrying out their assessment.

#### **3.3 Definitions**

We note the PCAOB's proposed changes in definitions and also that the old and the new definitions are derived from FAS 5.

We hope that the new definitions achieve their intended purpose, but we re-emphasise the points made above and in our letter of 26 February 2007 about risk averse behaviour and the need to align the definitions of material weakness. The proposals alone cannot fundamentally change behaviour.

### 3.4 Change in responsibility for the UK Turnbull guidance

Footnote 5 of AS 5 should be updated. Responsibility for the Turnbull guidance passed from the Institute of Chartered Accountants in England and Wales to the Financial Reporting Council in 2005.

### 3.5 Questions asked by the PCAOB in its document

*We have chosen not to answer all the questions in PCAOB Release 2006-007. Unanswered questions are left blank.*

	<u>Question</u>	<u>Comment</u>
1	Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?	<p>AS 5 represents an improvement on AS 2, although we have a number of concerns about alignment with the SEC's guidance and risk vs. controls-based approaches.</p> <p>No-one should expect however that AS 5 will, of itself, result in more efficient auditing, particularly if extraneous structural factors driving defensive auditing behaviour are not changed.</p> <p>Furthermore, the PCAOB should avoid creating an expectation that the level of judgement required to conduct an efficient audit will be reduced or that audits of internal control will necessarily become more uniform as a result of these changes.</p> <p>We also caution against an excessive focus in these proposals on the need to eliminate a perceived level of over-auditing.</p>
2	Does the proposed standard place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud?	<p>Fraud controls are important but should be seen in the context of a risk-based approach to internal control over financial reporting and not over-emphasised.</p> <p>We believe that there is insufficient emphasis on the inherent limitations of internal control and the concept of reasonable assurance in the document. These matters are covered in paragraphs 16-18 of the existing standard and we believe they should be carried over to the current standard.</p>
3	Will the top-down approach better focus the auditor's attention on the most important controls?	See Question 1 above.

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?	<p>The problem that existed with company level controls in AS 2 has not been eliminated in the proposed standard. References to reliance on company level controls in order to reduce or eliminate the testing of other controls are difficult to translate into practice.</p> <p>We therefore caution against the suggestion that testing of controls can routinely be eliminated as a result of the testing of company level controls and we believe that the proposed standard should recognise the rarity of this situation in paragraph 43.</p>
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?	<p>See Question 1 and Appendix 1.</p> <p>It is important to remember that an assessment of risk is just that, an assessment. One auditor's assessment may be different from another's and both may be acceptable based on the facts.</p> <p>The relationship between risk and necessary evidence is also a highly judgemental area.</p>
6	Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?	<p>We refer you to our comments in Appendix 1 on a risk-based approach. We caution against the belief that walkthroughs are a panacea for over-auditing.</p> <p>The question refers to lower risk controls. We would prefer to see these referred to as controls that address lower risks which by their nature need not be tested to the same level as controls that address higher risks.</p> <p>The suggestions here, and again in Q17 and paragraph 48 of proposed AS 5 that walkthroughs can be used to eliminate any further tests of design and operating effectiveness, and that a single walkthrough might be sufficient with regard to the former may encourage a 'bare minimum' approach to auditing.</p> <p>The standard should not make any specific references to sample sizes. The reference to the fact that a sample of 'one' may be sufficient is a dangerous bright line. Sample sizes should be left to the professional judgement of the auditor.</p>

7	<p>Is the proposed definition of "significant" sufficiently descriptive to be applied in practice?</p> <p>Does it appropriately describe the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency?</p>	<p>See Appendix 3.3.</p> <p>The proposed definition is different to the definition in AS 2 and, theoretically, this should make the standard easier to apply, but no less judgement will be required in its application.</p> <p>-</p>
8	<p>Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or the auditor?</p> <p>How could the proposed standard on auditing internal control further encourage auditors to appropriately identify material weaknesses when an actual material misstatement has not occurred</p>	<p>-</p> <p>Auditor behaviour is only partly driven by auditing standards and addressing the extraneous structural factors driving defensive auditing behaviour referred to above is far more likely to achieve this outcome than any amount of explanation in the standard itself.</p>
9	<p>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?</p>	<p>See Appendix 3.3.</p> <p>The proposed changes to the definitions will not of themselves necessarily result in more efficient or effective audits unless extraneous structural factors driving defensive auditing behaviour are also addressed.</p> <p>These changes will create an expectation among CEOs, CFOs and audit committee chairs that the scale of audits will be reduced.</p>
10	<p>Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present?</p>	<p>Yes. Question 8 assumes that weaknesses do not necessarily result in misstatements. Similarly, the fact that some significant fraud or error has occurred does not, of itself, necessarily indicate that a material deficiency exists. The inherent limitations of internal control systems mean that well designed and operated systems will, from time to time, fail to prevent or detect material weaknesses. As discussed in Appendix 1.4, this is particularly likely to be the case in the context of the complex US financial reporting framework.</p>

