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The Hundred Group
of Finance Directors

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Office of the Secretary
The Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

We would like to thank the Public Company Accounting Oversight Board (the "**PCAOB**") for the opportunity to comment on the issues raised in its proposed Auditing Standards "An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and related other proposals" ("**AS5**") and "Considering and Using the Work of Others in an Audit" ("**AS6**") of December 19, 2006, and we applaud the PCAOB's efforts to facilitate more streamlined compliance with Section 404 of the Sarbanes-Oxley Act of 2002 (the "**Act**") and the rules promulgated thereunder by the Securities and Exchange Commission (the "**Commission**").

By way of introduction, The Hundred Group of Finance Directors (the "**100 Group**") represents the finance directors of Britain's largest companies, mainly but not entirely drawn from the constituents of the FTSE 100 Index of the largest companies by market capitalisation listed on the London Stock Exchange. Almost 40 of our member companies are SEC registrants. We meet periodically to discuss issues affecting major corporations, and selectively respond to governmental and other consultation exercises where we believe that our role in companies and collective experience give us a particular insight into often complex matters.[1]

We acknowledge that Section 404 is designed to improve corporate governance, increase the quality of financial and other disclosure and instill investor confidence in the financial markets. Nevertheless, many market participants and commentators have observed the high cost and burden associated with its implementation. The Commission's "Staff Statement on Management's Report on Internal Control Over Financial Reporting" released on May 16, 2005 and the Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting of July 11, 2006 (the "**Concept Release**") were important steps in trying to ease the application of Section 404. Our group accepted the Commission's invitation to comment on the Concept Release and sent in a letter with our views on the questions posed by the Commission on September 15, 2006. The subsequent Commission release regarding "Management's Report on Internal Control Over Financial Reporting" (the

[1] While this letter expresses the views of The Hundred Group of Finance Directors as a whole, such views are not necessarily those of individual members or their respective employers.

"**Guidance"**) and AS5 and AS6 reflect a number of concerns and suggestions we voiced in our comments, and we applaud both the Commission and the PCAOB for their continuing efforts in this regard.

Following the publication of AS5, AS6 and the Guidance, a number of our member companies who are SEC registrants set out to consider the questions posed in both documents. A response prepared at a workshop was subsequently circulated to all members of the 100 Group who are SEC registrants for further comment. We have appended to this letter the 100 Group's response to the Commission concerning the Guidance. Our comments on AS5 and AS6 and responses to particular questions contained therein are set out below.

- We welcome the Guidance, which contains principle-based guidance for management to fully apply a top-down, risk-based approach to compliance with the Act, enabling management to exercise judgment and expertise in this regard. However, we are concerned that AS5 remains overly prescriptive and does not afford auditors sufficient flexibility to apply their professional judgment in the same fashion as the Guidance permits management to do in its assessment. The outcome of any such divergence between the Guidance and AS5 is likely to be a reduction in the alignment of management's and the auditors' own assessment processes, with a corresponding reduction of the potential benefit of the Guidance on the cost/benefit implications of complying with the Act. We therefore request and encourage the PCAOB to consider revising AS5 to be more principle based in nature and to avoid, where appropriate, prescriptive lists that the auditors "should" or "must" consider when conducting their assessment process.

- We recognize that the spirit of the Guidance and AS5 and AS6 is to reduce the high cost and burden currently incurred by registrants in complying with the Act. We consider the thrust of AS5 and AS6 is to offer potential reductions in those costs and burdens. For example we welcome:

    - the omission of the requirement from the new standard that "each year's audit must stand on its own" (paragraph 2 on page 19 of the Foreword to AS5),
    - the removal of the requirement for the auditor to test controls over a "large portion" of the company (paragraph 3 on page 20 of the Foreword to AS5), and
    - the removal of certain barriers to using the work of others (paragraph 4 on page 21 of the Foreword to AS5).

