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Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

February 26, 2007

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Subject: PCAOB Release No. 2006-007—*Proposed Auditing Standard—An Audit of Internal Control over Financial Reporting That is Integrated with an Audit of Financial Statements, and Related Other Proposals*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) proposed standard for the audit of internal control over financial reporting that is integrated with the audit of financial statements.

We commend the PCAOB for undertaking this project. Overall, we generally support the proposed standard and believe that it resolves many of the issues in Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. We especially support the proposed provisions on

- incorporating a top-down, risk-based approach to increase auditors' ability to detect material weaknesses before they result in material misstatements
- scaling the audit approach to efficiently test controls at smaller, less-complex entities
- focusing the multi-location testing guidance on risk rather than on coverage
- clarifying the role of materiality in an audit of internal control over financial reporting

We have a serious concern regarding the proposed changes to the definitions of material weaknesses and significant deficiencies. Specifically, we believe that these definitions will not achieve the PCAOB's intended results and we have a concern about the potential confusion and extra costs associated with the PCAOB changing these definitions that are currently consistent with those used by the other U.S. auditing standards setting organizations—the GAO and AICPA. We are providing suggestions for how to resolve this issue.

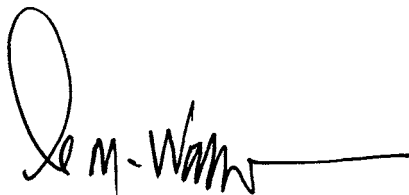
In addition to the above issue, we have identified several matters for which we are offering comments. Our comments, which are detailed in the enclosure to this letter, address the following issues:

- proposed revisions to the definitions of material weakness and significant deficiency
- evaluating identified deficiencies
- permitting consideration of knowledge obtained during previous audits
- company-level controls
- information technology controls
- reporting
- scope limitations

Also, we believe that revising the auditing standard, while an important step, will not, in itself, be sufficient to improve the efficiency and effectiveness of audits of internal control over financial reporting or assure audit quality. In this regard, it will be imperative to align the auditing standard, the approach used in inspections of registered public accounting firms, and the public message conveyed by PCAOB members and key staff.

Finally, we believe it is critical that the standard be viewed in the proper context and that auditors not take the PCAOB's intended changes too far. Therefore, we urge the PCAOB to make concerted efforts to clarify its intent with respect to its issuance of this auditing standard.

We thank you for considering our comments on this very important issue and look forward to working with you to promote high-quality auditing in the United States.

A handwritten signature in black ink, appearing to read "D. M. Walker", with a long horizontal line extending to the right.

David M. Walker
Comptroller General
of the United States

Enclosure

cc:
The Honorable Christopher Cox, Chairman
U.S. Securities and Exchange Commission

The Honorable Mark W. Olson, Chairman
U.S. Public Company Accounting Oversight Board

Harold Monk, Jr., Chair,
U.S. Auditing Standards Board

GAO Comments on PCAOB Release 2006-007Proposed Revisions to the Definitions of Material Weakness and Significant Deficiency

We have the following concerns about the proposed changes to the definitions of material weaknesses and significant deficiencies: (1) the potential that the revised wording will not achieve the intended result and (2) the potential confusion and extra costs of changing definitions that are now consistent with those used by the other U.S. auditing standards setters—GAO and the AICPA. Rather than adopting the proposed changes to the definitions of material weaknesses and significant deficiencies, we recommend clarifying the AS No. 2 definitions by providing guidance and explanation for interpreting terms such as “probable,” “reasonably possible,” “remote,” and “more than inconsequential.” The following sections present our concerns in more detail.

PCAOB’s discussion paper states that the revisions to the definitions are meant to clarify but not change the definitions. Specifically, it states that contrary to the application of the definitions in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* (FAS No. 5), “some auditors and issuers have misunderstood the term ‘more than remote’ to mean something significantly less likely than a reasonable possibility. This, in turn, may have caused these issuers and auditors to evaluate the likelihood of a misstatement at a much lower threshold than the Board intended.” However, we believe that the revised wording “there is a reasonable possibility that a material misstatement” will result in auditors and issuers applying the everyday English meaning of the words, consequently creating too high of a threshold for identifying a material weakness.

