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Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

December 9, 2003

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

Subject: PCAOB Rulemaking Docket Matter No.008—Proposed Auditing Standard—An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

This letter provides the U.S. General Accounting Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) October 7, 2003, proposed standard for the audit of internal control over financial reporting performed in conjunction with the audit of financial statements.

We commend the PCAOB for giving this important issue high priority and on the release of the proposed auditing standard. Overall, we support the proposed standard and believe that it is on track. We especially support the requirements for

- obtaining direct evidence about the design and operating effectiveness of internal control as well as evaluating management's assessment; and
- requiring tests of controls for "relevant assertions" rather than "significant controls" in order to link the internal control engagement to the entity's financial reporting.

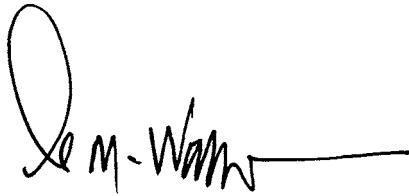
GAO strongly believes that management's assessment of the effectiveness of internal control, along with the auditor's attestation on that assessment, are critical components of monitoring the effectiveness of an organization's risk management and accountability systems. Auditors will better serve their clients and other financial statement users and will better protect the public interest by providing assurances about the effectiveness of internal control. In this regard, GAO seeks to lead by example in establishing an appropriate level of auditor reporting on internal control for federal agencies and programs, and for entities receiving significant amounts of federal funding. We already provide opinions on internal control for all our major federal audit clients, including the consolidated financial statements of the U.S. government.

Attached are GAO's responses to selected questions in PCAOB Release No 2003-017, along with our additional comments regarding the following:

- nonroutine transactions and processes,
- testing IT controls,
- materiality considerations,
- illustrative auditor's reports, and
- other clarifications.

We thank you for considering our comments on this very important issue.

Sincerely yours,

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

Enclosures

cc: The Honorable William H. Donaldson, Chairman
Securities and Exchange Commission

The Honorable William J. McDonough, Chairman
Public Company Accounting Oversight Board

**GAO'S RESPONSE TO SELECTED QUESTIONS IN
PCAOB RELEASE NO. 2003-017
AND OTHER RELATED COMMENTS**

Integrated audit of financial statements and internal control over financial reporting

Question 1. Is it appropriate to refer to the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting as the audit of internal control over financial reporting?

We believe it is appropriate to refer to an auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting as an "audit of **the effectiveness** of internal control over financial reporting." (We suggest adding "the effectiveness," as shown in bold.) As stated throughout the standard, the auditor will perform procedures and testing that go beyond evaluating management's assessment in order to determine whether management's assessment of the effectiveness of internal control is fairly stated. This will result in an audit of the effectiveness of internal controls, which we support.

Question 2. Should the auditor be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements?

Question 3. Rather than requiring the auditor to also complete an audit of the financial statements, would an appropriate alternative be to require the auditor to perform work with regard to the financial statements comparable to that required to complete the financial statement audit?

We believe that it is most efficient for the audit of the effectiveness of internal control over financial reporting to be performed in conjunction with the financial statement audit. However, we believe that there should be flexibility should the auditor wish to perform this work apart from the financial statement audit, and we do not support a prohibition against doing so.

Audit of internal control over financial reporting

Question 5. Should the Board, generally or in this proposed standard, specify the level of competence and training of the audit personnel that is necessary to perform specified auditing procedures effectively? For example, it would be inappropriate for a new, inexperienced auditor to have primary

responsibility for conducting interviews of a company's senior management about possible fraud.

We agree with the criterion set forth in paragraph 31 of the proposed standard “that the auditor should have competence in the subject matter of internal control over financial reporting.” We also agree with the additional general guidance in the proposed standard such as the example cited in question 5, “for example, it would be inappropriate for a new, inexperienced auditor to have primary responsibility for conducting interviews of a company’s senior management about possible fraud.” At the same time, we believe that any additional guidance added to the standard should avoid becoming overly prescriptive. An alternative would be for the Board to issue implementing guidance on this issue to supplement the standard if it further specified the level of competence and training.

Evaluation of management’s assessment**Question 6. Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?**

To provide an opinion on management’s assessment of the effectiveness of internal control, it is necessary for the auditor to both evaluate management’s assessment and obtain direct evidence about whether internal control is effective.