  However, we await demonstrable evidence of its application by auditors before drawing conclusions on whether an actual reduction in cost and burden will be achieved. As such, we encourage the PCAOB in its inspections of audit firms to consider, as a key performance indicator, the extent to which each audit firm has exploited the opportunities for cost savings and efficiency improvements contained in AS5 and AS6.

- We note the removal of the requirement for auditors to opine on management's evaluation process in complying with the Act, as cited in paragraph B1 on page 14 and at the top of page 17 of the Foreword to AS5, as well as the continued requirement for auditors to opine on the effectiveness of internal control over financial reporting ("**ICFR**") based on their own assessments. We have noted in our response to the Commission that we consider this proposal does not offer the most cost effective outcome in compliance with the Act, believing instead that a requirement for the auditor to provide only an opinion on management's assessment process would produce the most cost effective solution.

- If the current proposal to remove the requirement for auditors to opine on management's evaluation process is adopted, the requirement should be supported by the application of a principle-based, top-down and risk-based framework that permits the auditors to apply professional judgment in the performance of a truly integrated audit of ICFR and the financial statements. As such, we would await the final versions of AS5 and AS6, and also evidence of their application by auditors, before we could conclude on the extent to which retaining the requirement for auditors to opine on the effectiveness of ICFR would reduce the cost and burden to registrants of complying with the Act.

- We welcome the increased flexibility offered in AS6 to auditors to use the work of others in arriving at their own assessment on the effectiveness of ICFR. We request consideration as to whether it would be appropriate for management and the auditors to rely simultaneously upon the work of others in instances where testing of the controls relied upon by the auditors is performed with the direct assistance of others, as permitted by paragraphs 20 and 21 on page A2-8 of AS6.

- There are several differences between the definitions and language used in AS5 and those contained within the Foreword; we expect the planned review processes will ensure the full burden-reducing spirit of the Foreword is reflected in the final form of AS5. For example, on page 12 the Foreword to AS5 permits the application of professional judgment by the auditors in their assessment of uncorrected significant deficiencies, whereas the discussion in paragraph 79 on page A1-29 of AS5 appears to remove their ability to apply that judgment.

- With regard to the use of company-level controls in a top-down approach, we request clarification that paragraphs 17 – 22 on pages A1-11 through A1-13 are for illustrative purposes only and do not constitute a mandatory list of items that <u>must</u> be covered during the audit (which again could be perceived as constraining the use of professional judgment by auditors). We also request that the PCAOB recognise that company-level controls assessed using the control framework adopted by management (and the auditor, as stipulated in paragraph 5 on page A1-5) should be selected based on the risk assessment of material misstatements. Furthermore, we request that the PCAOB acknowledge that the selection and application of different weightings of importance to specific entity-level controls will be unique to each organization and may even vary by location within an organization.

- In respect of paragraph 5 on page A1-5, we request that the PCAOB replace the word "should" with "must" in respect of auditors using the same control framework to perform the audit of ICFR as management does.

In addition to the general comments set forth above, we have also prepared responses to specific questions raised in the Foreword to AS5 and AS6 where we felt it appropriate to share our views with the PCAOB.

- **Question 6: Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?**

  Yes.

- **Question 7: Is the proposed definition of "significant" sufficiently descriptive to be applied in practice?**

  Yes.

  Does it appropriately describe the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency?

  Yes, but please note our reservations about paragraph 79 on page A1-29 of AS5 set out in the general comments above.

- **Question 9: Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statements?**

  We believe that proper application of these changes by both management and the auditor would result in a reduction in the amount of effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement.

  We encourage the PCOAB to refine the AS5 definitions of materiality to permit the use of more than one measure of materiality, such as in circumstances where there is a disproportionate relationship between a company's income statement and balance sheet.

- **Question 10: Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present?**

  Yes.

  Will this change improve practice by allowing the use of greater judgment?

  Yes.

  Will this change lead to inconsistency in the evaluation of deficiencies?

  We do not consider that the change will lead to an inconsistency in the evaluation of deficiencies. Instead, it should enable the application of expertise and professional judgment in assessing the individual circumstances that will apply in each evaluation.