The three U.S. auditing standard setters now have adopted consistent definitions of material weakness and significant deficiency, which we believe is the most beneficial to the entire community of auditors and users of auditors’ reports in the United States. Specifically, the AS No. 2 definitions were recently adopted by the AICPA’s Auditing Standards Board in its Statement on Auditing Standard (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, and by GAO in our *Government Auditing Standards, January 2007 Revision*. U.S. investors and taxpayers will be better served by having standard setters minimize competing efforts and instead assure consistency, where appropriate, with regard to core auditing standards. Inconsistencies in such core standards increase audit costs and lead to potential confusion. We believe that the definitions and terminology used to communicate internal control deficiencies represent core concepts for which the standards setters should work together to achieve agreement and consistency.

If the PCAOB believes that the AS No. 2 definitions of material weaknesses and significant deficiencies need revision, we recommend convening a group of the U.S. auditing standards setters and the International Auditing and Assurance Standards Board to develop definitions that can serve as the common core for use in the

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standards for audits of all types of entities. The U.S. Auditing Standards Coordinating Forum would be an ideal forum for convening such a group. We at GAO would welcome the opportunity to work with the PCAOB on such an effort.

Evaluating Identified Deficiencies

We support the proposed changes to the standard on evaluating identified deficiencies that make that standard less prescriptive, since such evaluations require professional judgment in assessing the facts and circumstance surrounding the deficiencies. We believe that the pervasiveness of a control deficiency is also an important consideration and recommend including it in the guidance on evaluating deficiencies.

In addition, we recommend rewording two of the strong indicators of material weaknesses in paragraph 79 of the proposed standard, as follows:

- Control systems that did not prevent or detect material misstatements so that it was later necessary to restate ~~Restatement of~~ previously issued financial statements to reflect the correction of a misstatement.
- Control systems that did not prevent or detect material misstatements that were identified by the auditors. ~~Identification by the auditor of a material misstatement in financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting.~~

We believe these changes are needed to properly communicate that the deficiency is the weakness in the control system; the restatement and the auditor identification of a material misstatement are results of the control deficiency.

Permitting Consideration of Knowledge Obtained During Previous Audits and Special Considerations for Subsequent Years' Audits

We agree with the broad principles expressed in paragraphs 65 through 69 of the proposed standard that deal with using knowledge obtained during past audits. However, we have two concerns with these paragraphs. Specifically, we believe that (1) the proposed standard should be more fully developed, and (2) the proposed standard should incorporate relevant standards and guidance included in SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

First, we recommend moving pertinent guidance from the discussion paper in PCAOB Release 2006-007 to the proposed standard in order to more fully develop the standard and to help ensure consistent implementation. As written, we are concerned

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that the standard is not sufficiently clear and specific. For instance, the proposed standard does not include the concept expressed in the last sentence on page 19 of the discussion paper that “Under the approach described by the proposed standard, some controls would be so important to the overall effectiveness of internal control over financial reporting or otherwise present such a high degree of risk that, even in subsequent years, the necessary evidence would not be reduced.” Also omitted from the proposed standard is the concept in the first paragraph of page 19 of the discussion paper that “the proposed standard on auditing internal control would provide the auditor with the flexibility to decide to reduce testing in some areas based on that knowledge [gained from the prior years’ audits] and its effect on the auditor’s assessment of risk.” We believe that these concepts, which are critically important when using knowledge gained in prior year audits, should be included in the body of the proposed standard.

Also, we support using information from prior year audits to help improve audit efficiency and effectiveness and agree with the approach included in paragraphs 40 through 44 of SAS No. 110, which allows greater flexibility than the definition of rotation testing in footnote 25 on page 18 of the PCAOB discussion paper. In addition, we place a number of requirements and conditions surrounding the use of “rotation testing” in federal government audits, as is detailed in Section 395G of the GAO/PCIE *Financial Audit Manual*.¹

We encourage the Board to add specificity to the proposed standard relating to this issue.