Question 8. Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?

Inadequate documentation of management’s assessment, by itself, does not meet the definition of material weakness or significant deficiency. We agree with the guidance provided in paragraphs 43-47 of the proposed standard, that inadequate documentation is a deficiency that the auditor should evaluate to determine whether management can demonstrate adequate monitoring of internal control over financial reporting by other means.

Obtaining an understanding of internal control over financial reporting**Question 9. Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?**

We agree that performing walkthroughs can provide the auditor with helpful information about internal control design and operations. At the same time, we believe that walkthrough procedures are not always necessary or appropriate. For

instance, performing walkthroughs of highly automated processes or certain unusual nonroutine transactions could be extremely difficult or even impossible. Therefore, we suggest that the Board encourage auditors to use such procedures for relevant assertions for all significant accounts and disclosures but, at the same time, allow auditors to use other means for obtaining an understanding of internal control and determining the nature and extent of testing where appropriate. When alternative procedures are used, those procedures should provide the auditor with a similar level of evidence as walkthrough procedures would provide for understanding internal control and determining the appropriate level of testing.

Question 10. Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?

Under certain conditions it is appropriate for the auditor to use walkthrough procedures performed by internal auditors. Internal auditors can play an important role in concluding about the effectiveness of internal control. In some cases, the internal auditors may be assisting management with its assessment of internal control. In other cases, internal auditors may be testing controls and testing management's assessment. In either scenario, there are contributions that the internal auditor can make to the external auditor's understanding of internal control—including the results of procedures such as walkthroughs—as input to the auditor's determination of the nature and extent of testing to be conducted as part of the audit of internal control. However, the work of the internal auditor should not be used as the principal evidence, and the external auditor will need to determine the level of reliance to place on that work. Such a determination should be made on a case-by-case basis, based on facts, circumstances, and risk. We believe that the guidance in paragraph 108 for relying on the work of internal auditors is appropriate for making this determination.

If the auditor uses walkthrough procedures performed by management or a consultant hired by management, the auditor should test the walkthrough for validity and completeness, as the auditor would test any information provided by management.

Requirement for the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year

Question 11. Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

We support a requirement for the auditor to obtain evidence every year of the effectiveness of internal control for assertions for **material** accounts and disclosures **that present moderate or high risk**, as opposed to a requirement for the auditor to obtain evidence of the effectiveness for **all relevant** assertions for **all significant** accounts and disclosures every year.

We also believe that rotational testing of controls would be acceptable under the following conditions: (1) control risk is evaluated as low, the control environment is strong, and inherent and fraud risk factors are low, (2) the auditor possesses from past and current work a foundation of audit evidence on which to develop current audit conclusions; (3) financial reporting controls over all significant cycles or applications have been evaluated and tested during a fairly recent period (no more than 3 years); and (4) no specific reporting or risk issues preclude the use of rotation.

A requirement for evaluating the effectiveness of controls for all relevant assertions for **material** accounts and disclosures **presenting moderate or high risk** every year would not only guide the auditor in the audit of effectiveness of internal control, but would also contribute to the quality of the financial statement audit. This is a powerful means for linking the financial statement audit and the audit of the effectiveness of internal control and gaining synergy and overall improved audit quality.

Extent of reliance on the work of management and others

Question 12. To what extent should the auditor be permitted or required to use the work of management and others?

Question 13. Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?

Question 14. Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

This section of the standard should be made more specific to indicate that this section does not deal with the auditor's reliance on the work of other external auditors. Our answers are based on the assumption that the board will provide separate guidance for relying on the work of another external auditor.

We agree with the concept of delineating controls and procedures for which it is not appropriate that the auditor rely on the work of management and consultants hired by management. We would suggest, however, that the terminology "use the work of others" be changed to "**rely** on the work of others." Certainly, the auditor would want to use any information or evidence provided by management or consultants hired by management about control problems. The key point is that the auditor would

not **rely** on that work, but use it as part of the process of gaining an understanding of controls to determine the nature, timing, and extent of the auditor's tests.

We agree with the category of controls and with the degree of reliance set forth in paragraph 106; specifically, that the auditor might decide to use the results of tests performed by management and others within the company in areas such as controls over routine processing of significant accounts and disclosures without specific limitation.

