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Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

May 9, 2005

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

Subject: *PCAOB Rulemaking Docket Matter No. 018: Proposed Auditing Standard—Reporting on the Elimination of a Material Weakness*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) March 31, 2005, proposed auditing standard on reporting on the elimination of a material weakness.

Overall, GAO supports the proposed standard. We especially agree with provisions of the proposed standard that:

- explicitly state that auditors cannot obtain reasonable assurance sufficient to support an opinion if the auditors evaluate control design without also evaluating the effectiveness of those controls in operations (noted throughout the proposed standard);
- establish required conditions for performing such an engagement (paragraphs 7-8); and
- establish requirements for successor auditors, thus minimizing the opportunity for management "opinion shopping" (paragraph 23-24).

Detailed below are our views on the questions posed by the Board on page 12, part IX of the release that accompanied the proposed standard. The attachment to this letter includes our suggested revisions to the illustrative report in Appendix A of the standard.

<u>PCAOB Questions 1:</u> *Does the sample auditor's report, which is included in the proposed standard, clearly describe the results of the engagement? If not, how might it communicate more clearly to report users?*

<u>GAO Response:</u> We believe that the report language can be clarified and made more consistent with PCAOB Auditing Standard No. 2 by

- specifying that the auditors were engaged to express opinions on whether 1) management's assertion is fairly stated, and 2) management has eliminated the material weakness,

- requiring auditors to opine on whether 1) management's assertion is fairly stated, and 2) management has eliminated the material weakness,
- requiring auditors to indicate if more than one material weakness was identified in the auditor's original report on internal control over financial reporting,
- notifying readers where they can obtain the auditor's original report or indicating that a copy of the auditor's original report is attached, and
- clarifying that the auditor is not reporting that any other material weaknesses were corrected.

We have incorporated these recommendations in our suggested revisions to the illustrative report that are attached to this letter

PCAOB Questions 2: *If the auditor does not express an opinion on all of the material weaknesses that were identified during the company's most recent audit of internal control over financial reporting, should the proposed standard require the auditor's report to specifically identify the additional material weaknesses?*

Would such a requirement provide helpful information to report users or would it detract from an otherwise clear communication by implying that the auditor believes that those material weaknesses do still exist or that only those material weaknesses exist (i.e., no other controls have materially deteriorated since the date of the annual assessment of internal control over financial reporting)?

Might specific identification of other material weaknesses not addressed by the auditor's report deter companies from engaging the auditor to perform this work unless the company believed that all previously reported material weaknesses had been eliminated?

GAO Response: We believe that, in order to avoid confusion, an auditor's report on elimination of a material weakness should refer to the auditor's original report on internal control over financial reporting and disclose that the auditor's original report identified other material weaknesses. The auditor could attach a copy of the auditor's original report or disclose where the reader can obtain the auditor's original report. This would allow readers to consider the importance of the material weakness that was eliminated in relation to other material weaknesses, thus providing valuable context for the reader. Facilitating access to the auditor's original report should not deter companies from initiating such engagements.

Additional language would also be needed in the report on elimination of a material weakness to specify that the auditor was not engaged to perform procedures related to any other material weaknesses included in the auditor's original report and therefore, the auditor is not reporting on the other material weaknesses or on the overall effectiveness of internal control over financial reporting.

We have incorporated these recommendations in our suggested revisions to the illustrative report that are attached to this letter

<u>PCAOB Questions 3:</u> Should this standard allow an auditor to report on the elimination of a material weakness in the circumstance in which the material weakness was identified and eliminated by management as of an interim date (in other words, identified and eliminated without ever being addressed in the company's Section 404 reporting)?

<u>GAO Response:</u> The proposed standard states that in an engagement to report on the elimination of a material weakness, auditors <u>must</u>

- obtain sufficient competent evidence about the design and operating effectiveness of controls that provide reasonable assurance that the company's stated control objective has been achieved (paragraph 15),
- obtain an understanding of and evaluate management's evidence supporting its assertions that 1) the specified controls related to the material weakness are designed and operated effectively, 2) these controls achieve the company's stated control objectives(s) consistent with the control criteria, and 3) the identified material weakness has been eliminated (paragraph 25), and
- perform tests of controls over a period of time adequate to determine whether, as of the date specified in management's report, the controls necessary for achieving the objectives of the control criteria are operating effectively.

We believe it would be extremely difficult to satisfy these requirements in an engagement to report on the elimination of a material weakness that was identified and eliminated during an interim period. However, if auditors are able to satisfy these requirements, the standard should allow them to report on the elimination of a material weakness that was identified and eliminated during an interim period. The PCAOB should caution auditors that when performing an engagement to report on the elimination of a material weakness that was identified and eliminated during an interim period, the auditors should assure that they can obtain sufficient evidence to satisfy the requirements noted above.

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

Sincerely yours,

David M. Walker
Comptroller General
of the United States

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

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

Our suggested changes to the illustrative report in Appendix A of the proposed standard are as follows:

> We have previously audited and reported on management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X based on [*Identify control criteria, for example, "criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).*"]. A copy of our report can be obtained at [identify location or website where the report can be obtained, or state that a copy of the report is attached]. Our report, dated [*date of report*], identified ~~the following~~ material weaknesses in the Company's internal control over financial reporting, one of which was the following:
>
> [*Describe material weakness]*
>
> ~~We have applied auditing procedures to management's assertion, included i~~ In the accompanying [title of management's report], ~~that~~ management asserted that it has eliminated the material weakness in internal control over financial reporting identified above by implementing the following control(s):
>
> [*Describe control(s) implemented]*
>
> Management has asserted that the control(s) identified above eliminates the material weakness in internal control over financial reporting identified above because the control(s) achieves the following stated control objective, which is consistent with the criteria established in [*identify control criteria used for management's annual assessment of internal control over financial reporting*]: [*state control objective addressed*]. Management also has asserted that it has tested the control(s) identified above and concluded that the control(s) was designed and operated effectively as of [*date of management's assertion*]. XYZ Company's management is responsible for its assertion. ~~Our responsibility is to express an opinion on the elimination of the material weakness based on our auditing procedures.~~
>
> We were engaged to express an opinion on whether 1) management's assertion is fairly stated, and 2) management has eliminated the material weakness. Our engagement was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the engagement to obtain reasonable assurance about whether the company has eliminated a previously reported material weakness. Our engagement included obtaining an understanding of internal control over financial reporting, obtaining and evaluating evidence about whether controls identified in management's assertion as eliminating the material weakness were designed and operated effectively and satisfy the entity's control objective, ~~examining evidence supporting management's assertion,~~ and performing such other procedures as we considered necessary in the circumstances. We believe that our auditing procedures provide a reasonable basis for our opinion.

In our opinion, management's assertion that XYZ Company has eliminated the material weakness described above as of [*date of management's assertion*] is fairly stated. Also in our opinion, XYZ Company has eliminated the material weakness described above as of [*date of management's assertion*] because the stated control objective is met as of [*date of management's assertion*].

We were not engaged to and did not conduct an audit of internal control over financial reporting as of [*date of management's assertion*], the objective of which would be the expression of an opinion on the effectiveness of internal control over financial reporting. We also were not engaged to determine whether any other material weaknesses were corrected. ~~Accordingly, we do not express such an opinion.~~ This means that we have not applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company as of any date after December 31, 200X, other than the control(s) specifically identified in this report. Accordingly, we do not express an opinion that internal control over financial reporting ~~any other controls~~ operated effectively after December 31, 200X or that any other material weaknesses were corrected.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.
[
Signature]
[*City and State or Country*]
[*Date*]