



CENTER FOR CAPITAL MARKETS  
COMPETITIVENESS

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May 29, 2015

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Dear Mr. Schnurr and Chairman Doty:

The U.S. Chamber of Commerce (“Chamber”)<sup>1</sup> created the Center for Capital Markets Competitiveness (“CCMC”) to promote a modern and effective regulatory structure for capital markets to fully function in a 21<sup>st</sup> century economy. The CCMC believes that businesses must have a strong system of internal controls and recognizes the vital role external audits play in capital formation. The CCMC has a Financial Reporting Working Group (“FRWG”) that consists of representatives from other trade associations and a large number of companies of all sizes and a broad set of industries. The FRWG considers matters of common and general interest related to financial reporting and reporting on the effectiveness of internal control over financial reporting (“ICFR”) under Section 404 of the Sarbanes-Oxley Act of 2002 (“SOX”).

Accordingly, we respectfully request a meeting of stakeholders to jumpstart a dialogue between the business community, Public Company Accounting Oversight Board (“PCAOB”) and the Securities and Exchange Commission (“SEC” or “Commission”) in order to address issues impacting internal controls and audits that may erode judgment and impair capital formation.

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<sup>1</sup> The Chamber is the world’s largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are users, preparers, and auditors of financial information.

Mr. James Schnurr  
James R. Doty, Esq.  
May 29, 2015  
Page 2

First, thank you both for meeting with the FRWG this past February to discuss issues regarding internal controls and external audits. The business community believes that strong and effective internal controls and audits are an important component of the ability of businesses to communicate with investors in order to raise the capital needed to operate, grow, and compete. High standards and superior performance systems are essential for management, regulators and the audit profession to execute their responsibilities and for financial reporting to meet its intended purpose. However, developments over the past several years have raised concerns that the unintended consequences of the PCAOB inspection process and corresponding changes to internal control processes are eroding judgment, as well as increasing costs and burdens for work that may in some instances not lead to more effective audits or controls. While accelerated filers are feeling the direct impacts, even non-accelerated filers are being affected.

We believe that this is the result of a lack of a dialogue between the business community and the PCAOB. Accordingly, we would respectfully request a meeting of stakeholders, the PCAOB and SEC to discuss these issues, explore ways to address them, and create such a dialogue on a continuous basis in order to promote effective controls and an appropriate exercise of judgment to enhance investor protection, capital formation, and competition.

In our view, such a meeting should focus on three areas: management review controls, a “checklist” or “one-size-fits-all” approach, and materiality. To stimulate this discussion, this letter, based on companies’ experiences, provides a context for the current environment and gives an overview of concerns in each of these three areas.

## **1. Background**

Since 2002, the business community, the SEC, and the PCAOB have implemented provisions of SOX to improve financial reporting by creating a system for assessing the effectiveness of ICFR under Section 404. In addition, the PCAOB has implemented a robust inspection program for public oversight of the firms and individuals providing external audits for public companies—both integrated audits of the financial statements and ICFR, as well as audits of the financial statements only.

Mr. James Schnurr  
James R. Doty, Esq.  
May 29, 2015  
Page 3

As audited financial statements are a crucial device to communicate with investors and raise capital, companies are strong supporters of internal controls. However, this road has had its ups and downs. Initially, the costs of implementing Section 404 were expensive and burdensome for companies generally. These costs and burdens were also regressive as they disproportionately increased inverse to the size of a business. Nonetheless, over the course of time and with efforts by the SEC and the PCAOB, particularly in 2006 and 2007, costs and burdens stabilized and improvements to financial reporting had a positive impact. For example, non-reliance financial restatements were at a high of 977 in 2005, and steadily declined to 255 in 2012.<sup>2</sup>

#### **a. Rationalizing the Implementation of Section 404**

The efforts by the SEC and PCAOB nearly a decade ago included the issuance of interpretive guidance for management reports on ICFR (“management guidance”) and replacing PCAOB Auditing Standard (“AS”) 2 with AS 5 for audits of ICFR integrated with financial statement audits.<sup>3</sup> Under the SEC’s 404 implementation rules, management discloses its assessment on whether the company’s ICFR is effective at fiscal year-end. Management needs to have a reasonable basis for its ICFR disclosures. The SEC’s interpretive guidance is intended to help management do so.

