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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006

PCAOB Rulemaking Docket Matter No. 008

Dear Mr. Secretary:

Please consider these comments on the proposed standard of the Public Company Accounting Oversight Board (PCAOB) entitled "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Auit [sic] of Financial Statements" (Oct. 7, 2003) (the "Proposed Standard"). The comments are not geared discretely to any particular Question to which the PCAOB seeks responses, though they implicate Questions 1 and 26 set forth in the PCAOB's Release accompanying the Proposed Standard.

Summary. The Proposed Standard contemplates two separate audit opinions: a new one on internal control over financial reporting and the traditional one on financial statements. The Proposed Standard treats these exercises as integrated. The Proposed Standard also indicates it is possible to give a qualified or adverse opinion on one while giving an unqualified opinion on the other. This correctly implies that effective control is neither a necessary nor sufficient condition for fair financial reporting.1 It may be desirable for the Proposed Standard to make this reality express. Otherwise, there appears to be some risk that controls will come to be treated as ends in themselves rather than instruments to promote the ultimate end of fair financial reporting. There is also meaningful risk of confusion among investors and other users of financial data, control information, and audits of them.

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1 If a company can have ineffective control and fairly-presented financial statements, then effective control is not necessary; if a company can have effective control but materially-misstated financial statements, then effective control is not sufficient. Neither point negates the possibility that some level of control is necessary nor that in certain discrete contexts some level of control is sufficient.

Analysis. The Proposed Standard states that an auditor can issue (1) a qualified or adverse opinion on the effectiveness of internal control over financial reporting but (2) an unqualified opinion that the financial statements fairly present results and condition in conformity with generally accepted accounting principles. *Proposed Standard, ¶¶ 177-79.* This seeming incongruity is possible because a material weakness discovered in internal control can be overcome in a financial statement audit by substantive tests that do not rely upon the control bearing the material weakness.

Consider the opposite situation. Can an auditor issue (1) a qualified opinion on the financial statements but (2) an unqualified opinion on internal control over financial reporting? The Proposed Standard does not address this situation. Nothing in logic, control or auditing standards prevents the possibility, however. Control over matters such as transaction recording, classification and aggregation may be air-tight but various judgments ranging from allowance for doubtful accounts to off-balance sheet financing to stock option valuation may still be aggressive. The possibility undercuts an implicit premise upon which the mandatory attestation of internal control project builds: If control is effective, then companies should not produce financial statements that cannot be given unqualified audit opinions. But this premise is false and the Proposed Standard could be improved by so stating.

The possibility of effective control producing materially misstated financial statements is recognition that effective control cannot guarantee fairly-stated financial statements. This is inevitable but somewhat obscured in the Proposed Standard. True, the Proposed Standard correctly emphasizes inherent limitations of internal control and the contrast between reasonable assurance, which is possible, and absolute assurance, which is not. *Proposed Standard, ¶¶ 15-17*. It likewise notes that the same limits of financial statement audits apply to control audits. *Proposed Standard, ¶ 17.* The Proposed Standard also rightly describes these limits as known features of the financial reporting process and expresses the hope that installing safeguards will "reduce, though not eliminate, the risk" of material financial misstatements. *Proposed Standard, ¶ 15.* But the particular context of providing a qualified or an adverse financial audit opinion despite furnishing an unqualified control audit opinion is never mentioned.

As matters of logic and probability, it may be more likely that a company will boast ineffective control and yet be in a position to present fair financial statements than the other way around. But of greater concern is the situation in which effective control nevertheless yields materially misstated financial statements. After all, this seems to have been the situation plaguing Enron Corp. and other catalysts of the Sarbanes-Oxley Act.2 The possibility that effective control may nevertheless yield materially misstated financial statements therefore may warrant specific express attention in the articulation of auditing standards mandated by that Act.

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2 *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, U. CONN. L. REV., vol. 35 (2003), draft available on http://ssrn.com/abstract_id=337280).

Failure to draw express attention to this reality may produce investor confusion, particularly in light of rhetoric in pronouncements accompanying the Proposed Standard suggesting that incongruent opinions should not be possible. When the PCAOB released the Proposed Standard, for example, one Board member stated: "Reliable financial reporting would be impossible for a complex modern business without effective internal control." *Statement of Daniel L. Goelzer, PCAOB, Proposed Standard (Oct. 7, 2003).* That opinion conflicts directly with the express statements in the Proposed Standard contemplating exactly the opposite situation.