	Will this change improve practice by allowing the use of greater judgment? Will this change lead to inconsistency in the evaluation of deficiencies?	Yes. The reduction of inconsistencies in the evaluation of deficiencies is an aim that the PCAOB strives to achieve. However, it cannot and should not expect to eliminate inconsistencies that represent genuine judgement differences.
11	Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?	<p>Further clarifications will always be desirable in the eyes of those who seek ever-greater certainty but our experience of principles-based standard-setting shows clearly that an excessive level of detail in auditing standards is ultimately counter-productive.</p> <p>Changes to the extraneous structural factors driving defensive auditing behaviour would be a better guarantor of the avoidance of unnecessary testing than further clarifications.</p>
12	<p>Should the reference to interim financial statements be removed from the definitions of significant deficiency and material weakness?</p> <p>If so, what would be the effect on the scope of the audit?</p>	-
13	Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?	<p>We believe that eliminating the opinion on management's assessment is the wrong route. Our comments are set out in our letter of 26 February 2007 under the heading '<i>The consequences of separate auditor and management assessments are hard to predict</i>' and '<i>The proposals do not appear to reflect Congressional intent</i>'.</p> <p>If the proposal to eliminate the opinion on management's assessment is retained, then it will probably eliminate some audit work, but we do not believe that this work is without value.</p>
14	Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?	<p>No. See comments in Appendix 3.2.</p> <p>We also refer to our letter of 26 February 2007 in which we note that views should be sought on the fundamental question of whether the auditor's attestation needs to take the form of an audit in order to meet the apparent intentions of Congress. It is our continued belief that not all attestations are audits.</p>

15	<p>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?</p>	<p>With hindsight, investors may wish that the auditors had been required to put their names to the evaluation of management's assessment rather than to their own evaluation.</p> <p>Auditors and their clients are often accused of being too close to each other. In reality, failures can occur when the opposite happens. The tension resulting from the enforced proximity of auditors and companies with regard to internal control may not be comfortable for either party but it is a healthy tension.</p>
16	<p>Does the proposed standard appropriately incorporate the value of cumulative knowledge?</p>	<p>We welcome the recognition of the value of cumulative knowledge in paragraphs 65-69.</p> <p>However, these paragraphs do not adequately circumscribe the use of this knowledge which could be over-used or abused. International Standards on Auditing (ISAs) recognise a three year cycle for the audit of certain internal controls and we believe that consideration of some similar circumspection would be helpful.</p>
17	<p>What are the circumstances in which it would be appropriate for the auditor to rely upon the walkthrough procedures as sufficient evidence of operating effectiveness?</p>	<p>See Question 6 above.</p>
18	<p>Will the proposed standard's approach for determining the scope of testing in a multi-location engagement result in more efficient multi-location audits?</p>	<p>Yes. Auditors should be allowed to use their judgement, recognising that locations that are not subject to audit over a period of time may pose some risks. Bright lines in principles-based standards can however be dangerous.</p>
19	<p>Is the proposed standard's single framework for using the work of others appropriate for both an integrated audit and an audit of only financial statements?</p> <p>If different frameworks are necessary, how should the Board minimize the barriers to integration that might result?</p>	<p>Yes. Any other approach would be inefficient.</p> <p>-</p>