The purpose of issuing management guidance and AS 5 was to rationalize the planning and conduct of the ICFR evaluation process and audits of ICFR—for all companies, regardless of size. The SEC and PCAOB were committed to allowing management and auditors to get “out of the weeds” and focus on what matters most.

The SEC and PCAOB recognized that assessing and attesting to the effectiveness of ICFR is all about risk and materiality. For example, the SEC’s management guidance is intended to allow companies to focus their efforts on those areas that management identifies as posing the greatest risks of material misstatements in the financial statements

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<sup>2</sup> Center for Audit Quality, *Financial Restatement Trends in the United States: 2003-2012* by Professor Susan Scholz.

<sup>3</sup> See Commission Guidance Regarding Management’s Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act [Release Nos. 33-8810; 34-55929; FR-77; File No. S7-24-06] effective June 27, 2007 and PCAOB Auditing Standard No. 5 – An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit Of Financial Statements and Related Independence Rule and Conforming Amendments (PCAOB Release No. 2007-005A, PCAOB Rulemaking Docket Matter No. 021), approved by the Commission on July 27, 2007 [Release No. 34-56152; File No. PCAOB-2007-02].

Mr. James Schnurr  
James R. Doty, Esq.  
May 29, 2015  
Page 4

not being prevented or detected on a timely basis. The SEC appreciated that this is what investors care about and what is important for achieving reliable financial reporting.

The SEC's guidance is supposed to allow management to exercise significant and appropriate judgment in designing and conducting an evaluation that is tailored to the company's individual facts and circumstances. It is worth noting that under SEC guidance prior to SOX, management is responsible for maintaining a system of internal control that provides *reasonable assurance* regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (GAAP). The "reasonable assurance" referred to in the SEC's rules implementing Section 404 relates to similar language in the Foreign Corrupt Practices Act of 1977 ("FCPA").<sup>4</sup> Exchange Act Section 13(b) (7) defines "reasonable assurance" and "reasonable detail" as "such detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."<sup>5</sup> The Commission has long held that:

"[R]easonableness" is not an "absolute standard of exactitude for corporate records." In addition, the Commission recognizes that while "reasonableness" is an objective standard, there is a range of judgments that an issuer might make as to what is "reasonable" in implementing Section 404 and the Commission's rules. Thus, the terms "reasonable," "reasonably," and "reasonableness" in the context of Section 404 implementation do not imply a single conclusion or methodology, but encompass the full range of appropriate potential conduct, conclusions or methodologies upon which an issuer may reasonably base its decisions.<sup>6</sup>

The SEC also recognizes that reliable financial statements come from control systems that provide reasonable assurance. Control frameworks such as COSO 1992 and COSO 2013 explain what is required of a system to achieve reasonable assurance, unlike the SEC's management guidance and the PCAOB's auditing standards, including AS 5, which do not.

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<sup>4</sup> Title 1 of Pub. L. 95-213 (1977).

<sup>5</sup> See 15 U.S.C. 78m(b)(7).

<sup>6</sup> See SEC management guidance (p. 3). The SEC's management guidance also discusses that the conference committee report on the 1988 amendments to the FCPA note that the standard "does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance" (p. 3).

Mr. James Schnurr  
James R. Doty, Esq.  
May 29, 2015  
Page 5

Therefore, spending inordinate amounts on audits does not promote investor protection or provide the basis for an effective and sustainable system of controls. ICFR audits can only help assure that management's disclosures are materially correct. The SEC staff worked closely with the PCAOB on coordinating their respective sets of guidance to ensure that there was *not* an expectation that controls needed to be designed and tested to fit the audit—rather the audit should be planned and conducted to fit the controls.

To improve the implementation of Section 404, the SEC's management guidance and AS 5 are aligned. Both sets of guidance are principles-based and intended to provide for the exercise of judgment by management and auditors under a top-down, risk-based approach to management assessments and auditor attestation of ICFR, respectively. In describing this approach, the guidance includes the role of entity-level controls in assessing financial reporting risks and the adequacy of controls.

