



G A O

Accountability * Integrity * Reliability

Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

November 28, 2007

International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017

Subject: International Auditing and Assurance Standards Board (IAASB) July 2007
Exposure Drafts:

- *ISA 700, The Independent Auditor's Report on General Purpose Financial Statements*
- *ISA 705 (Revised), Modifications to the Opinion in the Independent Auditor's Report*
- *ISA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor's Report*
- *ISA 800 (Revised), Special Considerations--Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*
- *ISA 805 (Revised), Engagements to Report on Summary Financial Statements*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the IAASB's proposed revisions to the International Standards on Auditing (ISAs) listed above.

GAO is committed to providing leadership in modernizing and transforming the accountability profession in the public and private sectors, both domestically and internationally. Accordingly, we commend the IAASB's efforts in developing global auditing standards, including the organization's work to improve the clarity and structure of the auditors' report. This work is crucial for improving the quality of auditing world wide.

In our review of the proposed standards, we identified certain aspects of the standards that should be either clarified or better defined for users to effectively apply the standards. These matters are discussed further in the attachments to this letter

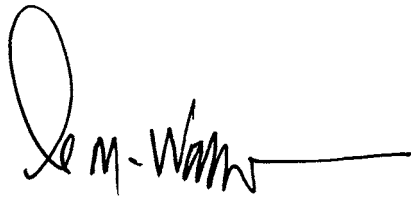
We are concerned that the IAASB's accelerated schedule for revising and redrafting all the ISAs by late 2008 does not allow sufficient time for users to consider the revisions to the various standards in the aggregate. Accordingly, we recommend extending the IAASB's schedule for revising and redrafting the ISAs to allow adequate time for the IAASB to finalize one set of standards before requesting comment on subsequent proposed standards. We believe such an extension is needed so that stakeholders can evaluate the effect of prior revisions on current projects.

For example, in the ISA 700 Explanatory Memorandum, the IAASB has requested comment on the proposal to limit the scope of ISA 450, *Evaluation of Misstatements Identified during the Audit*, to evaluating the effect of uncorrected misstatements, while ISA 700 would discuss evaluating whether the financial statements as a whole are free from material misstatement. However, until the IAASB issues finalized ISA 450, potential respondents cannot draw valid conclusions on this matter.

Similarly, the IAASB has requested comment on the proposed guidance in ISA 700, which addresses financial reporting frameworks described by reference to International Financial Reporting Standards (IFRS). Proposed ISAs 705, 706, 800, and 805 also discuss financial reporting frameworks. In April 2007, the IAASB exposed for comment proposed revised and redrafted ISA 200, *Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with ISAs*, which includes definitions and guidance on financial reporting frameworks. Until the final revised and redrafted ISA 200 is released, potential respondents cannot draw valid conclusions on the guidance on financial reporting frameworks in the proposed ISAs.

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

Sincerely yours,

A handwritten signature in black ink, appearing to read "D. M. Walker", with a long horizontal line extending to the right.

David M. Walker
Comptroller General
of the United States

Attachments

cc: Mr. James M. Sylph, Technical Director
International Auditing and Assurance Standards Board

The Honorable Christopher Cox, Chairman
Securities and Exchange Commission

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

Mr. Harold Monk, Chair
Auditing Standards Board

GAO Comments Related to ISA 700 - The Independent Auditor's Report on General Purpose Financial Statements

Objectives

We recommend revising the ISA 700 objectives to better summarize how auditors form and express their opinion on the financial statements, as follows:

Paragraph 5: The objectives of the auditor are to:

- (a) Form an opinion on the financial statements based on an evaluation of ~~the conclusions drawn from~~ the audit evidence obtained; and
- (b) Express clearly that opinion through a written report that explains the basis ~~for~~ ~~of~~ the opinion.

Title of ISA 700

The standards and guidance on forming an opinion on the financial statements in paragraphs 8-16 of ISA 700, *The Independent Auditor's Report on General Purpose Financial Statements*, are an essential part of reporting on the financial statements. Therefore, we recommend changing the title of this standard to reflect that this ISA includes this information. We suggest renaming ISA 700 to *Forming an Opinion and Reporting on General Purpose Financial Statements* so that users will know where to find this important information.