20	Does the proposed definition of relevant activities adequately capture the correct scope of activities, including activities that are part of the monitoring component of internal control frameworks?	-
21	Will requiring the auditor to understand whether relevant activities performed by others identified control deficiencies, fraud, or financial statement misstatements improve audit quality?	Yes.
22	Is the principal evidence provision that was in AS No. 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?	<p>No. The principal evidence provisions have probably led to inefficiencies in the implementation of section 404.</p> <p>Requirements for objectivity and competence taken together with paragraphs 8 and 9 on the sole responsibility of the auditor are adequate.</p> <p>We believe that these paragraphs would benefit from being strengthened with wording similar to that in Paragraph 8 of ISA 610, "Considering the work of internal audit".</p>
23	<p>Does the proposed standard provide an appropriate framework for evaluating the competence and objectivity of the persons performing the testing?</p> <p>Will this framework be sufficient to protect against inappropriate use of the work of others?</p> <p>Will it be too restrictive?</p>	<p>Yes.</p> <p>No. There is insufficient emphasis on situations in which it will be inappropriate for the work of others to be used and no recognition of the fact that reliance on the work of others will rarely if ever eliminate the need for the involvement of the auditors. Paragraph 8 of ISA 610 deals with this.</p> <p>No.</p>
24	<p>Has the Board identified the right factors for assessing competence and objectivity?</p> <p>Are there other factors the auditor should consider?</p>	<p>Yes.</p> <p>No.</p>

25	What will be the practical effect of including, as a factor of objectivity, a company's policies addressing compensation arrangements for individuals performing the testing?	We would not expect the effect to be significant and would therefore suggest that this factor is excluded in the interests of simplicity.
26	Will requiring a walkthrough only for all significant processes reduce the number and detail of the walkthroughs performed without impairing audit quality?	Not necessarily. Requiring a walkthrough only for significant processes may reduce the number of the walkthroughs performed in some cases but the only example given (relating to revenues) is a poor one.  The walkthrough requirements are of themselves inefficient.
27	Is it appropriate for the auditor to use others as direct assistance in performing walkthroughs?  Should the proposed standard allow the auditor to more broadly use the work of others in performing walkthroughs?	Yes.  -
28	Does the proposed standard on auditing internal control appropriately describe how auditors should scale the audit for the size and complexity of the company?	In our view the needs of smaller companies are best addressed by setting "think small first" principles-based standards, rather than by requiring auditors of smaller companies to apply additional requirements and complex guidance.
29	Are there other attributes of smaller, less-complex companies that the auditor should consider when planning or performing the audit?	We note that the language used in the proposed standard is very similar to that used in auditing guidance for the audit of very small owner managed businesses.  The difficulty with smaller entities as envisaged by the market capitalisation is that they are often, by definition, growing, or in a period of transition, during which they bear some characteristics of both larger and smaller entities.
30	Are there other differences related to internal control at smaller, less complex companies that the Board should include in the discussion of scaling the audit?	See Question 29.
31	Does the discussion of complexity within the section on scalability inappropriately limit the application of the scalability provisions in the proposed standard?	See Question 28.

32	<p>Are the market capitalization and revenue thresholds described in the proposed standard meaningful measures of the size of a company for purposes of planning and performing an audit of internal control?</p>	<p>See Question 28.</p>
33	<p>Is there other information the auditor should provide the audit committee that would be useful in its pre-approval process for internal control-related services?</p>	<p>It should be emphasised that an auditor should not accept an engagement for the provision of internal control related services when the auditor concludes that the threats to independence cannot be reduced to an acceptable level through appropriate safeguards.</p> <p>It is also not clear that there is any process for reviewing auditor independence after the initial approval has been made, be this at the annual audit committee meeting or on an ad hoc basis. Once an initial assessment and approval of auditor independence is made by the audit committee, then there should be the opportunity to review and update this assessment as circumstances change.</p> <p>The assessment of an auditor's independence should not be a one-off evaluation at a point in time but there should be a process for continually evaluating an auditor's independence.</p> <p>It should also be the responsibility of the auditor to inform the audit committee of any changes in circumstances that may affect the auditor's independence, since the auditor rather than the audit committee is likely to have knowledge about those changed circumstances.</p>
34	<p>How can the Board structure the effective date so as to best minimize disruption to on-going audits, but make the greater flexibility in the proposed standards available as early as possible?</p> <p>What factors should the Board consider in making this decision?</p>	<p>We believe that this question is premature since there is still a substantial amount of work for the PCAOB and the SEC to do to ensure that AS 5 delivers benefits, for example, in terms of flexibility.</p>