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United States Government Accountability Office
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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006-2803

Subject: *PCAOB Rulemaking Docket Matter 034, PCAOB Release No. 2011-003: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*

This letter provides GAO's comments on the Public Company Accounting Oversight Board's (PCAOB) concept release on possible revisions to PCAOB standards related to reports on audited financial statements.

We support the general premise of enhancing the auditor's report, and believe that this concept release is a positive step toward improving the transparency and relevance of these reports. We believe that several of the suggestions—specifically, those relating to clarification of wording in the auditor's report to help users understand management's and the auditor's responsibilities, and enhanced use of "Emphasis of Matter" and "Other Matter" paragraphs to identify specific issues to which the auditor wishes to draw the users' attention—would improve the usefulness of the auditor's report. While we believe that the current "pass/fail" reporting model should be retained as an effective means of encouraging management to provide appropriate disclosure, the above suggestions for improving the auditor's report, the auditor's primary means of communicating audit results, should be considered. GAO and others in the federal audit community have had significant experience in enhanced reporting, and we have attached an illustrative audit report from the GAO/President's Council on Integrity and Efficiency (PCIE) *Financial Audit Manual* (FAM).[1]

Although we support enhancing the auditor's report, we do not support the required use of "Emphasis of Matter" paragraphs in all cases or a requirement for an Auditor's Discussion and Analysis narrative report. In addition, we caution against an expansion

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[1] See FAM/PCIE Section 595 A - Example of Unqualified Financial Statement, Internal Control Opinion, and Opinion on Substantial Compliance of Entity's Systems with FFMIA on GAO's special publications web page (http://www.gao.gov/special.pubs/gaopcie/).

of the auditor's reporting or assurance to include information outside the financial statements as part of the financial statement audit.

Consistent with both the auditing standards and years of accepted practice, management of the audited entity is responsible for the fair presentation of the entity's financial statements, including disclosure of all information required by the applicable financial reporting framework, and for the full, accurate, and timely disclosure of information required by federal securities laws and the Securities and Exchange Commission (SEC). Such disclosures include Management's Discussion and Analysis (and the critical accounting estimates or assumptions contained therein) and additional disclosures necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations, and cash flows. The role of the auditor is to assess the fair presentation of the financial statements, including the completeness of management's disclosures. If there is a situation in which management does not provide the required disclosures, or such disclosures are not fairly presented, then the auditor considers the effect on the auditor's opinion and report.

As we've stated in previous comment letters, we strongly believe that auditing standard setters should work together to achieve core auditing standards that are universally accepted. This issue is an especially timely subject for discussion, as the International Auditing and Assurance Standards Board (IAASB) has recently issued its consultation paper entitled *Enhancing the Value of Auditor Reporting: Exploring Options for Change*. We encourage the PCAOB, the IAASB, and the Auditing Standards Board to coordinate the development of potential new expanded auditor reporting requirements with a goal of harmonizing the auditor's report to the maximum extent possible, based on common core auditing and reporting requirements. We believe that having different audit reports in the marketplace will create significant confusion to the users of the financial statements and may lessen, rather than enhance, the users' understanding of the auditor's report. Only where there is a clear and compelling reason should the individual standard-setting bodies develop differential standards to meet the unique needs of their respective constituencies. The nature of any differences from core auditing standards and the basis for the differences also should be communicated.

We also encourage the PCAOB to seek ways to work with the Financial Accounting Standards Board (FASB) and the SEC on issues related to management disclosures. For instance, collaboration with the FASB and the SEC could provide valuable information in developing, as appropriate, management disclosure requirements or guidance that provides additional information to users, based on needs identified by the PCAOB (e.g., disclosure of risks, significant estimates and judgments, critical accounting issues, and audit committee views). Such disclosures could then be evaluated by the auditors, as appropriate, during the audit process.

We have specific comments related to the PCAOB's questions and potential changes to the auditor's reporting model, which are provided below.

Questions 1-4: Content and Form of the Auditor's Report

Question 1: Auditor's Report and Role

We support the general premise that the auditor's report should be improved so that it is more relevant and useful to the financial statement users. Specifically, we would be in favor of wording in the auditor's report that provides a fuller explanation and expanded description of the respective responsibilities of management and the auditor, especially with respect to fraud, risk, nonfinancial disclosures, the extent of internal control testing, and auditor independence.