- **Question 11: Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?**

  We encourage the PCAOB to clarify that the focus of effort and risk assessment is to identify material fraud or potential for material misstatement. The latter is emphasized in a number of places in both the Foreword to AS5 and AS5 itself. We encourage the PCAOB to state clearly that it is only material fraud that should be included in the risk assessment performed during the scoping and evaluation of ICFR.

- **Question 12: Should the reference to interim financial statements be removed from the definitions of significant deficiency and material weakness? If so, what would be the effect on the scope of the audit?**

  Section 404 of the Sarbanes-Oxley Act requires an annual "as of" assessment. We therefore consider it inappropriate to review deficiencies using interim financial statements.

- **Question 13: Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?**

  We believe the potential does exist for some unnecessary audit work to be eliminated by this proposal. However, please see our comments in the general response above.

- **Question 14: Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?**

  Yes. However, please see our comments in the general response above.

- **Question 15: Will an opinion only on the effectiveness of internal control, and not on management's assessment, more clearly communicate the scope and results of the auditor's work?**

  As noted on page A-17 of the appended response to the Guidance, we understand the Commission's and the PCAOB's intention to be to remove the requirement for auditors to give an opinion on the effectiveness of management's evaluation of ICFR, but find the expression of this intent in AS5 and the Guidance to be confusing in certain respects. For example, the elimination of this requirement does not appear to be fully reflected in the example report on page A1-38 of AS5. If the current proposal for the role of the auditor is adopted in the final Guidance, we would request that the removal of the requirement for auditors to opine on management's assessment of ICFR in the Foreword to AS5 be clearly reflected in AS5 itself.

- **Question 18: Will the proposed standard's approach for determining the scope of testing in a multi-location engagement result in more efficient multi-location audits?**

  We welcome the removal of the requirement for auditors to test controls over a "large portion" of a company, and await demonstrable evidence of the application by auditors of a truly top-down, risk-based approach in determining the scope of testing in a multi-location engagement.

We request that the Note contained within paragraph B12 on page A1-51 be removed from AS5 as it could potentially encourage auditors to consider risk and materiality at a more stringent level to cover the possibility of material misstatement emerging through aggregation of a number of, in themselves, low-risk or immaterial business units or locations.

- **Questions 19 – 25**

  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? If different frameworks are necessary, how should the Board minimize the barriers to integration that might result?

  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?

  Will requiring the auditor to understand whether relevant activities performed by others identified control deficiencies, fraud, or financial statement misstatements improve audit quality?

  Is the principal evidence provision that was in AS No. 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?

  Does the proposed standard provide an appropriate framework for evaluating the competence and objectivity of the persons performing the testing? Will this framework be sufficient to protect against inappropriate use of the work of others? Will it be too restrictive?

  Has the Board identified the right factors for assessing competence and objectivity? Are there other factors the auditor should consider?

  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?

With regard to questions 19-25, AS6 should positively encourage auditors to place reliance on the work of others, as this is the understanding we have derived from both the Foreword to AS5 and AS6 and the Guidance. Encouraging auditors to do this is likely to have a direct and positive impact on the cost and burden of compliance with the Act.

- **Questions 26 and 27**

  Will requiring a walkthrough only for all significant processes reduce the number and detail of the walkthroughs performed without impairing audit quality?

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?

With regard to questions 26 and 27, where testing of controls is performed under the direct assistance of others, as permitted by paragraphs 20 and 21 on page A2-8, we request clarity on whether simultaneous reliance may be placed on this work by management and auditors.

As consistency between the proposed auditing standards and the Guidance is of central importance, the responses we have provided above should be read in conjunction with the 100 Group's response to the Commission concerning the Guidance, a copy of which is attached hereto for your convenience.

Once again, we appreciate the opportunity to comment on AS5 and AS6, and hope that our comments will assist the PCAOB in evaluating the issues raised therein. We are also available to consult with the PCAOB concerning our comments.

Yours sincerely,

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cc: Sebastian R. Sperber
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