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United States Government Accountability Office
Washington, DC 20548

August 12, 2008

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Subject: AICPA Auditing Standards Board (ASB) June 2008, Exposure Draft: Proposed Statement on Standards for Attestation Engagements, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (Supersedes AT Section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*).

This letter provides the U.S. Government Accountability Office's (GAO) comments on the ASB's proposed revisions to AT Section 501. We have major concerns about the provisions of the proposed standard that would prohibit auditors from issuing an adverse opinion any time they encounter restrictions on the scope of an engagement, regardless of the nature or extent of the restrictions. Our concerns on this issue along with other comments and suggestions are summarized below.

Scope Limitations

Proposed AT 501 would require auditors to withdraw from an engagement or disclaim an opinion any time there are restrictions on the scope of an engagement, even when the auditors have identified one or more material weaknesses. We believe that the standard should allow flexibility for auditors to issue an adverse opinion when they have sufficient evidence to conclude that an entity's system of internal control is not effective. The existence of a material weakness provides such evidence.

To incorporate flexibility into the proposed standard, we recommend revising paragraph 118 as follows:

> Paragraph 118: The auditor can express an unqualified or adverse opinion on the entity's internal control only if the auditor has obtained sufficient appropriate evidence to support such an opinion. ~~been able to apply the procedures necessary in the circumstances. If there are~~ If the auditor is unable to obtain sufficient appropriate evidence to support such an opinion due to restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion. If the auditor has

obtained sufficient appropriate evidence to support an adverse opinion in spite of restrictions on the engagement scope, the auditor's report should describe the nature and effect of any scope limitations on the report.

We also recommend revising paragraph 13 of the proposed standard to allow flexibility for auditors to issue an adverse opinion in situations when (1) management refuses to furnish a written assertion, (2) law or regulation does not allow the auditors to withdraw from the engagement, and (3) the auditors have obtained sufficient appropriate evidence to support such an opinion. We recommend revising paragraph 13 as follows:

> Paragraph 13: Management's refusal to furnish a written assertion should cause the auditor to withdraw from the engagement. However, if law or regulation does not allow the auditor to withdraw from the engagement and management refuses to furnish a written assertion, the auditor should disclaim an opinion on internal control unless the auditor has obtained sufficient appropriate evidence to support an adverse opinion.

We apply the above provisions in our audit of the Consolidated Financial Statements of the U.S. Government and believe they have served audit report users well, allowing us to inform them that (1) in our opinion, the federal government did not maintain effective internal control because of the effects of the material weaknesses discussed in our report, and (2) due to limitations on the scope of our work, additional material weaknesses and significant deficiencies may exist that have not been reported.

We believe that a compelling reason exists in the government environment for this type of reporting flexibility due to the need for transparency and the public interest in audits of government entities and those receiving taxpayer funding. We recognize that revising paragraphs 118 and 13 of the proposed standard will cause the proposed standard to diverge from Auditing Standard (A.S.) No. 5, issued by the Public Company Accounting Oversight Board (PCAOB).

Convergence

The summary to the proposed standard states that it converges with A.S. No. 5. We noted a number of differences between the two standards that are not explained in the proposed standard or related material. To assist auditors in appropriately understanding the proposed standard, we recommend including a schedule of differences between the requirements of the proposed standard and A.S. No. 5. Such a schedule would be similar to the schedules published with ASB standards redrafted under the clarity conventions that identify and explain the rationale for all substantive differences between the redrafted Statement on Auditing Standards (SAS) and the corresponding International Standard on Auditing (ISA).

These differences, which are detailed in the attachment to this letter, involve the following issues:

- Certain unconditional requirements in A.S. 5, indicated by the word "must" have been replaced with presumptively mandatory requirements, indicated by the word "should" in proposed AT 501.

- A.S. No. 5 discusses internal control in terms of the ability to *prevent or detect* misstatements, while proposed AT 501 discusses the ability of controls to *prevent, or detect and correct* misstatements. This difference is especially important when it relates to an audit requirement or to critical guidance.

- Proposed AT 501 uses different wording from A.S. No. 5 in the definition of significant deficiency and from both A.S. No. 5 and International Standard on Auditing (ISA) 265 in its definitions of control deficiency and material weakness.

We thank you for considering our comments on these important issues.