Along with providing for effective ICFR assessments and attestation, the respective sets of guidance for management and auditors are intended to promote efficiency. For example, the SEC's interpretive guidance states:

The guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement of its financial statements. The guidance does not require management to identify every control in a process or document the business processes impacting ICFR. Rather, management can focus its evaluation process and the documentation supporting the assessment on those controls that it determines adequately addresses the risk of a material misstatement of the financial statements. For example, if management determines that a risk of a material misstatement is adequately addressed by an entity-level control, no further evaluation of other controls is required.<sup>7</sup>

To summarize, "reasonable assurance" is the foundation of SEC requirements that registrants maintain adequate books and records and systems of internal controls. Reasonable assurance is also the foundation of the COSO 1992 and 2013 frameworks

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<sup>7</sup> See the SEC's interpretive guidance for management, pp. 4-5.

Mr. James Schnurr  
James R. Doty, Esq.  
May 29, 2015  
Page 6

and the SEC's interpretive guidance for management on evaluating the effectiveness of ICFR.<sup>8</sup>

Companies are passionate about supporting the goal of high quality financial reporting and recognize the contributions of effective systems of ICFR to achieving this goal. In this regard, companies appreciate the role of effective audits and the PCAOB inspection process. In addition, companies do not decide what auditors need to do for their audits.

However, balance is essential and it is reasonable to expect that companies understand why certain audit activities take place. It is problematic to expect companies to support apparent excessive compliance activities that are not understood and where the costs clearly exceed the benefits. Additionally concerning is the apparent retrenchment on the rationalization of the implementation of SOX Section 404. In the current environment, from a company perspective, principles-based guidance, such as the SEC's guidance for management and COSO, has not been able to withstand the authoritative weight of new interpretations of AS 5 for auditors from PCAOB inspections and the goal of both audit firms and individual auditors to reduce the risk of inspection findings.

We appreciate the opportunity to discuss how to obtain the right balance in the current environment based on the foundational concept of reasonable assurance, along with materiality and the principles of SEC management guidance and AS 5 for top-down, risk-based approaches to ICFR assessment and attestation.

## **2. Specific Concerns**

This section summarizes some of the concerns identified by the business community that have arisen in the current environment in three areas: management review controls, a "checklist" or "one-size-fits-all" approach, and materiality. To better understand the nature of the concerns and explore feasible options for addressing them, a sample of experiences of companies are presented in bullet-point format and described

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<sup>8</sup> PCAOB auditing standards require that the auditor must plan and perform the ICFR audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment. In an audit context, reasonable assurance is defined as a high, but not absolute, level of assurance.

Mr. James Schnurr  
James R. Doty, Esq.  
May 29, 2015  
Page 7

“in their own words.” While the experiences reflect some variability, there is nonetheless consistency across them on the overarching need to obtain the right balance in the current environment.

#### **a. Management Review Controls**

As discussed in the background section of this letter, a focus on entity-level controls is an important element of the top-down risk-based approach emphasized in the SEC’s management guidance and AS 5. Unfortunately, the ability of companies (and auditors) to rely on entity-level controls, including management review controls, has become a challenge in the current environment. This is particularly problematic because management review controls are critically important to companies for addressing the risks of material misstatements in financial statement amounts and disclosures. Thus, what is actually most important to companies is now being deemphasized. Several factors are contributing to this situation. The following are illustrative of some of the experiences and concerns of companies regarding entity-level controls, particularly management review controls:

- Expectations around the evaluation of control design have moved well beyond the guidance in AS 5 and are not in line with risk associated with the control. The overall direction appears to be deemphasizing the risk-based approach and appropriate reliance on entity-level controls that were introduced as part of AS 5. Indeed, it appears that the audit industry has taken a step back to auditing exhaustively the process level controls and has made the bar so high for reliance on entity level controls that they are being scoped out of the framework. It appears that practice is moving gradually back to AS 2 as a result of the PCAOB inspection process.
- Requirements for documentation and levels of precision around management review controls are increasing without regard to the underlying control environment. Auditors are pushing for all review controls to have specified precision (quantitative thresholds) and no qualitative measures can be relied upon because they are not evidenced as clearly as quantitative measures. This takes any judgment or knowledge out of the process and causes companies to focus time and effort documenting their review controls to pass the audit tests rather than focusing effort on

the type of review that would most benefit the control environment. Further, it appears that all testing of management review controls (e.g., analytical reviews) must be the same (and fully documented) regardless of risk and the auditor's familiarity and historical experience with the process.