We disagree, however, with the classification of controls and procedures listed in paragraphs 104 and 105. For instance, in paragraph 105, the proposed standard states that the auditor's use of the results of procedures performed by management and others should be limited for (1) controls over significant nonroutine and nonsystematic transactions, and (2) controls over significant accounts, processes, or disclosures where the auditor has assessed as high the risk of failure of the controls to operate effectively. We believe that these are significant controls and that the auditor should not rely on procedures performed by management or consultants hired by management for these controls. However, the auditor could, based on the auditor's assessment of the internal audit function in accordance with criteria set forth in paragraph 108, determine the appropriate reliance to place on the internal audit function for the controls and procedures listed in both paragraphs 104 and 105.

Finally, as stated in our answers to questions 9 and 10, we believe that the auditor could place some reliance on walkthrough procedures performed by internal auditors. If the auditor uses a walkthrough provided by management or another party (such as a consultant hired by management), the auditor should test the walkthrough for such factors as validity and completeness, as the auditor would in testing any information received by management.

Therefore, we suggest restructuring and rewording paragraphs 104 and 105 to read as follows:

The following are controls for which the auditor should not **rely** on the results of testing performed **by management or by consultants hired by management**:

- controls that are part of the control environment, including controls specifically established to prevent and detect fraud that is reasonably likely to result in material misstatement of the financial statements;
- controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications);

- controls that have a pervasive effect on the financial statements, such as certain information technology general controls on which the operating effectiveness of other controls depend;
- controls over significant nonroutine and nonsystematic transactions (such as accounts involving significant judgments and estimates); and
- controls over significant accounts, processes, or disclosures where the auditor has assessed as high the risk that the controls will fail to operate effectively.

In some cases, it may be appropriate for the auditor to place some reliance on work performed by the internal auditor related to the above controls. Based on risk and the auditor's assessment of the internal audit function in accordance with criteria in paragraph 108, the external auditor should determine the appropriate level of reliance to place on the internal audit function.

Question 16. Is the requirement for the auditor to obtain the principle evidence, on an overall basis, through his or her own work the appropriate benchmark for the amount of work that is required to be performed by the auditor?

As we commented in our response to question 14, this section of the standard should be made more specific to indicate that it does not deal with the auditor's reliance on the work of other external auditors. Therefore, our answer to question 16 also is based on the assumption that the board will provide separate guidance for relying on the work of another external auditor.

We agree that requiring auditors overall to obtain the principal evidence through their own work (when relying on the work of internal auditors, management, or consultants hired by management) is an appropriate benchmark for the amount of work that is required to be performed by the auditor. We also agree with the criteria set forth in paragraph 103 for determining whether to use work performed by management and others. We further agree with the recognition given to the unique position of internal auditors in this process as set forth in paragraph 108.

Evaluating results

Question 17. Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

We support the revised definitions of significant deficiency and material weakness as set forth in paragraphs 8-9 of the proposed standard. The revised definitions are more specific and provide clearer guidance to the auditor than the previous definitions from AU section 325 and AT section 501.

Question 19. Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies?

Unless clearly inconsequential, the auditor should evaluate the severity of all identified internal control weaknesses in order to determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses.

Question 20. Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?

With regard to communicating results that are not significant deficiencies, we recommend that the Board adopt requirements similar to *Government Audit Standards*, which state “When auditors detect deficiencies in internal control that are not reportable conditions, they should communicate those deficiencies separately in a management letter to officials of the audited entity unless the deficiencies are clearly inconsequential considering both quantitative and qualitative factors. Auditors should use their professional judgment in deciding whether or how to communicate to officials of the audited entity deficiencies in internal control that are clearly inconsequential. Auditors should include in their audit documentation evidence of all communications to officials of the audited entity about deficiencies in internal control found during the audit.”¹

Forming an opinion and reporting

Question 25. Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?

Question 26. Are there circumstances where a qualified "except for" conclusion would be appropriate?

We agree that it is only appropriate for the auditor to issue an unqualified opinion on internal control when there are no identified material weaknesses and when there have been no restrictions on the scope of the auditor’s work.