Likewise, the Release accompanying the Proposed Standard states: "Effective internal control over financial reporting is essential for a company to effectively manage its affairs and to fulfill its obligations to investors." *PCAOB Release No. 2003-17 (Oct. 7, 2003), at 5*. If this were so, then it would not be possible to give a qualified or adverse opinion on control and an unqualified opinion on financial statements. The possibility of unqualified financial statement opinions with qualified or adverse control opinions means effective control is not essential, but the quoted sentence says it is essential. *See also Proposed Standard, ¶ 23* ("internal control over financial reporting . . . enhances the quality of financial reporting . . .").

The Proposed Standard describes itself as an integrated standard that refers to both audits of control and of financial statements. That interrelationship and the integrated standard evince a strong sense that it should not be possible to have ineffective control but fair financial statements or *vice versa*. Throughout the Proposed Standard, emphasis is laid on the interrelationship between the two types of audit. Sometimes the Proposed Statement indicates the direction of the relationship and sometimes does not.3 While the Proposed Standard draws from the interrelated character of the two audits the implication that an auditor cannot audit control without also auditing financial statements, there is also a false implication that effective control is the key to fair financial statements.4

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3 The Release accompanying the Proposed Standard refers to knowledge from financial audit informing the auditor's conclusions about the control audit. *PCAOB Release No. 2003-17 (Oct. 7, 2003), at 3*. Paragraph 26 of the Proposed Standard refers to deficiencies discovered in the control audit triggering adjustments to be made in the financial audit. It also indicates the two are interrelated. Paragraph 27 of the Proposed Statement states that knowledge gained from a financial audit informs auditors about control effectiveness. Paragraph 132 again describes the understandings obtained as interrelated, without expressing the direction of any relationship (control understanding from control audit is "interrelated with" control understanding gained in assessing control risk for a financial audit).

4 Oddly, the Proposed Standard also says the reverse is possible, that an auditor can audit financial statements without also auditing controls. The Proposed Standard gives as an example the case of an IPO, but does not explain how this illustrates the point. *Proposed Standard, at A-16, note 10*. Failure to clarify this could leave important obscurity in any final standard. As designed, the Proposed Standard permits performing financial audits giving unqualified opinions without the need to perform the control audit,

The Proposed Standard emphasizes that discovered financial misstatements may imply ineffective control but that their absence does not imply effective control. *Proposed Standard, ¶ 144.* Auditors of financial statements who discover misstatements are to be alert that this may signal ineffective control. *Proposed Standard, ¶ 143* ("The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls"). This may lead the auditor to issue a qualified or adverse control opinion due to the time required to achieve effective control while issuing an unqualified opinion on the financial statements by first correcting misstatements.

But the Proposed Standard does not mention that ineffective control may not lead to financial misstatements nor that effective control may still produce financial misstatements. This asymmetry can create undue emphasis on control and insufficient emphasis on matters that must be valued by judgment. After all, everything about control over financial reporting is and should be geared to fairly-presented financial statements, not as ends in themselves.

This perspective generates a comment concerning Question 26 contained in the Release accompanying the Proposed Standard. It asks whether there are "circumstances where a qualified 'except for' conclusion [in a control audit] would be appropriate" as an alternative to expressing an adverse control-audit opinion when a material weakness exists. One possible circumstance is when the control material weakness did not prevent giving an unqualified opinion on the financial statements. Unless there is reason to believe that the material weakness in control will somehow prevent giving an unqualified financial statement opinion in a future period, there is no obvious purpose to giving an adverse control opinion in the current period.

A possible purpose is enhancing disclosure of the interior processes of financial reporting, control and audit. The contemplated regime pressures companies to reveal information concerning internal control. Adding an adverse auditor opinion on control effectiveness despite an unqualified opinion on financial statements strengthens this pressure. In giving an adverse control opinion, the Proposed Standard requires the auditor to disclose relevant material weaknesses.

As written, the Proposed Standard does not require disclosure of the auditor's processes or assessments during the control audit (or the financial statement audit). But if the value of providing an adverse (or qualified) control opinion despite an unqualified financial statement opinion is altering investors to impending adversity, logic suggests that the auditor fully disclose such risk and its processes and assessments concerning it. This result would forge a substantial change in the standards governing auditing

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but any auditor who performs a control audit must perform the financial statement audit where the Proposed Standard makes express the possibility of giving a qualified or adverse opinion.

practice,[5] a position the public accounting profession has in the past successfully resisted.[6]

Some of the tension between different opinions in this integrated exercise may be due to two differences between what the Sarbanes-Oxley Act says and what the Proposed Standard contemplates (and addressing these may provide a way to reduce the tension). The first relates to Question 1 in the Release accompanying the Proposed Standard. It asks: "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?" The answer depends on what turns on the characterization.

