

## COMMENT LETTER

February 26, 2007

# Institute Comment Letter on PCAOB Proposal Relating to Audits of Internal Control Over Financial Reporting (pdf)

February 26, 2007 Office of the Secretary Public Company Accounting Oversight Board  
1666 K Street, N.W. Washington, D.C. 20006-2803 Re: Audits of Internal Control Over Financial Reporting; PCAOB Rulemaking Docket Matter No. 021 Dear Sir or Madam: The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed auditing standard, An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements.<sup>2</sup> As investors in securities, funds have a significant interest in ensuring the integrity of corporate financial reporting on which their investment decisions are based. Accordingly, the Institute supports the Proposal in that it seeks to retain the benefits associated with audits of internal control over financial reporting while reducing the related costs. We urge the PCAOB to state more strongly that restatement of previously issued financial statements does not necessarily constitute a material weakness in internal control over financial reporting. Finally, we seek clarification on that portion of the Proposal that delineates the circumstances that should be regarded as a strong indicator of a material weakness in internal control over financial reporting. Retain Benefits While Reducing Costs Strong internal control over financial reporting has long been recognized to be important to the reliability of financial reporting. Companies have been required to have such controls since the passage of the Foreign Corrupt Practices Act in 1977. The requirement for issuers to assess and auditors to 1 The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter. 2 PCAOB Release No. 2006-007 (December 19, 2006) (the "Proposal"). February 26, 2007 Page 2 report on internal controls was mandated by Section 404 of the Sarbanes-Oxley Act of 2002. In June of 2003, the Securities and Exchange Commission implemented Section 404 by adopting rules requiring issuers to include in their annual reports an assessment of the company's internal control over financial reporting as well as an auditor's report on that assessment. Soon thereafter, the PCAOB adopted Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements ("AS No. 2"). Various commenters have recognized the benefits associated with audits of internal control over financial reporting. These benefits include, for example, improved governance, enhanced transparency, and higher quality financial reporting.<sup>3</sup> Others have indicated that enhancements to internal control over financial reporting could drive gains in corporate productivity and profits.<sup>4</sup> Other commenters, however, have noted that the mandated audits of internal control over

financial reporting have required greater effort and resulted in higher costs than originally anticipated. Often, these commenters indicate that internal control audits require allocation of significant resources to transaction level testing and the identification of errors, as opposed to the identification and prevention of the kinds of financial fraud and manipulation of accounting rules that led to the adoption of the Sarbanes-Oxley Act. 5 The Proposal is intended to maintain the benefits associated with an audit of internal control over financial reporting while reducing associated costs. In particular, the Proposal would: focus the audit on the matters most important to internal control; eliminate unnecessary procedures; scale the audit for smaller companies; and simplify requirements by reducing detail and specificity. Recognizing that shareholders ultimately bear costs associated with audits of internal control over financial reporting, we strongly support the PCAOB's efforts to improve the efficiency of internal control audits without sacrificing their effectiveness. Further, we urge the PCAOB to monitor implementation of the Proposal to ensure that the anticipated reduction in unnecessary effort and cost is realized. Restatement of Previously Issued Financial Statements as Indicator of Material Weakness AS No. 2 describes circumstances that should be regarded as at least significant deficiencies and as strong indicators of a material weakness in internal control.<sup>6</sup> AS No. 2 identifies restatement of 3 See comments of Michael J. McConnell, Managing Director, Shamrock Capital Advisors at Roundtable Discussion on Second-Year Experiences with Internal Control Reporting and Auditing Provisions (May 10, 2006). 4 See Duncan W. Richardson, Chief Equity Investment Officer, Eaton Vance Management, Businessweek (January 29, 2007). 5 See comments of William E. Keitel, Executive Vice President and Chief Financial Officer, QUALCOMM Incorporated; Comments on Second-Year Experiences with Implementation of Sarbanes-Oxley Internal Control Reporting and Auditing Provisions (April 27, 2006). 6 See AS No. 2, paragraph 140. February 26, 2007 Page 3 previously issued financial statements for the purpose of correcting a misstatement as one such circumstance. AS No. 2 provides that identification of one of the strong indicators should bias the auditor toward a conclusion that a material weakness exists but does not require the auditor to reach that conclusion. Instead, the auditor may determine that these circumstances do not rise to the level of a material weakness and that only a significant deficiency exists. Paragraph 140 contains an explanatory note regarding restatements that indicates: "The correction of a misstatement includes misstatements due to error or fraud; it does not include restatements to reflect a change in accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle."<sup>7</sup> Significant Deficiency The Proposal notes that, in practice, auditors have encountered circumstances that are strong indicators of a material weakness under AS No. 2, where there is, in fact, no significant deficiency. To ensure that the auditing standard does not force the auditor to conclude that a deficiency exists when one does not, and to reaffirm the degree of judgment involved in making these determinations, the Proposal would eliminate the requirement to conclude that the presence of one of the strong indicators is necessarily a significant deficiency. The Institute supports the proposed change. We believe it will enable auditors to exercise their professional judgment based on the particular facts and circumstances and result in more faithful characterizations of the control system. Material Weakness We urge the Board to more strongly state that the presence of one of the strong indicators included in paragraph 79 of the Proposal does not necessarily require the auditor to reach a conclusion that a material weakness exists. We are concerned that, in practice, any restatement of previously issued financial statements is deemed to be a material weakness, notwithstanding extenuating circumstances that should enable the auditor to conclude no material weakness exists. For example, certain restatements may be attributable to the complexity of generally accepted accounting principles, rather than poor controls. Accounting standards that are difficult for issuers and auditors to apply can give