Special Considerations in the Audit of Public Sector Entities

1. Paragraph 18 of the proposed standard requires the auditor's report to have a title that clearly indicates that it is the report of an independent auditor. However, in some circumstances auditors employed by government entities may be required by law to audit certain entities even though the auditors have organizational impairments to their independence. In circumstances when government auditors cannot decline to perform these audits, U.S. *Government Auditing Standards* require the auditors to report the impairment in the scope section of the auditors' report. The proposed standard should state that in these circumstances, it would not be appropriate for the title of the auditors' report to suggest that the auditors are independent.
2. The objectives of an audit of a public sector entity are often broader than expressing an opinion on financial statements and may include additional responsibilities, such as reporting on internal control over financial reporting and/or compliance with applicable laws and regulations. We believe it would be helpful to users if the proposed standard recognized these additional considerations.

**GAO Comments Related to ISA 700 - The Independent Auditor's
Report on General Purpose Financial Statements**

3. We believe that the term “compliance framework” may cause confusion for auditors and users of audited financial statements, since the term compliance is used in the public sector to describe conforming with legislative and regulatory requirements that apply to government entities and entities that receive government funding. We are especially concerned since, as noted in our attached letter, the IAASB has not released the finalized ISA 200, and we are not sure if the concerns we expressed in our September 15, 2007, comment letter about the definition of the term “compliance framework,” in proposed ISA 200 have been addressed. Accordingly, we recommend that the IAASB replace the term “compliance framework” in paragraph 16, 32, A-14 and illustration #2 on page 29 with “financial reporting framework that conforms with relevant laws and regulations,” which is consistent with the terminology used in Illustration 2 of proposed ISA 700.

Dating the Auditors’ Report

We recommend that the IAASB modify paragraph 38(a) to indicate that, with regard to dating the auditors’ report, sufficient appropriate audit evidence includes evidence that the audit documentation has been reviewed and that the entity’s financial statements, including disclosures, have been finalized. We recommend replacing “prepared” with “finalized” to be clear in indicating that the auditors’ report shall be dated after all changes to the financial statements are made. These revisions would encourage consistency of application, and accordingly, we recommend revising the proposed ISA as follows:

Paragraph 38: The auditor’s report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor’s opinion on the financial statements. Sufficient appropriate audit evidence shall include evidence that:

(a) the audit documentation has been reviewed, All the statements that comprise the financial statements have been prepared; and

(b) the entity’s financial statements, including disclosures, have been finalized, and those with the recognized authority have asserted that they have taken responsibility for them.

**GAO Comments Related to ISA 705 (Revised) -
Modifications to the Opinion in the Independent Auditor's Report**

Determining the Type of Modified Opinion

We believe that clearer requirements and guidance are needed to assist auditors in determining the type of modified opinion to issue. For instance, we believe that the definition of the term “pervasive” should clearly state that, when used in the context of a modified opinion, it would apply to a misstatement, an aggregation of misstatements, or an inability to obtain sufficient appropriate audit evidence that (a) could cause the financial statements taken as a whole to be misleading, or (b) are so widespread that the auditors cannot determine if the financial statements taken as a whole are fairly presented. Accordingly, we recommend revising paragraph 8 of proposed ISA 705 as follows:

Paragraph 8: For purposes of the ISAs, the following term has the meaning attributed below:

Pervasive – ~~in the context of misstatements or an inability to obtain sufficient appropriate audit evidence,~~ the term pervasive is used to describe the effects or possible effects on the financial statements of a misstatement, or aggregation of misstatements, or an inability to obtain sufficient appropriate audit evidence matter that, in the auditor’s judgment, ~~are not confined to specific elements, accounts or items of the financial statements, or, if confined, represent or could represent a substantial proportion of the financial statements.~~

a. cause the financial statements taken as a whole to be misleading, or

b. are so widespread that the auditors cannot determine if the financial statements taken as a whole are fairly presented.

In using this proposed definition of pervasive, the proposed standard could be revised to state that auditors would issue:

a. an adverse opinion when a material misstatement or an aggregation of misstatements is so pervasive that they cause the financial statements taken as a whole be misleading, or

b. a disclaimer of opinion when the inability to obtain sufficient appropriate audit evidence is so widespread that the auditors cannot determine if the financial statements taken as a whole are fairly presented.