Sincerely yours,

McCoy Williams

McCoy Williams
Managing Director
Financial Management and Assurance

Attachment

cc:

Mr. Harold Monk, Chair
Auditing Standards Board

The Honorable Mark W. Olson, Chairman
Public Company Accounting Oversight Board

Mr. John Kellas, Chairman
International Auditing and Assurance Standards Board

Differences Between Proposed AT 501 and A.S. No. 5

Unconditional requirements in A.S. 5, indicated by the word "must," that have been replaced with presumptively mandatory requirements, indicated by the word "should," in proposed AT 501:

Proposed AT 501	A.S. No. 5
Paragraph 9: …the auditor **should** plan and perform the examination to obtain sufficient appropriate evidence…	Paragraph 3: …the auditor **must** plan and perform the audit to obtain competent evidence…
Paragraph 39: The auditor **should** test those entity-level controls that are important to his or her conclusion about whether the entity has effective internal control.	Paragraph 22: The auditor **must** test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting.
Paragraph 40: …the auditor **should** evaluate the control environment at the entity.	Paragraph 25: …the auditor **must** evaluate the control environment at the company.
Paragraph 41: …the auditor **should** evaluate the period-end financial reporting process.	Paragraph 26: …the auditor **must** evaluate the period-end financial reporting process.
Paragraph 82: The auditor **should** evaluate the severity of each deficiency to determine whether the deficiency, individually or in combination, is a material weakness as of the date of management's assertion.	Paragraph 62: The auditor **must** evaluate the severity of each control deficiency that comes to his or her attention to determine whether the deficiencies, individually or in combination, is a material weakness as of the date of management's assessment.
Paragraph 108: The auditor's report on the examination of internal control **should** include the following elements…	Paragraph 85: The auditor's report on the audit of internal control over financial reporting **must** include the following elements…
Bolding above added for emphasis.	

Differences Between Proposed AT 501 and A.S. No. 5

A.S. No. 5 discusses internal control in terms of the ability to *prevent or detect* misstatements, while proposed AT 501 discusses the ability of controls to *prevent, or detect and correct* misstatements.

Proposed AT 501	A.S. No. 5
Paragraph 57: The auditor should evaluate the design effectiveness of controls by determining whether the entity's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the entity's control objectives, and can effectively **prevent, or detect and correct** misstatements caused by errors or fraud that could result in material misstatements in the financial statements.	Paragraph 42: The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively **prevent or detect** errors or fraud that could result in material misstatements in the financial statements.
Paragraph 108j: The auditor's report on the examination of internal control should include … A paragraph stating that, because of inherent limitations, internal control may not **prevent, or detect and correct** misstatements…	Paragraph 85j: The auditor's report on the audit of internal control over financial reporting must include the following elements… A paragraph stating that, because of inherent limitations, internal control over financial reporting may not **prevent or detect** misstatements…
Paragraph 83: The severity of a deficiency depends on •the magnitude of the potential misstatement resulting from the deficiency or deficiencies; and •whether there is a reasonable possibility that the entity's controls will fail to **prevent, or detect and correct** a misstatement of an account balance or disclosure.	Paragraph 63: The severity of a deficiency depends on – • Whether there is a reasonable possibility that the company's controls will fail to **prevent or detect** a misstatement of an account balance or disclosure; and • The magnitude of the potential misstatement resulting from the deficiency or deficiencies.
Paragraph 92: Indicators of material weaknesses in internal control include … identification by the auditor of a material misstatement of financial statements under audit in circumstances that indicate that the misstatement would not have been **detected and corrected** by the entity's internal control…	Paragraph 69: Indicators of material weaknesses in internal control over financial reporting include… Identification by the auditor of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been **detected** by the company's internal control over financial reporting;
Bolding above added for emphasis.	

Differences Between Proposed AT 501 and A.S. No. 5

Proposed AT 501 uses different wording from A.S. No. 5 in the definition of significant deficiency and from both A.S. No. 5 and International Standard on Auditing (ISA) 265 in its definitions of control deficiency and material weaknesses:

	Proposed AT 501	**A.S. No. 5**	**Proposed ISA 265**
Deficiency	Page 10: A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to **prevent, or detect and correct** misstatements on a timely basis.	Page 431, paragraph A3: A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to **prevent or detect** misstatements on a timely basis.	Paragraph 6(a): A control that is either missing or is designed, implemented or operated in such a way that it is unable to **prevent, or detect and correct**, misstatements in the financial statements on a timely basis.
Significant Deficiency	Page 11: A deficiency, or a combination of deficiencies, in internal control that, **in the auditor's professional judgment**, is less severe than a material weakness, yet important enough to merit attention by those charged with governance.	Page 433, paragraph A11: A deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.	Paragraph 6(b): A deficiency or combination of deficiencies in internal control relevant to the audit that, **in the auditor's professional judgment**, is of sufficient importance to merit the attention of those charged with governance.
Material Weakness	Page 11: A deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be **prevented, or detected and corrected** on a timely basis.	Page 433, paragraph A7: A deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be **prevented or detected**	Proposed ISA 265 does not define the term material weakness but states in paragraph A8: Law or regulation in some jurisdictions may establish requirements for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) details of

		on a timely basis.	specific types of deficiencies in internal control that the auditor has identified during the audit, and may define terms such as "material weakness" for this purpose.
Bolding above added for emphasis.			