Question 2: Pass/Fail Option

We believe that the current pass/fail reporting model should be retained, and we agree with several Standing Advisory Group members that the pass/fail model is clear, consistent, comparable, and easy for the investing public to digest. Further, we believe it is an important tool that encourages management to make all necessary and appropriate disclosures.

Question 3: Additional Information

We believe that management and the audit committee, rather than the auditor, should provide any additional information about the entity and that an auditor's discussion of these matters, as well as discussions of significant management judgments and estimates, may blur the lines regarding the roles of the auditor, preparer, and the audit committee. It is important that users clearly understand their respective roles. We believe that an expansion of this sort could potentially increase the auditor's role and could challenge users with competing disclosures about the entity from management and the independent auditor. Further, we are concerned that the audit report language would become "boilerplate" and not ultimately improve reporting, the descriptions of the audit procedures applied would lack context and not convey the significant judgment involved in an audit, and an expansion of the auditor's reporting would increase audit costs.

Question 4: Internal Control

Our envisioned modifications to the standard auditor's report would not result in the need for amendments to the report on internal control as auditors are currently able to report on internal controls as part of a financial audit.

Questions 5-12: Auditor's Discussion and Analysis

We do not support a requirement for an Auditor's Discussion and Analysis narrative report discussing auditor views on significant matters because, in addition to believing that disclosure of such information is management's responsibility, such a requirement may result in unintended consequences. For instance, it might present conflicting information and serve to confuse users. The auditor's view on critical accounting estimates may not necessarily correspond with the way such information is disclosed by management in the financial statements, and this conflicting information may confuse users and lead to a situation where users are faced with the challenge of interpreting competing disclosures. Further, we believe that a discussion providing insights about the entity and the quality of its reporting may not provide sufficient context, and we do not support such an expansion. If the auditor finds it necessary to provide commentary on matters significant to users' understanding, we support the expanded use of "Emphasis of Matter" paragraphs, as discussed below.

Questions 13-18: Required and Expanded Use of Emphasis Paragraphs

We support the greater use of "Emphasis of Matter" paragraphs, but we do not support the required use of such paragraphs in all cases. The use of "Emphasis of Matter" paragraphs is helpful to call users' attention to the most significant matters in the financial statements or any other matter that is significant to the users' understanding of the audit, the auditor's responsibilities, or the auditor's report. These issues might include reference to management's discussion of critical accounting judgments and estimates and other areas with significant measurement uncertainty. GAO has frequently used "Emphasis of Matter" paragraphs to highlight significant uncertainties and risks that are important to the users' understanding of the financial statements. If the PCAOB decides to expand the use of "Emphasis of Matter" paragraphs, we encourage the PCAOB to provide guidance on when the use of these paragraphs is appropriate.

We do not support the required use of "Emphasis of Matter" paragraphs in all cases, because they may not always be appropriate, necessary, or useful and could be confusing for report users. In some cases, a required "Emphasis of Matter" paragraph might be of little use to the users and may result in boilerplate paragraphs that provide little value and distract users from more relevant information contained in the report.

Questions 19-20: Auditor Assurance on Other Information outside the Financial Statements

We caution against requiring auditors to provide assurance or related services on information not within the current scope of the financial statement audit. We believe the ability to provide assurance fully depends on the nature of the information provided during a financial statement audit. Therefore, the scope of information reported by management would need to be expanded. Auditors would also need to be able to audit that information against objective criteria to sufficiently provide assurance. The feasibility will depend on the nature of the information and the availability of suitable criteria. Some information may be better suited for use in audit procedures. For example, an auditor may be able to determine whether performance measures have been properly calculated. The auditor can also provide reports on internal control. Other information, such as non-GAAP[2] financial information and whether an organization fosters strong governance, may not be auditable.

Another consideration is the cost to provide assurance on information outside the financial statements. Requiring the auditor to provide assurance on information outside the financial statements (e.g., corporate governance arrangements, internal controls, key performance indicators, and other information) may be challenging in practice, involving significant additional cost while providing limited additional user benefit.