- Most of the work related to gathering additional evidence of review controls has been non-value added. As a result, companies are adding more process level controls around transaction processing since these are easier to evidence and test by auditors. However, review controls are what companies rely upon. And, a major part of a system of internal control is to have experienced, qualified finance professionals that have the skills to review and question transactions and results.
- Auditors appear to have a bias to exclude review controls where possible and/or encourage the addition of control activities that eliminate business judgment. Auditor control testing methodology and acceptable audit evidence does not appear to adjust for internal control components beyond control activities. Even though AS 5 states that the auditor can employ a mix of approaches, the audit firm's "review control" guidance states that the approach and evidence should be the same for all types of controls, irrespective of control objective.
- Significant growth in key controls has occurred specific to control activities in contrast to other COSO components and driven by increased pressure from auditors to have controls operating at the lowest level of precision rather than appreciating the assurance received from the broader integrated framework. Over-reliance by the auditor on control activities is also counter-productive to the value of implementing COSO 2013.
- Adding lower level or other key controls and testing by auditors has several other implications for companies. For example, companies end up supporting the increased work of the auditors related to additional testing and documentation requirements for these controls (e.g., walkthroughs, flowcharts, increased sample sizes and related furnishing of documents, discussions, etc.). This additional work requested of the company is significant.

- The auditors required “the review of offer letter data entry” as a key control rather than relying on seven existing key controls operating at a range of precision (e.g., journal entry review, cost center/salary reconciliations, multiple meetings/department review controls/group/business unit headcount and spending analysis, country level flux analysis etc.) In addition, the company experienced an increase in auditor designing controls and/or architecting control language to facilitate a one-for-one mapping of risk to control.
- 20% of the company key controls classified as monitors, information and communication, and risk assessment were not acknowledged or evaluated as part of the overall design assessment by the auditors. Yet, these control components provided valuable assurance over critical financial statement risks as part of the overall control framework.

*i. Documentation Issues Related to Management Review Controls*

- The PCAOB inspection process requires auditors to document the “precision” of every significant judgment, decision, or review procedure performed by the company’s personnel performing or reviewing the controls over an account. In reality, it is a very time consuming and potentially impossible task to document every complex judgment made by experienced personnel when performing or reviewing controls. What is most important is the competency of the personnel making these judgments. Moreover, without this documentation, even if control and substantive audit results show an account has no errors, the auditor is not allowed to conclude that the controls within the account operated, or the judgment of the personnel performing the controls was competent. It does not appear that auditors are allowed to exercise their own professional judgment, as PCAOB inspectors conclude that if something is not documented, it did not occur. As a result, companies and auditors spend an extensive amount of time attempting to document every judgment and decision made in complex accounts to avoid having auditors receive PCAOB inspection comments. In turn, auditors end up focusing on documentation rather than substance.

- Auditors are aggressively challenging the effectiveness of management review controls through documentation requirements. This has become especially difficult and time consuming in an electronic (paperless) environment. In turn, companies have to meet these extensive documentation requirements for reliance on controls classified as management review and for reliance on reports produced by computer applications (known as "electronic audit evidence" (EAE). An added consideration is that companies have had to spend resources to train personnel in order to implement these new documentation requirements.
- Documentation requirements to prove robust reviews have taken place are exceptionally time consuming. Sign-off or approval is no longer sufficient—comments about the details or tick marks evidencing a “number” or “fact” have been considered as being used to conclude whether a review has been performed. In an electronic/paperless environment this is even more time consuming, and the company reverted back to documentation style from the early years of SOX.
- In 2013, the auditors established a prescribed 3-page framework document for how review-based controls need to be defined and evidenced by the company. This resulted in an unplanned impact of approximately 500 hours across the company to document a prescriptive set of criteria for how reviews occur, and to remove professional experience and judgment expected in a review. This also illustrates the emphasis being placed on designing checklist controls and formulaic driven judgment.
- The company had not entered into a new inventory supply agreement since 2010. The auditors requested that the company go back and find emails or other support to demonstrate the contract was reviewed at a proper level of precision by the proper individuals of the company. This is an example where the company pushed back—how does this demonstrate that controls are designed and operating effectively in fiscal year 2015? Nonetheless, these are the kind of requests companies are receiving from auditors.