When there is one or more material weaknesses, we believe that it is appropriate for the auditor to express an adverse or qualified opinion about the effectiveness of the company’s internal control over financial reporting, depending on the facts and circumstances. In certain circumstances, qualified or “except for” reports could be

¹ *Government Auditing Standards* (GAO-03-673G, June 2003), paragraph 5.16.

appropriate for localized deficiencies, deficiencies involving one control cycle, or material weaknesses that are detected and corrected by management. Therefore, we do not support a requirement that would direct the auditor to issue an adverse opinion on internal control in the event of one or more material weaknesses. Instead, we believe the auditor would need to consider issuing an adverse opinion based on the facts and circumstances surrounding the weaknesses identified.

Auditor independence

28. Should the Board provide specific guidance on independence and internal control-related non-audit services in the context of this proposed standard?

29. Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client?

We believe that the proposed standard, as written, provides an appropriate level of guidance on auditor independence. In particular, we are pleased that paragraphs 32-35 of the proposed standard incorporate GAO's two overarching principles for auditor independence. The GAO independence standard emphasizes a substance-over-form approach. We recommend that any additional requirements in the standards should take this approach, as follows:

In making judgments on independence, audit organizations and audit committees should take a substance-over-form approach and consider the nature and significance of the services provided to the audited entity and the facts and circumstances surrounding those services. Before an audit committee approves and before an audit organization agrees to perform nonaudit services, careful consideration should be given to avoid situations that could lead reasonable third parties with knowledge of the relevant facts and circumstances to conclude that the auditor is not able to maintain independence in conducting the audits. It is imperative that auditors always be viewed as independent in fact and appearance.²

GAO issued its independence standard in January 2002,³ and due to the many inquiries we received and the standard's significant effect on auditors of federal entities and programs, we subsequently provided additional guidance in the form of questions and answers to assist in implementing the standard.⁴

² Adapted from *Government Auditing Standards: Answers to Independence Standard Questions* (GAO-02-870G, July 2002).

³ *Government Auditing Standards Amendment No. 3: Independence* (GAO-02-388G, January 2002).

⁴ *Government Auditing Standards: Answers to Independence Standard Questions* (GAO-02-870G, July 2002).

Additional GAO Comments

Nonroutine Transactions and Processes

Controls over nonroutine transactions and processes may be less well developed and more susceptible to management override and therefore have increased risk of being ineffective. In paragraphs 74-78 on identifying controls to test, we suggest that the standard provide a more explicit requirement on testing controls over nonroutine transactions and indicate that normally the auditor should expand testing of these controls. We also suggest that the discussion of fraud considerations in paragraphs 24-26 emphasize controls over nonroutine transactions.

Testing IT controls

Paragraph 41 of the proposed standard states that, when obtaining an understanding of the entity's internal control over financial reporting, the auditor should determine whether management has addressed the need to test controls "including information technology general controls, on which other controls are dependent." In addition, paragraphs 53 and 61 seem to make reference to IT controls as company-level controls, but they are not specific. We suggest that the standard be expanded to include general controls, application controls, and controls over IT security. We also suggest that the standard incorporate guidance as to what is needed to evaluate management's assessment process of these IT controls and for the auditor's testing of IT controls.

Paragraph 70 is unclear about how the requirements of AU 319 relate to this standard. Instead of referring to Paragraphs 16-20 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit*, in paragraph 70 of the proposed standard, we suggest that the PCAOB update and expand the guidance of this AU section and include it in this proposed standard. In today's environment, auditors normally would not be able to attest to the effectiveness of an entity's internal control without understanding and testing relevant IT controls.

Materiality Considerations

We believe that the concepts in the second and third sentences of paragraph 21 of the proposed standard could more clearly convey that, depending on the facts and circumstances, the auditor should consider materiality at the financial-statement level and/or at the individual account-balance level in determining whether a deficiency represents a significant deficiency or a material weakness.

Materiality considerations for internal control over financial reporting would logically follow the materiality considerations for the financial statement audit. However, this is one area where we believe the financial audit standards need to be strengthened.

For instance, we suggest that financial auditing standards require the auditor to document (1) the planning materiality selected, (2) the method of determining planning materiality, (3) the auditor's consideration of materiality in designing the nature, timing, and extent of audit procedures, and (4) the auditor's consideration of materiality in evaluating the results of audit procedures. We encourage the PCAOB to give high priority to revising the interim standards on materiality, which are in AU section 312, *Audit Risk and Materiality in Conducting an Audit*. We believe that additional guidance on applying the concept of materiality is needed in areas such as estimating materiality, determining an appropriate materiality base, and applying materiality concepts in audit planning and reporting. We also believe that the standard should require auditors to quantify and document their consideration of materiality.