[2] GAAP: Generally Accepted Accounting Principles.

Questions 21-22: Clarification of the Standard Auditor's Report

We support the clarification of wording in the auditor's report to help users better understand management's and the auditor's responsibilities for information in the report. This clarification of wording in the auditor's report may help reduce the "expectations gap" by more clearly explaining difficult concepts, such as reasonable assurance, and better explaining the auditor's responsibility for fraud, financial statement disclosure, and other information outside the financial statements. Such clarified wording should not change the concepts or the auditor's responsibilities but could help clarify the auditor's communication of this information.

Questions 23-30: Alternatives

We support (1) the clarification of wording in the auditor's report to help users understand management's and the auditor's responsibilities and (2) the enhanced use of "Emphasis of Matter" paragraphs to identify specific issues to which the auditor wishes to draw the users' attention. As noted above, we do not support requiring an "Emphasis of Matter" paragraph in all cases. Similarly, we do not support use of an Auditor's Discussion and Analysis narrative report that discusses the auditor's views on significant matters as it might present conflicting information and expand the auditor's reporting responsibilities. In addition, we caution against requiring auditors to provide assurance on information outside the financial statements.

Questions 31-32: Other Considerations and Potential Effects

If the board decides to undertake a standard-setting project on auditor reports to include consideration of the areas discussed above, we encourage it to develop enhanced guidance for implementing such new requirements and information in coordination with the FASB and the SEC, as necessary. For example, the FASB and the SEC could develop guidance concerning any additional required disclosures, and the PCAOB could develop guidance and criteria to help the auditor evaluate management's disclosures. Absent this guidance, there may be a lack of conformity across auditor reports that confuses the user and diminishes the usefulness of the report.

We thank you for considering our comments on this important issue as the PCAOB considers possible revisions to standards related to reports on audited financial statements.

Sincerely yours,

James R. Dalkin
Director
Financial Management and Assurance

Enclosure

Auditor: This illustrative audit report from the GAO/PCIE *Financial Audit Manual* presents an example of GAO's enhanced reporting.

Enclosure

Example 1 - Unqualified Financial Statement, Internal Control Opinion, and Opinion on Substantial Compliance of Entity's Systems with FFMIA

[Addressee]

In accordance with [cite audit authority] we are responsible for conducting audits of [full name of entity]. In our audits of the [entity] for fiscal year(s) [cite], we found

- the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles,
- [entity] had effective internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations,
- [entity's] financial management systems substantially complied with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA),[3] [for CFO Act agencies, omit for non-CFO Act agencies] and[4]
- no reportable noncompliance with laws and regulations we tested.

The following sections discuss in more detail (1) these conclusions, (2) our conclusions on Management's Discussion and Analysis and other supplementary information, (3) our audit objectives, scope, and methodology, and (4) agency comments and our evaluation.

Opinion on Financial Statements

The financial statements including the accompanying notes present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, [entity's] assets, liabilities, and net position as of September 30, 20XX [and 20X1]; the financial condition of [entity's] social insurance programs (if applicable) as of [the specified date]; and net costs; changes in net position; budgetary resources; and custodial activity (if applicable)[5] for the year[s] then ended.

Opinion on Internal Control

[Entity] maintained, in all material respects, effective internal control over financial reporting (including safeguarding assets) and compliance as of [end of fiscal year] that provided reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements would be prevented or detected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. 3512 (c), (d), the Federal Managers' Financial Integrity Act, and the Office of Management and Budget (OMB) Circular No. A-123, *Management's Responsibility for Internal Control*, [or other criteria].

[3] OMB audit guidance provides guidance for reporting on FFMIA compliance without expressing an opinion.
[4] Non-GAO auditors may combine bullets 3 and 4.
[5] This list assumes the entity follows U.S. GAAP issued by FASAB. If the entity follows U.S. GAAP issued by FASB (government corporations and others such as the U.S. Postal Service), modify the list accordingly.