- The company has certain liability accounts that require significant judgment. As part of our SOX control process, management meets on a quarterly basis to discuss the assumptions and review the appropriateness of the liability balances. Although we previously did not document meeting minutes, this meeting is evidenced by a comprehensive presentation document that is discussed during the meeting. The auditors have asked that we now document the meeting minutes or if that was not feasible, they suggested the auditors could attend the meeting as evidence of what was being discussed. We do not believe that documenting meeting minutes would be value-added as the meeting itself accomplishes the control objective, which is ensuring that the liability balances are appropriately stated. We also would prefer not to include the auditor in the meeting as we want to ensure a safe environment where everyone feels comfortable speaking openly. Documentation of minutes at the granular level that is now required is non-value added.

***ii. Training of Company Personnel to Adequately Perform and Document Management Review Procedures***

- In order to prepare the company's accounting staff to adequately document management review (and EAE) procedures in accordance with the external auditor's new documentation requirements, the company had to conduct an elaborate training program. This training involved compiling a 25-page set of instructions with examples of what the auditors expected for management review (and EAE) documentation; distributing these instructions to approximately 50 accountants throughout the company; and providing webinar and in-person training sessions to explain expectations and answer questions. This training was conducted such that two detailed matrices for each of the accounting processes could be prepared (one for management review controls and the other for EAE used in those controls). These comprehensive matrices (consisting of 19 columns of information per control with 230 rows of data for the management review matrices and 17 columns of information with 360 rows of data for the EAE matrices) were prepared to supplement the company's process narratives and provide the required documentation for these items to the external auditors. These matrices now need to be updated each year.

Management estimates that the manager of accounting internal controls spent 600 hours on these tasks; in addition, it took about 1,500 hours for the matrices to be completed by the accountants. None of these changes improved the underlying quality of the review.

**b. “Checklist” or “One-Size-Fits All” Approach**

*i. For ICFR Documentation*

- Process narratives (memoranda) are no longer sufficient. Auditors are requiring flow charts to supplement process narratives for all significant areas. In turn, process narratives are required to include a level of detail more akin to the documentation requirements circa AS 2 (10 years ago). For example, auditors are requesting supporting documentation for every aspect outlined in a process narrative regardless of whether it is key or not.
- Citing PCAOB inspection reports, the auditor requires a fully documented re-articulation of the process, a test of “one for all” processes and controls regardless of risk, and documentary evidence beyond documenting what is required for the test of control.
- The auditors utilize specific templates for their walkthrough documentation to ensure that all PCAOB inspection points of focus are addressed. These templates are time consuming to complete and do not contribute to the overall value of the process walkthrough in a significant manner. In addition, the company was required to use these walkthrough templates for the walkthroughs it performed on the external auditor’s behalf.

*ii. Regardless of Risk*

- Inspection results are driving auditors to perform a similar scope of procedures for lower risk accounts (that have little judgment and complexity) as for higher risk accounts (that involve significant judgment and complexity). Accounts are either “in-scope” or “out of scope.” If in-scope, all accounts appear to be tested with the same level of procedures in order to avoid PCAOB inspection findings.

- The auditors are required to treat multiple locations (e.g., regions of the country) as separate populations. This requires separate sample selections for each location, even if the accounting policies, processes, and systems are the same across all locations.
- Auditors have been required to significantly reduce their reliance on work performed by internal auditors. Despite the fact that both internal and external auditors typically report directly to the audit committee, external auditors are now required to re-perform work done by internal audit. The conclusion not to rely on the work of internal audit is not based on the merits of the facts and circumstances of the particular company but rather is a rule that applies across the board to all companies.<sup>9</sup>
- PCAOB inspection results appear to focus on “hot topic” areas without acknowledging that an account can be high risk for one company, but low risk for another. For example, even revenue in companies with non-complex, automated revenue processes can have a much lower risk profile. However, as revenue is viewed as a “hot topic” in PCAOB inspections, auditors are not allowed to apply professional judgment on the extent of procedures performed. Thus, extensive time is spent on an account with inherently low risk by auditors and by the company personnel providing information to the auditors. Other “hot topic” areas include related party transactions, defined benefit pension plans, investment valuations, inventory write-downs, fixed assets, business combinations, intangibles, and multi-location audits.

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<sup>9</sup> We note that AS 5.19 states: “The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.”<sup>10</sup> In promulgating AS 18, the PCAOB changed the language in AU 333.06.1 on Management Representations from matters including: “Information concerning related-party transactions and amounts receivable from or payable to related parties” to: “Information concerning related party transactions and amounts received from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm’s-length-transaction.”