rise to differences in interpretation that are not necessarily indicative of control failures. We note that SEC staff statements have indicated that neither Section 404 nor the Commission's implementing rules require that a material weakness in internal control over financial reporting must be found to exist in every case of restatement resulting from an error. Rather, both management and the external auditor should use their judgment in assessing the reasons why a restatement was necessary and whether the need for restatement resulted from a material weakness in 7 Errors in financial statements result from mathematical mistakes, mistakes in the application of generally accepted accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. See FAS 154, paragraph 2.h. February 26, 2007 Page 4 controls. Such an evaluation should be based on all the facts and circumstances, including the probability of occurrence in light of the assessed effectiveness of the company's internal control, keeping in mind that internal control over financial reporting is defined as operating at the level of "reasonable assurance."<sup>8</sup> Restatement of Previously Issued Financial Statements The Proposal carries forward the explanatory note contained in Paragraph 140 of AS No. 2 indicating that correction of a misstatement includes misstatements due to error or fraud and excludes restatements due to 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.<sup>9</sup> We seek clarification that restatement of previously issued financial statements in the circumstance described below would not be deemed a material weakness and would be treated the same as a restatement due to 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 under paragraph 79 of the Proposal. Where an issuer is required to restate previously issued financial statements as a result of a change in the application of an accounting principle, the issuer should not be deemed to have a material weakness in internal control, so long as: i) the issuer's controls over the selection and application of accounting policies in the period to be restated provided reasonable assurance<sup>10</sup> regarding the reliability of its financial reporting; and ii) the auditor opined that the prior period's financial statements were prepared in conformity with generally accepted accounting principles. In other words, provided the issuer had reasonable controls over the application of accounting policies, and the auditor agreed with the issuer's application of the accounting principle, the need to restate previously issued financial statements would be excluded from those circumstances that are strong indicators of a material weakness in internal control over financial reporting. A change in the application of an accounting principle necessitating restatement could result, for example, from a new or evolving interpretation of an accounting standard, particularly where the accounting standard is unusually complex and difficult for issuers and auditors to apply. \* \* \* \*<sup>8</sup> See Securities and Exchange Commission Staff Statement on Management's Report on Internal Control Over Financial Reporting (May 16, 2005). See also *S.E.C. v. World-Wide Coin Investments, Ltd.*, 567 F.Supp. 724, 751 (D.C.Ga.,1983) ("The definition of accounting controls does comprehend reasonable, but not absolute, assurances that the objectives expressed in it will be accomplished by the system. The concept of "reasonable assurances" contained in section 13(b)(2)(B) recognizes that the costs of internal controls should not exceed the benefits expected to be derived."). <sup>9</sup> See the Proposal, paragraph 79. <sup>10</sup> Exchange Act Section 13(b)(7) defines reasonable assurance and reasonable detail as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs." February 26, 2007 Page 5 The Institute appreciates the opportunity to comment on the Proposal. If you have any questions about our comments or would like any additional information, please contact me at 202/326- 5845 or Greg Smith at 202/326-5851. Sincerely, /s/ Donald J. Boteler Vice President – Operations cc: Andrew J. Donohue, Director Division of

Investment Management U.S. Securities and Exchange Commission About the Investment Company Institute The Investment Company Institute's membership includes 8,795 open-end investment companies (mutual funds), 658 closed-end investment companies, 325 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$10.279 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.

---

**Source URL:**

<https://icinew-stage.ici.org/CommentLetter/InstituteCommentLetteronPCAOBProposalRelatingtoAuditsofInternalControlOverFinancialReportingpdf>

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.