Illustrative Auditor Reports

- Unqualified Opinion, Example A-1

In the illustrative report expressing an unqualified opinion, we believe that the opinion paragraph should be revised to clearly state the following: (1) management's assessment of internal control over financial reporting, (2) whether the auditor agrees with management's assessment, and (3) the auditor's opinion on the effectiveness of internal control.

Management has assessed the internal control over financial reporting of W Company, and has concluded that internal control over financial reporting was effective as of December 31, 20x3. We agree with management's assessment. In our opinion, ~~management's assessment that~~ W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20x3, ~~is fairly stated, in all material respects~~, based on [identify criteria...]

- Adverse Opinion, Example A-2

In the illustrative report expressing an adverse opinion, we suggest that the last sentence of the explanatory paragraph should be revised as indicated below:

...We considered this material weakness in determining the nature, timing, and extent of the audit procedures applied in our audit of the 20x3 financial statements. As a result of performing these revised audit procedures, we were able to express an opinion on W Company's 20x3 financial statements. However, information that management uses in making decisions during the year, as well as information presented in its quarterly reports, could be misstated as a result of the material weakness. ~~This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20x3 financial statements, and this report does not affect our report dated [date of report...] on those financial statements.~~

- Disclaiming An Opinion, Example A-4

In the illustrative report disclaiming an opinion, we believe that guidance is needed for an auditor's explanation of how the disclaimer on the effectiveness of internal control over financial reporting affects the auditor's opinion on the entity's financial statements.

- Report That Refers to the Report of Other Auditors, Exhibit A-5

In the illustrative report that refers to the report of other auditors as a basis, in part, for the auditor's opinion, we believe that the introductory and opinion paragraphs are unclear and suggest revision to clarify that the opinion and the responsibility belong to the auditor of the consolidated entity. Even when a wholly owned subsidiary is autonomous of its parent, the parent establishes the subsidiary's overall control environment and the "tone at the top." We suggest that the last sentence of the introductory paragraph be revised as follows:

The effectiveness of B Company's internal control over financial reporting was audited by other auditors whose report has been furnished to us, and we considered their report and evidence obtained during our audit in order to form our opinion on the effectiveness of W Company's internal control over financial reporting. ~~our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors~~

- Combined Report, Example A-6

In the illustrative combined report expressing an unqualified opinion on financial statements and an unqualified opinion on management's assessment of the effectiveness of internal control over financial reporting, we suggest revising the opinion paragraph to state: (1) management's assessment of internal control over financial reporting, (2) whether the auditor agrees with management's assessment, and (3) the auditor's opinion on the effectiveness of internal control. This parallels our recommendation for revising the opinion of the illustrative report expressing an unqualified opinion in Example A-1.

Management has assessed the internal control over financial reporting of W Company effective as of December 31, 20x3. We agree with management's assessment. Also in our opinion, ~~management's assessment that~~ W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20x3, ~~is fairly stated, in all material respects,~~ based on [identify criteria...]

Other Clarifications

- Clarify example of evaluating the operating effectiveness of internal control

In the second example provided in the last sentence of paragraph 93 of the proposed standard, reperforming the control is recommended as a procedure for testing the

control. We do not believe that this procedure provides the auditor with evidence of the effectiveness of the control. We suggest that instead, the auditor should be advised to ask the person responsible for signing the voucher what he or she looks for when approving packages and how many errors have been found on vouchers. We also suggest that the auditor be advised to ask others with knowledge of the procedure about their understanding of the number of errors found. The auditor could also ask whether management has knowledge of any errors that the person responsible for signing the vouchers failed to detect.

- Reconsider requirement regarding subsequent discovery of information existing at the date of the auditor's report on internal control over financial reporting

The PCAOB should reconsider the requirement that the auditor determine “whether there are persons currently relying on or likely to rely on the auditor’s report” as discussed in paragraph 180 of the proposed standard in the context of AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report*. Specifically, the requirement for the auditor to determine “whether there are persons currently relying on or likely to rely on the auditor’s report” is not always possible in light of today’s technology. The auditor cannot reasonably determine who may rely on an auditor’s report when these reports are readily available on the Internet, often from the Web site of the Securities and Exchange Commission.