***iii. Use of Checklists and Templates***

- PCAOB inspection results frequently focus on minute defects, departures from audit methodology, or lack of persuasive documented evidence within an account without regard to whether or not the account is a high risk account for the company. As a result, audit firms have developed extensive forms to facilitate quality assurance. Completion of these forms has increased audit hours for many accounts by more than 100%. However, the focus of these hours is on documentation and not substance or risk.
- The audit team spends a significant amount of time completing templates or checklists based on the firm's documentation standards. This distracts the team from having time to fully understand the business and determine if the disclosures or controls are material/key or a risk area to our company. Standard templates and procedures appear to have replaced auditor judgment. A key area is around significant estimates (fair value estimates) and disclosure requirements. This leads to having to respond to multiple inquiries from various audit members on the same questions. The extensive documentation also detracts from the audit staff learning accounting and auditing skills. There is so much focus on documentation and testing of controls that the staff is not generally getting exposure to how transactions are accounted for.

***iv. Related Party Transactions***

- PCAOB AS 18 is effective for audits of fiscal years beginning on or after December 15, 2014. It covers related party transactions, significant unusual transactions, and amendments to other auditing standards, including changes to management's representations to the auditor on a quarterly and annual basis.<sup>10</sup> In implementing AS 18, auditors are now asking companies to provide them with a list of the names of all related parties (even if the

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Mr. James Schnurr  
James R. Doty, Esq.  
May 29, 2015  
Page 15

company has no related party transactions) and also that there are no side agreements or other arrangements (oral or written) undisclosed to the auditors. Given the GAAP definition of related parties, companies are facing challenges in putting together a complete list of related parties and side agreements. For example, companies are being told to identify all entities in which a member of management controls, or has significant influence over, or serves in a leadership role. Board members are also scoped into this listing and companies are facing challenges in being able to identify all family members who might control or influence.<sup>11</sup>

Furthermore, auditors are now asking management to represent: “We have made and caused the company to make available to you the names of *all* related parties and *all* relationships and transactions with related parties;” that “transactions with related parties...and information concerning these transactions and amounts have been made available to you,” and “there have been *no* side agreements or other arrangements (oral or written) undisclosed to you.” This is a big change from the previous language used by the auditors in management representation letters in which auditors asked whether: “Significant transactions with related parties...have been properly recorded and disclosed in the consolidated financial statements.” The new language loses sight of the fact that GAAP requires disclosures of *material* related party transactions (other than compensation arrangements, expense allowances, other similar items in the ordinary course of business, and transactions eliminated in the preparation of consolidated or combined financial statements (ASC 850-10-50-1)—with an objective of disclosing related party transactions that would make a difference in users’ decision-making (ASC 850-10-10). It also seems inconsistent with the actual language in PCAOB AU 333 on Management Representations (see footnote 9).

These new requirements assume a level of precision in collection procedures (e.g., capturing *all* related parties and side agreements) that does

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<sup>11</sup> We appreciate that the SEC requirements for disclosing (in proxy statements and other filings) transactions with the company in which any related person had or will have a direct or indirect material interest has a relatively low threshold. However, the respective GAAP and SEC definitions of related parties differ and this represents an area where GAAP and SEC corporate disclosures may not link up.

not exist today in preparers' systems and would require significant incremental effort to achieve. Company control procedures that are in place to meet current related party reporting and disclosure obligations are not at zero thresholds. It is also unclear how companies can address a 100% certainty of no side agreements or other arrangements, no matter how inconsequential. Further, it is unclear what all of the terms mean (e.g., what is covered under "other arrangements"—what its scope should be).

It is almost impossible to make these requirements operational and at the same time retain reasonable levels of procedures. While the auditing standard requires the auditor's work to focus on related party transactions that pose significant risk, the preparer is being required to have procedures to identify related party transactions and side agreements even if they are inconsequential, which appears wholly inconsistent with GAAP (ASC 850). As noted, GAAP requires disclosures of material related party transactions with the objective of providing information that would make a difference in users' decision-making. Bear in mind that related party transactions often occur in the normal course of business, including: sales, purchases, and transfers of real and personal property, services received or furnished, leases of property and equipment, lending and other financial transactions, intra-entity billings based on allocations of common costs, and the list goes on. This level of granularity (not based on GAAP, risk, or materiality) makes it nearly impossible to provide auditors with what they require to meet the interpretation of the new auditing standard. For this quarter, some companies adjusted their management representations for related parties and side agreements or other arrangements to focus disclosure to the auditors of all *material* items. Companies continue to evaluate their current procedures and what they can do to support the auditors need to comply with AS 18, and at the same time retain reasonable control procedures.

