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Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

May 19, 2006

Mr. John Fogarty, Chair
Auditing Standards Board
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Subject: Proposed Statement on Standards for Attestation Engagements –*Reporting on an Entity’s Internal Control Over Financial Reporting*

This letter provides the U.S. Government Accountability Office’s (GAO) comments on the Auditing Standards Board’s (ASB) January 19, 2006, exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) entitled *Reporting on an Entity’s Internal Control Over Financial Reporting*, codified as AT 501. This proposed standard would replace the current standard AT 501. Our comments focus on five areas:

- Consistency with the PCAOB’s Auditing Standard No. 2
- Rotational testing
- Guidance on written assertion
- Options to limit extent of testing
- Strengthen assessment of IT controls

Consistency with PCAOB’s Auditing Standard No. 2

We note that the ASB proposed standard provides for an approach that is generally consistent with Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* for engagements involving an auditor attestation on the effectiveness of internal control. We acknowledge the important objectives that this approach supports, namely consistency and harmonization, and avoiding inconsistent standards. In addition, consistency between the PCAOB standard and the ASB AICPA proposed standard allows for a common understanding by users of financial statements and among audit practitioners. It also allows an audit organization to establish a common core audit methodology for different types of clients who may require an auditor attestation on the effectiveness of internal control over financial reporting.

We commend the ASB for updating its proposed standard to reflect additional guidance issued by PCAOB¹ dealing with auditors exercising judgment to tailor their audit plans to the risks facing individual audit clients and the need to effectively apply a top-down approach to evaluating the effectiveness of internal control. We believe that in updating AT 501 and the related guidance, the ASB should, as the PCAOB continues to assess its standard No. 2, continue to consider the lessons learned and the evolving guidance from the PCAOB. For instance, on May 10, 2006, the SEC and PCAOB hosted a roundtable discussion on second-year experiences with the reporting and auditing requirements. The purpose of the roundtable was to obtain feedback so that the PCAOB could assess progress in implementation and continue to assess the need for additional guidance or updates to the standard. A large part of the roundtable discussion dealt with the SEC and PCAOB's request for specific feedback about actions they can take to make the internal control auditing process more efficient and effective, including possible modification of the Auditing Standard No. 2 and other actions that can be taken.

Earlier this week, the PCAOB announced its intention to amend Auditing Standard No. 2 to direct the auditors' primary focus in the audit of the effectiveness of internal control over financial reporting on areas that pose higher risk of fraud or material error, including consideration of allowing for and promoting auditors' use of experience gained in previous years' audits to focus and make most of the work in subsequent years. The ASB should consider whether it would be beneficial to delay finalizing its proposed standard until the PCAOB amends its standard.

Further, in our April 2006 report, *Sarbanes-Oxley Act Challenges for Small Companies* (GAO-06-361), we recommended that the SEC coordinate with PCAOB to help ensure that Sarbanes-Oxley Act section 404 related audit standards (PCAOB Auditing Standard No. 2) identify additional ways in which auditors of public companies can achieve more economical, effective, and efficient implementation of the standards and guidance related to internal control over financial reporting. The actions taken by PCAOB and the SEC in response to this recommendation will also be relevant to the ASB proposed standard.

In summary, the ASB should continue to consider the ongoing activities of the SEC and PCAOB and work closely with these and other organizations, such as the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Rotational Testing

We believe that AT 501 should allow for rotational testing, which would provide increased opportunity for audit firms to use reasoned risk and experienced-based judgment in planning and performing a body of work over internal control over financial reporting. We previously made a similar recommendation to the PCAOB.

¹ Policy Statement Regarding Implementation of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (PCAOB Release No. 2005-009, May 16, 2005) and Report on the Initial Implementation of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (PCAOB Release No. 2005-023, November 30, 2005)

By rotational testing, we mean that the auditor is making risk-based and reasoned judgments about the controls to be tested each year. We still believe that rotational testing could be used to promote effective and efficient audits of internal controls. We support a requirement for the auditor to obtain evidence every year of the effectiveness of internal control 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 of **all relevant** assertions for **all significant** accounts and disclosures every year. PCAOB Audit Standard No. 2 continues to include the latter requirement, which has been carried forward to the ASB proposed standard in paragraph 111.

