



Consumer Federation of America

April 4, 2007

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Dear Chairman Cox:

I am writing on behalf of the Consumer Federation of America to express our deep disappointment over today's Commission meeting to discuss the PCAOB's proposed standard for an audit of internal controls that is integrated with the financial statement audit. The meeting did nothing to dispel the notion that the SEC is more concerned with reducing costs to business than it is with ensuring that audits are effective. This concern, which derives originally from the language and approach of the SEC proposed guidance, as noted in our comment letter on that proposal, was only reinforced by both the meeting's agenda and by the nature of the discussion that ensued.

The agenda of the meeting was devoted exclusively to issues raised in comment letters submitted by various business interests. Concerns raised by investors were barely acknowledged, let alone seriously addressed. This was true, even in areas where those concerns related directly to issues under discussion. It is ironic, for example, that the discussion focused so extensively on concerns that the proposal will lead auditors to engage in excessive testing of internal controls, when a key investor concern regarding the proposed standard is that it is larded with language that suggests auditors will be second-guessed by regulators if their judgment leads them to do more than the absolute minimum amount of testing permitted. Similarly, the meeting included extensive hand-wringing over the issue of how the standard could permit more extensive use of the work of others, when it already permits, even encourages, auditors to use the work of others for purposes, such as the performance of walk-throughs, that are integral to the audit process and should not ever be delegated, and even where the auditor believes the individual performing the work is of only marginal competence or objectivity.

Given the fact that investors' concerns were entirely ignored during the meeting – or raised only to be dismissed without substantive discussion – we'd like to take this opportunity to comment on some of the issues that were discussed.

1) **The need for better alignment between the PCAOB and SEC standards.**

The stand-alone management assessment of internal controls and the auditor's review of controls as a part of the financial statement audit are related, but distinct, processes. While it is important that they not be in conflict with each other, there is no reason to believe their approaches need be as closely "aligned" as the staff seemed to imply in today's discussion. In fact, this issue was dealt with through the elimination of the requirement that auditors assess management's processes and procedures for assessing controls and instead restrict themselves to evaluating the control environment itself. The only reason we can see that management might feel pressured to adopt the PCAOB approach is if their own procedures repeatedly fail to identify material weaknesses in internal control. However, if that were the case, it would provide cause to reevaluate the approach being advocated by the SEC for management's assessment, not for scaling back the auditor's assessment so that it is equally ineffective.

This concern seems particularly misplaced when it comes to issues regarding the "overall approach" of the two proposals. In this context, the staff incorrectly states that the SEC guidance takes a more principles-based approach than the PCAOB proposal. While it is true that the SEC provides even greater flexibility than does the PCAOB standard, neither of them includes either a clearly articulated investor protection outcome auditors and managers are responsible for achieving or core investor protection principles to guide them in achieving that outcome. In short, this is a principles-based approach without the principles. If the SEC and PCAOB are to examine ways to provide a more principles-based approach, developing these core principles would be a good place to start.

We have suggested, for example, that the following principles be incorporated at the beginning of the PCAOB standard and that related principles be incorporated in the SEC guidance:

- # An independent audit of internal controls over financial reporting provides an essential supplement to reporting requirements of managers, who may have incentives not to report weaknesses in their controls.
- # The purpose of the audit is to determine whether internal controls at the company are functioning at a level that provides reasonable assurance they will detect and prevent a material misstatement of the financial statements and, if not, to identify and report on material weaknesses.
- # In assessing internal controls, auditors are responsible for obtaining sufficient evidence to support their conclusion about the adequacy of internal controls.
- # The auditor must ensure that decisions regarding the audit that require the analysis of complex issues or the exercise of professional judgment are handled by members of the audit team with adequate experience and training to perform those functions.
- # To the degree that the auditor relies on the work of others in performing the audit,

the auditor is responsible both for ensuring that the individual performing the work has sufficient expertise to perform those functions and for reporting to investors on the extent to which it has relied on the work of others and for what purposes.

- # The auditor must maintain sufficient documentation to allow a third party to review the work performed and determine whether the conclusion reached by the auditor is reasonable.

If the PCAOB and SEC were to adopt an approach along these lines, they could perhaps afford to include less prescriptive language in their standards. Until they do so, however, the SEC should stop mis-characterizing either its proposed guidance or the PCAOB's proposed standard as principles-based.