v. ***Non-Integrated Inspection Process***

- Companies and management are strong supporters of robust internal controls over business activities and financial reporting. In fact, the main focus of effective business management, top down, starts with risk

assessment followed by establishing effective internal controls over both business practices and financial reporting. Further, internal audit departments plan their activities starting with their assessment of risk and their evaluation of internal controls. External auditors likewise determine their financial statement audit scope and plan by integrating risk assessment and evaluation of internal controls over financial reporting. And, of course, the financial statement audit is integrated with the audit of ICFR for accelerated filers.

However, there seems to be a disconnect between the integrated approach and requirements that business managers, internal auditors, and external auditors use and what some companies understand is the approach used in the PCAOB inspection process. Some companies understand that the inspections of ICFR and financial statement audits are treated by the PCAOB as two separate inspections in that they are staffed with two different and independent inspection teams. It is difficult to understand how two pieces of an integrated audit can be effectively inspected without an integrated understanding of the inter-relationship of risk, controls, materiality, and resulting financial reports. It is therefore not surprising that ICFR inspection findings have increased. The assessment of ICFR alone cannot be done in a vacuum without the complete integrated understanding of a business, its material risks, its internal controls, and its financial statements.

## **C. Materiality**

### ***i. Related to Reclassifications and Disclosures***

- Auditors are required to accumulate information on items that are clearly immaterial at the consolidated level and, in many cases, report this information to audit committees. The PCAOB concluded about three years ago that there was a single threshold for evaluating errors in the balance sheet and income statement. As a result, auditors must accumulate information for balance sheet reclassifications at a threshold as is applied to a net earnings impact and present these to the audit committee in the “Summary of Unadjusted Audit Differences.” This seems wholly

inconsistent with views expressed by the SEC on materiality and leads to non-value added work by auditors, management, and the audit committee. Similar practices do not appear to be followed in other (foreign) jurisdictions.

- In the past year, auditors have begun to extend the “single quantitative threshold” to disclosures. In addition, they have started insisting that if one disclosure item is material than all required disclosures must be presented, regardless of materiality. These disclosure changes have been attributed to the PCAOB inspection staff. These changes have the effect of making the disclosures more detailed without providing material information to investors and are placing additional burdens on audit committees by having to review longer reports and immaterial errors or immaterial information in disclosures. There is a fundamental conflict between these changes and work underway by the SEC and FASB on disclosure effectiveness.
- During the year-end audit process, the auditors identified an adjustment in the tax area for a balance sheet reclassification between line-items. The amount represented a meaningful adjustment when compared against the income statement, but the adjustment was less than 0.5% of total assets and less than 1% of current assets. The reclassification was clearly minimal to any investor that would be reviewing our balance sheet, and it is absurd to conclude that an investment decision would be in any way altered by a minor balance sheet reclassification compared to a large asset base, simply based on how the adjustment measures against operating results. The PCAOB has driven a faulty standard of comparing balance sheet (reclassification) materiality based on an income statement calculation. In addition to discussing this matter extensively with the audit firm, the company also was required to generate significant amounts of documentation on why this matter was not considered to be a material weakness or significant deficiency.

Mr. James Schnurr  
James R. Doty, Esq.  
May 29, 2015  
Page 19

*ii. Related to Entity-Level Controls*

- Our auditors are now doing more with lower level affiliates that are immaterial individually, but could be material in the aggregate. The view of the PCAOB (the company understands) is that entity-level controls at a higher level cannot be relied upon for these lower material affiliates if the entity level testing is only done for the higher materiality affiliates. So now, the auditors are spending more time and effort testing affiliates that are truly immaterial.

**Conclusion**

Thank you again for your candor and willingness to engage on these issues. Our hope is to start a long-term dialogue to ensure that we have strong controls in place to provide investors with reliable decision useful information to facilitate an efficient capital formation process.

We hope that you find these illustrative examples helpful and we would like to take the next step and work with you to have a meeting of stakeholders to discuss these concerns and identify possible alternatives to address them.

Sincerely,

A handwritten signature in black ink, appearing to read 'T. Quaadman', with a long, sweeping horizontal stroke extending to the right.

Tom Quaadman