



17 May, 2004

Mr Jonathan G. Katz
Securities and Exchange Commission
450 Fifth Street
NW
Washington
DC 20549-0609

Dear Sir

File No. PCAOB-2004-03

PCAOB Auditing Standard No. 2: An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

The Institute of Chartered Accountants in England & Wales (ICAEW) is pleased to provide a letter of comment in response to the SEC's exposure of the PCAOB's Auditing Standard No. 2. The ICAEW is the largest individual body of professionally qualified accountants in Europe with over 126,000 members who work in many sectors in business and the public sector, as well as practising as accountants and auditors. We operate under a Royal Charter that requires us to act in the public interest and in 1999 published "Internal Control: Guidance for Directors on the Combined Code" (the Turnbull Report) which applies to UK listed companies.

The work already done

We understand and acknowledge the efforts made in the United States over the past two years to respond to the breakdown in public confidence in corporate financial reporting. We commented on the PCAOB's proposed standard in November 2003 and we are pleased to note that the standard issued by the PCAOB explains in detail how comments on many of the issues we raised were dealt with, and gives greater recognition to the importance of auditors exercising professional judgement. We are aware of the practical constraints which restrict the ability of the SEC and the PCAOB to deal with criticism of their output. Time is short, a line has to be drawn somewhere and further refinements to the PCAOB's auditing standard at this time are probably neither desirable nor practicable. The comments set out below are made with these thoughts in mind.

We remain concerned that the standard, on its own, will fall significantly short of achieving its stated objective which is to provide stakeholders with a reasonable basis on which to rely on financial statements. There is a risk that aspects of the standard will create considerable additional costs for companies, ultimately borne by investors, without proportionate benefits. It is therefore of the utmost importance that the SEC takes advantage of opportunities to lead public discussion on reliable financial reporting and remind all concerned that the standard is not a panacea, and that it must be viewed in its proper context as just one part of the infrastructure designed to protect investors.

The task ahead

The messages that accompany the issuance of this standard are as important as the standard itself. This auditing standard, and any improved standard that might be developed in future, will only improve internal control within companies if all concerned acknowledge its importance and work hard to make it a success. The standard itself cannot provide a cast-iron guarantee that internal control issues within companies are now somehow resolved and it should not be portrayed as such. The tone at the top is paramount. Boards of directors and senior management should resist the temptation to regard internal control as henceforth a compliance issue and to push responsibility for it down within companies. Investors must not be lulled by soothing words about internal control into a false sense of security; their expectations need to be managed. And the SEC itself should not instigate regulatory action every time an adverse report is issued.

The key issues set out below represent what we believe to be the most significant areas for attention. We make suggestions as to what the SEC might do to mitigate potential adverse effects and to improve the standard's operational effectiveness.

1. Inappropriate focus on low level control activities

We remain concerned that the standard focuses too much on low level control activities, particularly in the practical examples in the Appendices. The principal cause of recent major scandals was senior management's fraudulent manipulation of earnings. The standard gives little guidance in this crucial area. The level of detail provided on low level control activities in the standard will tempt management and auditors to focus on the wrong areas at the expense of more significant risks relating to the integrity of financial reporting.

This is a pervasive weakness in the standard typified by examples B1 to B4 in Appendix B which deal with low level control activities. It is unfortunate that there are no examples of the other four COSO control components in this appendix, such as the control environment. The control environment features prominently in the standard and is often much more important in practice than control activities.

It would help greatly if the SEC were to emphasise to both companies and auditors the importance of the tone at the top, integrity, and the need for audit efforts to be directed towards testing of the control environment.

2. Definitions and adverse audit opinions

The standard requires adverse opinions for any material weakness. The justification for this approach lies in the requirement for the external auditor's report to mirror management's report which is also required to draw adverse conclusions from material weaknesses. The result of this could be a plethora of adverse reports from over-cautious management and auditors which quickly become the norm, or a complete absence of adverse reports for fear of regulatory action. Both scenarios would be dysfunctional because they would not help investors to distinguish between well and badly-run companies.

The likelihood of 'boilerplate' adverse reports would be lower if changes were made to the definitions of material weakness and significant deficiency. Despite noting that most commentators objected to the definitions in the exposure draft, the PCAOB has retained them. We consider that the arguments set out by the PCAOB for their retention are weak, as

is the assertion by the PCAOB that commentators' concerns have been adequately dealt with by means of a note to the standard concerning compensating controls and clarification as to what is meant by 'inconsequential'.

If it is not possible to provide both management and auditors with the option of issuing qualified reports, it would help if the SEC were to make it clear that the issue of an adverse report will not of itself result in regulatory action and that meaningful disclosure of problems and improvements is in the interests of investors. Equally, the absence of an adverse report should not, of itself, offer protection from regulatory action.

We also suggest that the SEC considers carefully the comments made in connection with the definition of material weakness and significant deficiency in Auditing Standard No. 2 and satisfy itself that these definitions do indeed mark out the SEC's expectations of issuers and either confirm this explicitly or amend the definitions in the SEC's own rules for issuers.

3. Reasonable and high assurance

We remain concerned that there still appear to be fundamental misunderstandings about the level of assurance provided. These matters may appear academic but their importance should not be underestimated when things go wrong. Paragraph 17 of the standard continues to state that reasonable assurance is a high level of assurance and that it includes the understanding that there is a relatively low risk that material misstatements will not be prevented or detected. This is a misleading over-simplification of current thinking on this subject that will encourage investors to take much greater comfort from the work performed by external auditors than is warranted. We suggested that the PCAOB aligned its description of reasonable assurance with current thinking in this area to prevent false expectations, confusion and misunderstanding but this was not done.

In this context the SEC should emphasise:

- ***the inherent limitations of internal control;***
- ***the inherent limitations of audit and the fact that absolute assurance can never be provided; and***
- ***the need for constant vigilance on the part of investors and other stakeholders.***

4. Management and auditor responsibilities (SEC Rules)

The standard is a standard for external auditors, compliance with which cannot necessarily be forced upon the management of a company. The proposed standard introduces examples of new and specific requirements for companies that exceed those described in the relevant SEC rules on matters including the documentation and testing of controls by management.

We suggest that the SEC consider the specific responsibilities of companies in this regard and that the directors and senior management of companies be reminded of their absolute responsibility for internal control by the publication of SEC rules or guidance on those management responsibilities arising from Auditing Standard No. 2.

We hope you find these comments helpful and we would welcome further dialogue with the SEC on how, in the interests of investors globally, we might promote international convergence on internal control reporting.

Yours sincerely

A handwritten signature in cursive script that reads "Robert Hodgkinson".

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