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United States Government Accountability Office
Washington, DC 20548

May 28, 2010

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

Subject: PCAOB Rulemaking Docket Matter 030: PCAOB Release No. 2010-001:
*Proposed Auditing Standards Related to Communications with Audit
Committees and Related Amendments to Certain PCAOB Auditing Standards*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) proposed new auditing standards on auditor communications with the audit committee.

We appreciate the PCAOB's efforts to update its auditing standard on auditor communications with audit committees and agree that this communication is a critical element of an effective audit. We also agree that independent, informed, and proactive audit committees are necessary to protect the interests of public company investors, and we believe that the changes in the proposed standard to align more closely with the communication requirements of the Securities and Exchange Commission (SEC) are necessary and appropriate. Similarly, we believe that the proposed standard would provide auditors valuable guidance for enhancing the substance of those communications.

We do have concerns, however, on several important issues in the proposed standard, which we discuss below.

Going Concern

Paragraph 16 of the proposed standard requires that *"the auditor should communicate to the audit committee, when applicable, certain matters relating to his or her evaluation of a company's ability to continue as a going concern."* A footnote in the introduction to the proposed standard recognizes that *"the requirements included in this standard may change depending on the outcome of the Financial Accounting Standards Board's project regarding going concern."* However, due to the importance of the Financial Accounting Standards

Board (FASB) project, users of this proposed standard should be made aware of the ongoing FASB project related to the going concern issue, and that the FASB has recently decided to provide guidance that defines a going concern and clarifies the time period for the going concern assessment. If this PCAOB-proposed standard is finalized before the FASB issues its guidance, the finalized standard should alert users about the pending FASB guidance and the effect it may have on implementation of the PCAOB standard. If the PCAOB's proposed standard is finalized after the FASB issues its guidance, we trust that the finalized standard will incorporate any changes resulting from this project to help ensure that the proposed standard is consistent with any guidance or requirements established by the FASB.

Corrected and Uncorrected Misstatements

Paragraph 17 of the proposed standard requires that *“the auditor should provide the audit committee with the schedule of uncorrected misstatements related to accounts and disclosures that was presented to management.”* However, the comparison to the analogous standards issued by the International Auditing and Assurance Standards Board (IAASB) and the American Institute of Certified Public Accountants (AICPA), listed in Appendix 3, states that *“The proposed standard requires the auditor to provide the audit committee with the **same** [bolding added for emphasis] schedule of uncorrected misstatements related to accounts and disclosures presented to management...”* Therefore, as written, it appears that the PCAOB standard would allow for a summary or other higher-level presentation for the audit committee. If the PCAOB wishes to require that the audit committee be provided with the same schedule of uncorrected misstatements presented to management, rather than a summary of uncorrected misstatements or a schedule that shows only the net effect of the uncorrected misstatements, the requirement should be expressly stated in the standard.

Further, we note that while the requirement in paragraph 17 references the Securities Exchange Act of 1934,¹ there is no mention of the guidance contained in the SEC Staff Accounting Bulletin No. 108, (SAB No. 108) *“Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements”*. The effects of prior year misstatements are integral to evaluating the effect of uncorrected misstatements for the current year. The SEC staff noted in SAB No. 108 that the evaluation of uncorrected misstatements related to prior periods can be accomplished by quantifying an error under both the rollover, or income statement, approach, and the iron curtain, or balance sheet, approach and evaluating the error measured under each approach. As both the “iron curtain” and “rollover” methods are commonly used in practice and the choice of method can significantly affect the auditors’ proposed adjustment decisions, we believe that the proposed standard should alert users of the issue and refer them to the guidance in SAB No. 108.

¹ 48 Stat. 881, 15 U.S.C. § 78a – 78kk

Form and Content of Communications

Paragraph 23 of the proposed standard requires that *“The auditor should communicate to the audit committee the matters in this standard either in writing or orally, unless otherwise specified in this standard. The auditor should document the communications, whether communicated orally or in writing, in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, **to understand the communications made to comply with the provisions of this standard.**”* [bolding added for emphasis]

We note that although the PCAOB, IAASB, and AICPA have issued similar audit documentation standards, only the PCAOB has this very specific documentation requirement in its standard on communications with audit committees. We see no compelling reason for this additional PCAOB requirement, and we are concerned that this PCAOB requirement, taken in combination with the phrase “made to comply with the provisions of this standard” implies a level of specificity of documentation not otherwise required by PCAOB standards. This level of specificity may inhibit effective two-way communication between the auditors and the audit committee. Accordingly, we encourage the PCAOB to remove this requirement from the standard on communications with audit committees.

Lack of objective criteria for determining the adequacy of two-way communications

Paragraph 28 of the proposed standard requires that *“If the auditor determines that the two-way communications between the audit committee and the auditor have not been adequate and the situation cannot be resolved, the auditor should consider taking such actions as: (a) Communicating with the full board of directors; (b) Modifying the auditor's opinion on the basis of a scope limitation; or (c) Withdrawing from the engagement.”*

We are concerned that the proposed standard provides no objective criteria for determining when the two-way communications between the audit committee and the auditor have not been adequate and the situation cannot be resolved, and we believe that the proposed standard should establish objective criteria to determine when the auditor should take actions. In order to improve consistency of application, we recommend adapting and incorporating criteria from ISA 260, “Communication with Those Charged with Governance” paragraph A42, and the clarified SAS, “The Auditor’s Communication With Those Charged With Governance”, as follows:

ISA 260, paragraph A42

Adequacy of the Communication Process (Ref: Para. 22)

A42. The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and **the audit committee** ~~those charged with governance~~; rather, that evaluation may be based on

observations resulting from audit procedures performed for other purposes. Such observations may include:

- The appropriateness and timeliness of actions taken by **the audit committee** ~~those charged with governance~~ in response to matters raised by the auditor. Where significant matters raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.
- The apparent openness of **the audit committee** ~~those charged with governance~~ in **its** ~~their~~ communications with the auditor.
- The willingness and capacity of **the audit committee** ~~those charged with governance~~ to meet with the auditor without management present.
- The apparent ability of **the audit committee** ~~those charged with governance~~ to fully comprehend matters raised by the auditor, for example, the extent to which **the audit committee** ~~those charged with governance~~ probe issues, and question recommendations made to them.
- Difficulty in establishing with **the audit committee** ~~those charged with governance~~ a mutual understanding of the form, timing and expected general content of communications.
- Where all or some of **the audit committee** ~~those charged with governance~~ are involved in managing the entity, **the committee's** ~~their~~ apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.
- Whether the two-way communication between the auditor and **the audit committee** ~~those charged with governance~~ meets applicable legal and regulatory requirements.

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

Sincerely yours,

A handwritten signature in black ink, appearing to read 'James R. Dalkin', with a stylized flourish at the end.

James R. Dalkin
Director
Financial Management and Assurance