Company-Level Controls

While we support the concepts related to evaluating and testing company-level controls in the proposed standard, we are concerned that the current presentation of the standard may result in auditors placing too much emphasis on company-level controls. For instance, paragraph 17 contains an unconditional requirement to test those “company-level controls that are important to the auditors’ conclusion of the effectiveness of internal control over financial reporting.” Since (1) auditors must fulfill the responsibilities of unconditional requirements in all cases in which the circumstances exist to which the requirement applies, and (2) failure to discharge such an unconditional requirement is a violation of the relevant standard and PCAOB Rule 3100, this will focus auditor attention on controls that are often difficult to assess and generally offer only a negative indicator of the effectiveness of controls. Specifically, ineffective company-level controls provide a strong indicator of pervasive problems. However, company-

¹U.S. Government Accountability Office / President’s Council on Integrity & Efficiency, *Financial Audit Manual* (GAO-01-765G July 2001), pgs. 395 G-1 through 395 G-4. <http://www.gao.gov/special.pubs/gaopcie/>.

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level controls assessed as effective do not necessarily provide sufficient assurance about the effectiveness of controls throughout the entity by themselves.

Other statements in the standard may lead auditors to inappropriately conclude that they need not test beyond company-level controls. Examples of such statements include the following:

- "...if a company-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk." (Excerpt from the Proposed Auditing Standard, Paragraph 12, second bullet, last sentence)
- "The proposed standard omits the statement in paragraph 54 of AS No. 2 that '[t]esting company level controls alone is not sufficient for the purposes of expressing an opinion on the effectiveness of a company's internal control over financial reporting.' This statement has been interpreted to prohibit reliance on company level controls related to individual relevant assertions. The proposed standard would allow the auditor to determine that company-level controls are sufficient to address the risk of misstatement to a particular relevant assertion." (Excerpt from the Discussion Paper, page 6, footnote 10)

We recommend adding guidance to the standard limiting the circumstances under which it might be appropriate for auditors to reduce or eliminate testing of additional controls based on the effectiveness of a company-level control, such as when the risk of material misstatement is considered low and the relevant control relates to an immaterial account or assertion.

Finally, in paragraph 18, the proposed standard identifies eight specific company-level controls. Then, in paragraphs 19 through 23, the standard goes on to discuss in detail only two of the eight controls. This seems to suggest that these two controls are more important than the others, but we are unsure if this is the Board's intent. Therefore, we recommend revising the proposed standard to either include a discussion of each of the eight controls or explain why additional guidance is provided for only two controls.

Information Technology Controls

We recommend adding a caution in or immediately following paragraph 35 that the effectiveness of user controls —application controls that are performed by people interacting with IT systems—typically depend on the accuracy of the information produced by the IT systems. For example, the effectiveness of a user control consisting of supervisory review of an IT system exception report is dependent on (1) the effectiveness of the supervisor's review and (2) the accuracy of the exception

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report, including relevant controls. Therefore, relevant IT controls would impact the effectiveness of these types of user controls.

Reporting

One of the stated objectives of the proposed standard is to eliminate unnecessary procedures, including the requirement to evaluate management's process. However, the report language included in paragraph 96 contains the following statement:

“We also have audited management's assessment, included in the accompanying [*title of management's report*] that W Company maintained effective internal control over financial reporting as of December 31, 20x8...”

This language seems to contradict the elimination of the requirement to evaluate management's process. We recommend that PCAOB staff review this language to make sure that it is consistent with the Board's intent.

Scope Limitations

Paragraphs 83 and C3 of the proposed standard indicate that auditors should disclaim an opinion or withdraw from the engagement if there are restrictions on the engagement scope. We believe that when auditors are aware of one or more material weaknesses in an entity's internal control over financial reporting, they should be required to issue an adverse opinion even if the engagement scope is restricted. No matter how much additional testing the auditors perform, they will not be able to issue an unqualified opinion; because of the material weakness, the auditors must conclude that internal control over financial reporting is not effective. Thus, we suggest revising paragraphs 83 and C3 to indicate that auditors should express an adverse opinion when the scope of the audit is restricted but they are aware of material weaknesses. An exception to this requirement would provide for situations when auditors withdraw from an engagement and do not issue a report. In this situation, the auditors should also state that, due to the restrictions on the engagement scope, they did not examine all controls; therefore, additional material weaknesses may exist that have not been reported. We also suggest deleting the last part of paragraph 99 (“unless there is a restriction on the scope of the engagement”) for consistency.