<u>Systems' Compliance with FFMIA Requirements [Omit this section for non-CFO act entities]</u>

[Entity's] financial management systems, as of [end of fiscal year], substantially complied with the following requirements of FFMIA: (1) federal financial management systems requirements, (2) federal accounting standards, and (3) the *U.S. Government Standard General Ledger* (SGL) at the transaction level. Our opinion is based on criteria established under FFMIA, OMB Circular No. A-127, *Financial Management Systems* (which includes the Joint Financial Management Improvement Program/Office of Federal Financial Management series of system requirements documents), U.S. generally accepted accounting principles, and the SGL.[6]

<u>Compliance With Laws and Regulations</u>

Our tests of the [entity's] compliance with selected provisions of laws and regulations for fiscal year 20XX disclosed no instances of noncompliance that would be reportable under U.S. generally accepted government auditing standards or OMB audit guidance. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

<u>Consistency of Other Information</u>

The [entity's] Management's Discussion and Analysis, required supplementary information (including stewardship information), and other accompanying information contain a wide range of information, some of which is not directly related to the financial statements.[7] We do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with [name of entity] officials. On the basis of this limited work, we found no material inconsistencies with the financial statements, U.S. generally accepted accounting principles, or OMB guidance.

<u>Objectives, Scope, and Methodology</u>

[Entity] management is responsible for (1) preparing the financial statements in conformity with U.S. generally accepted accounting principles, (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act are met, (3) ensuring that the [entity's] financial management systems substantially comply with FFMIA requirements (for CFO Act agencies), and (4) complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the [entity's] financial statements are presented fairly, in all material respects, in conformity with

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[6] Non-GAO auditors may combine this information with compliance with laws and regulations.

[7] The Annual Financial Statement that includes the MD&A, any RSSI, RSI, and OAI, may be included in a larger document such as a Performance and Accountability Report (PAR). Depending on the presentation of these items in the PAR, the auditor may find it useful to refer to the specific page numbers on which this information appears. Additionally, there may be additional information presented in the PAR on which the auditor may need to provide an additional disclaimer. This disclaimer may be worded as "The other accompanying information included on pages XX, XX, and XX of this PAR is presented for purposes of additional analysis and is not a required part of the financial statements. This information has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it."

U.S. generally accepted accounting principles and (2) [entity] management maintained effective internal control, the objectives of which are as follows:

- Financial reporting: Transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.
- Compliance with laws and regulations: Transactions are executed in accordance with (1) laws governing the use of budget authority, (2) other laws and regulations that could have a direct and material effect on the financial statements, and (3) any other laws, regulations, and government-wide policies identified by OMB audit guidance.

We are also responsible for (1) testing whether [entity's] financial management systems substantially comply with the three FFMIA requirements [omit for non-CFO Act agencies], (2) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (3) performing limited procedures with respect to certain other information appearing in the Annual Financial Statement.

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the financial statements;
- obtained an understanding of the entity and its operations, including its internal control related to financial reporting (including safeguarding assets), and compliance with laws and regulations (including execution of transactions in accordance with budget authority);
- tested relevant internal controls over financial reporting and compliance, and evaluated the design and operating effectiveness of internal control;
- considered the design of the process for evaluating and reporting on internal control and financial management systems under the Federal Managers' Financial Integrity Act;
- tested whether [entity's] financial management systems substantially complied with the three FFMIA requirements [omit for non-CFO Act agencies]; and
- tested compliance with selected provisions of the following laws and regulations: [list laws and regulations]

We did not evaluate all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate.

We did not test compliance with all laws and regulations applicable to [entity]. We limited our tests of compliance to selected provisions of laws and regulations that have a direct and material effect on the financial statements and those required by OMB audit guidance that we deemed applicable to the [entity's] financial statements for the fiscal year ended [date]. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

We performed our audit in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

Agency Comments and Our Evaluation

In commenting on a draft of this report (see appendix x), [entity] concurred [or partially concurred, or did not concur] with the facts and conclusions in our report. Discuss agency comments with auditor evaluation if agency partially concurred or did not concur. [8]

[Auditor's signature]

[Date of audit completion]

[8] If the entity's comments include discussions of corrective action plans or other matters as discussed in FAM 580.84, example wording is: "We did not perform audit procedures on [entity's] written response to the significant deficiencies [and material weaknesses, if applicable] and, accordingly, we express no opinion on it."