Sarbanes-Oxley calls for an *attestation* of managerial assertions concerning control effectiveness, while the Proposed Standard contemplates prescribing an *audit* of such control effectiveness assertions. Though one footnote in the Proposed Standard suggests a modest and technical distinction between the two (designating audit as the process and attestation as the conclusion drawn), *Proposed Standard, A-8, note 3,* a number of statements in the Proposed Standard and accompanying release documents suggest a more significant difference.[7] Using the term audit instead of attestation in the Proposed Standard may suggest a higher level of obligation and expected result compared to what the Sarbanes-Oxley Act contemplates. But the possibility of incongruent opinions in the two exercises shows any such higher level of obligation and result to be somewhat illusory.

Second, the Sarbanes-Oxley Act prescribes that the control attestation and the financial statement audit be performed by the same independent public accounting firm. *See* Sarbanes-Oxley Act, § 404(b) (providing that the control assessment not be a separate engagement from the financial audit). The Act does not specify that the two undertakings should have any other particular relation between them. The Proposed Standard expressly and firmly contemplates a close interrelationship between the two and articulates a standard expressing the goal of an integrated engagement for the two assignments.

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5 Such substantial changes may be behind one PCAOB Board member's statement that the coming regime of internal control certification and attestation "revolutionizes" managerial and auditor attention to internal control. *Statement of Daniel L. Goelzer, PCAOB, on the Proposed Standard (Oct. 7, 2003)*.

6 *See Monroe v. Hughes*, 31 F.3d 772 (9th Cir. 1994) (rejecting shareholder argument that public accounting firm had duty to disclose discovered internal control deficiencies or material weaknesses).

7 *See, e.g., Statement of Douglas Carmichael, Chief Auditor, PCAOB, on the Proposed Standard (Oct. 7, 2003)* (clarifying choice to use the term audit rather than attestation by explaining that financial statement audits are a form of attestation and that internal control assignments are similar). The presence of Question 1 in the Proposed Standard itself provides a basis to infer something more significant than semantics or technical characterization is at stake in the distinction between attestation and audit.

That integration suggests the two assignments are on par with each other in terms of level of obligation and expected assurance level. The public accounting profession has substantial experience with full-fledged auditing of financial statements that may enhance its capabilities and judgments honed from professional lessons. These are less likely to exist as to full-fledged auditing of control (as contrasted with the selected testing of controls in a financial statement audit). Aligning the obligation and expectations between the two types of assignments as the Proposed Standard contemplates may therefore be more ambitious than is reasonably justified, at least at present. Denominating the control assertion exercise as an attestation rather than an audit may be a way to recognize these differences.

Nor are these concerns directed solely at the potentially limited class of circumstances producing incongruent opinions. Consider the significance of a qualified opinion as to both control and financial statements or an unqualified opinion as to both. For joint qualified opinions, the alignment may signal to investors and others that control weaknesses are to blame for noncompliant financial statements. But this may not be the case. For joint unqualified opinions, the alignment may tend to create in the investment community a sense that control is working to the end of promoting fair financial statements. But this sense may be false.[8]

The stated purpose of effective internal control over financial reporting is to facilitate preparation of fairly-presented financial statements. But the possibility of incongruent audit opinions shows that there is no necessary connection between the two. In fact, the recognized possibility of incongruent opinions suggests reason to be concerned that control can become an end in itself rather than the means to the ultimate objective of fair financial reporting.[9] To the extent possible, it would seem desirable for the Proposed Standard to be modified to neutralize this concern.[10]

Sincerely yours,

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8 This raises another comment, concerning Example A-2. This example shows an adverse audit opinion when management's assessment is that its company did not maintain effective internal control. If management says its company did not maintain effective internal control, users do not need an auditor to attest to this assertion.

9 *See* Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, JOURNAL OF CORPORATION LAW (UNIVERSITY OF IOWA), vol. 29 (forthcoming 2004) (available at http://ssrn.com/abstract_id=444600).

10 To minimize forecasted investor confusion, consideration might be given to including illustrations of circumstances that could produce incongruent opinions.