One further note on the issue of "overly prescriptive" language in the PCAOB proposal: a key complaint in the wake of the Enron and WorldCom disasters was that audit standards were so vague as to be unenforceable. It is truly mind-boggling to see how quickly those lessons are forgotten, as the Commission publicly pressures the PCAOB to return to the days of vaguely worded, difficult to enforce audit standards.

2) The need for improved guidance regarding scaling of the audit.

Once again, the SEC makes clear with this discussion that it supports, not principles-based rules, but simply rules that provide greater flexibility. In fact, the PCAOB standard articulates fairly clearly the factors that auditors should take into account when making decisions regarding the scaling of the audit, and it requires auditors to use professional judgment in deciding how those factors relate to each particular audit client. Contrary to the suggestions made at today's meeting, telling auditors what factors they should consider in making that judgment does not in any way diminish the degree of professional judgment exercised. It doesn't tell them how they must decide the question. It simply ensures that the proper factors are taken into account in making a decision of central importance to the effectiveness of the audit.

Instead of applauding this more principles-based approach, the SEC appears to be pressuring the PCAOB to provide "clearer guidance." As the discussion made clear, that "guidance" is expected to lead to less testing, not more. But scalability does not, or should not, mean simply scaled back. It should mean that the audit is scaled – either up or down – based on the particular facts and circumstances of the company, such as its size and complexity. And, despite the discussion today, complexity is clearly just another "fact or circumstance" that should be taken into account. There is nothing about the PCAOB standard that suggests this calls for a "binary" decision on the part of the auditor. In fact, to maintain otherwise, and to suggest furthermore that every judgment call must be backed up in the standard by "clarifying" examples, is to call into question the viability of the principles-based approach to regulation.

3) Further encouraging the use of the work of others.

As noted above, one of the concerns we raised in our comment letter on the PCAOB standard is that it appeared to encourage increased use of the work of others, even where the individuals performing the work are of marginal competence or objectivity. This concern was not even acknowledged, let alone addressed, in today's discussion. (Patting investors on the head and telling them not to worry does not count as a serious discussion of their concerns.) Nor did today's discussion address the suggestion that auditors be required to disclose to investors the extent to which they have used the work of others and for what purposes. As we noted above, we have proposed including a clear principle in the standard that states that the work of others should be used when doing so benefits investors either by improving the quality of the audit or by reducing its cost with no material loss of quality. Since the Commissioners and staff offered repeated assurances that this is their intention, the SEC should embrace such an approach. Failure to do so would again send the message that reducing costs, regardless of the impact on investor protection, is the chief concern driving this process.

4) Revived proposals for design-only, single walk-through, and rotational testing of controls.

A portion of the staff discussion today appeared to revive what we had hoped were discredited suggestions that auditors should rely on design-only, single walk-through, or rotational testing of "low risk" control areas. This is a problem for a number of reasons. First, the proposed standard already limits control testing to significant controls related to areas where a material weakness is reasonably likely to occur. There are no truly "low-risk" areas covered by this standard. So, by definition, we are talking about minimizing testing of significant controls in areas that are material to the financial statements. Second, the SEC has failed to address, or even acknowledge, the past catastrophic failure of the risk-based approach to financial statement audits. Saying that this was a problem of "implementation" rather than a problem with the standard does not address the central unanswered question: on what basis does the SEC believe auditors will be any better at assessing the risks in an internal control audit than they have been in past financial statement audits? Until the SEC and PCAOB are prepared to answer that question – and to do so with concrete changes, such as requiring certain key functions to be performed by senior audit staff – they have no business pushing to minimize testing based on a subjective and unreliable assessment that a particular area poses little risk.

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The PCAOB appears to be engaged in an appropriate process of reviewing comments on its proposal and revising its proposal in light of those comments. It was unseemly today to see the SEC, which promotes itself as the investor's advocate, so blatantly elevating business concerns over investor concerns and appearing to strong-arm the PCAOB into doing the same. We can only hope that the PCAOB will assert its independence and produce a strong standard – one that addresses investor concerns as well as legitimate business concerns – and that the Commission ultimately accedes to that standard. It is a hope that has become increasingly difficult to maintain.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

cc: Commissioner Paul Atkins
Commissioner Kathleen Casey
Commissioner Roel Campos
Commissioner Annette Nazareth
Mark Olson, Chairman, PCAOB
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