We 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.

Guidance on Written Assertion

The current AT 501 has a requirement that we believe remains critical to retain in the revised version of AT 501. Specifically, the current AT 501.07 states that:

Regardless of whether the practitioner's client is the responsible party, the responsible party's refusal to furnish a written assertion as part of an examination engagement should cause the practitioner to withdraw from the engagement. However, an exception is provided if an examination of internal control is required by law or regulation. In that circumstance, the practitioner should disclaim an opinion on internal control unless he or she obtains evidential matter that warrants expressing an adverse opinion. If the practitioner expresses an adverse opinion and the responsible party does not provide an assertion, the practitioner's report should be restricted as to use.

This guidance is especially important to government auditors since they may not have the option of withdrawing from the engagement if the responsible party refuses to furnish a written assertion as part of the examination engagement.

The current guidance allows an exception if an examination of internal control is required by law or regulation. However, we also believe it is important to recognize that sometimes the government auditor may elect to conduct an examination engagement of internal control and the refusal of the responsible party to furnish the written assertion should not be a reason that the government auditor should be precluded from issuing a disclaimer or, if sufficient evidence is obtained by the auditor, an adverse opinion. Likewise, auditors could be engaged by a third party to conduct an examination engagement of internal control, and we again believe that the refusal of the responsible party to provide an assertion should not preclude the auditor from issuing a disclaimer or, if sufficient evidence is obtained by the auditor, an adverse opinion.

We recommend that the proposed standard be amended to reincorporate the current requirement. We further recommend that the standard be revised to permit auditors, either when engaged by a third-party or when they independently determine the scope of their work, to be able to complete the engagement and issue a disclaimer or an adverse opinion, as appropriate, if the responsible party refuses to furnish the written assertion.

Options to Limit Extent of Testing

Under the proposed standard, the practitioner must obtain sufficient evidence about whether the entity's internal control, including the controls for all internal control components is operating effectively each year. This means that each year the practitioner must obtain evidence about the effectiveness of controls for all relevant assertions related to all significant accounts and disclosures in the financial statements. However, we believe that if the practitioner has sufficient evidence to provide an adverse opinion on the effectiveness of internal control, cost and benefit considerations usually would suggest that it is more logical for the practitioner to report without conducting the level of work required by this standard. Our Financial Audit Manual (FAM) takes this approach to our audits of the effectiveness of internal control over financial reporting.

We recommend that the ASB incorporate a similar language to allow auditors to limit their work when the auditor has sufficient evidence to support an adverse opinion on internal control, subject to any legal, regulatory, contractual, or other requirements.

Strengthen Assessment of IT Controls

The proposed standard approaches the issue of IT controls from same standpoint as the new audit risk standards and refers to this guidance for practitioners to use in assessing the use of information technology as part of their assessment of internal control. In our comment letter of August 26, 2005, we noted that we believed that the computer security issue is essential to the understanding and assessment of internal control and was not sufficiently addressed. We believe that the proposed standard revising AT 501 still has not sufficiently addressed this problem.

We still believe that the basic principles for manual and automated controls are the same—that auditors should obtain evidence that the control operated effectively for the entire period to which the internal control opinion applies. In addition, the proposed standard should discuss the auditor's assessment of IT general controls in a clear and consistent manner. As drafted, the standard might lead auditors to perform insufficient tests of IT general controls. The standard should clearly indicate that to assess the effectiveness of an automated control, the auditor also depends on the auditor's assessment of the operating effectiveness of IT general controls. For example, the auditor should consider the effectiveness of IT general controls that would prevent management overrides or other unauthorized changes to applications or data that would preclude or impair the operation of the automated control. While such IT general controls would include program change controls, they also would

include other IT general controls, such as access, segregation of duties, and security management controls.

We thank you for considering our comments on this important proposed standard as we work together on issues of mutual interest to the accountability profession.

Sincerely yours,

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

David M. Walker
Comptroller General
of the United States

cc:

The Honorable Christopher Cox, Chairman
Securities and Exchange Commission

The Honorable Bill Gradison, Acting Chairman
Public Company Accounting Oversight Board