**GAO Comments Related to ISA 705 (Revised) -
Modifications to the Opinion in the Independent Auditor's Report**

Communication with Those Charged with Governance

We recommend revising the standard and guidance on communicating a modification of opinion to those charged with governance. Revisions are needed, we believe, in order clearly indicate that the auditors make the decision whether to modify the auditors' report and do not need the agreement of those charged with governance to do so. Accordingly, we recommend revising paragraphs 30 and A 30 as follows:

Paragraph 30: When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that lead to the expected modification and the ~~nature~~~~proposed wording~~ of the modification. (Ref: Para. A30)

Paragraph A30: Communicating with those charged with governance the circumstances that lead to ~~a an-expected~~ modification to the auditor's opinion and the ~~nature~~~~proposed wording~~ of the modification enables:

- (a) The auditor to give notice to those charged with governance of the ~~intended~~ modification(s) and the reasons (or circumstances) for the modification(s);
- (b) The auditor ~~to informs~~ ~~seek the concurrence of~~ those charged with governance regarding the facts of the matter(s) giving rise to the ~~expected~~ modification(s), ~~and/or~~ ~~to~~ confirm matters of disagreement with management as such; and
- (c) Those charged with governance to have an opportunity, where appropriate, to provide the auditor with further information and explanations in respect of the matter(s) giving rise to the ~~expected~~ modification(s).

**GAO Comments Related to
ISA 800 (Revised) - Special Considerations--Audits of
Special Purpose Financial Statements and Specific Elements,
Accounts, or Items of a Financial Statement, and
ISA 805 (Revised) - Engagements to Report on
Summary Financial Statements**

Definitions

We believe that consistency of practice is aided by the use of clear, easily understood definitions in the auditing standards. This is especially important with the standards being translated into numerous languages. We believe the definitions included in ISAs 800 and 805 would provide clearer guidance by using words or terms other than those being defined. For example, we would revise ISA 800, paragraph 7(b) and ISA 805, Paragraph 3(a), as follows:

ISA 800, paragraph 7(b): Special purpose framework – A structured representation of financial information that is A financial reporting framework designed to meet the financial information needs of specific users who understand the structured representation; such a structured representation is not designed to meet the needs of a wide range of users.

ISA 805, Paragraph 3(a): Applied criteria – The laws, regulations, contracts, grant agreements, standards, and/or framework followed ~~criteria applied~~ by management in preparing and presenting the summary financial statements.

Special Considerations in the Audit of Public Sector Entities

We encourage revising the proposed wording on restricted use or distribution of the auditor's report to recognize that in audits of government entities, the auditors' report is often a matter of public record and not subject to restriction. Accordingly, we recommend revising paragraphs 14 and A13 and illustrated reports 1 through 4 in proposed ISA 800 as well as paragraph 21 of proposed ISA 805, as follows:

Proposed ISA 800:

Intended Restriction on Use and Distribution

Paragraph 14: The auditor's report on the special purpose financial statements shall include a statement that the financial statements are prepared in accordance with a special purpose framework and that, as a result, the financial statements and related auditor's report may not be suitable for another purpose. The statement shall be included in a separate paragraph following the auditor's opinion and under the heading Other Matter – Intended Restriction on Use and Distribution. (Ref: Para. A13-A14)

**GAO Comments Related to
ISA 800 (Revised) - Special Considerations--Audits of
Special Purpose Financial Statements and Specific Elements,
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ISA 805 (Revised) - Engagements to Report on
Summary Financial Statements**

Intended Restriction on Use and Distribution (Ref: Para. 14)

Paragraph A13: The special purpose financial statements and related auditor's report may be used for purposes other than those for which they were intended. For example, a regulator may require certain entities to place the special purpose financial statements and related auditor's report on public record. To avoid misunderstandings, the auditor alerts users of the auditor's report that the financial statements are prepared in accordance with a special purpose framework and, therefore, may not be suitable for another purpose.

Paragraph A14: The auditor may also consider including a statement in the auditor's report that it is intended solely for the intended users, ~~and should not be distributed to or used by other parties.~~ Where this is the case, the heading referred to in paragraph 14 would read Other Matter – Intended Restriction on Use and Distribution.

Illustrations 1-4: Other Matter Paragraph — Intended Restriction on Use [and Distribution]

As indicated above, the financial statements are prepared in accordance with the financial reporting provisions of section Z of the contract to assist ABC Company to comply with the provisions of the contract. The financial statements and related auditor's report may not be suitable for another purpose. ~~{Our report is intended solely for ABC Company and DEF Company and should not be distributed to or used by parties other than ABC Company or DEF Company.}~~

Proposed ISA 805:

Intended Restriction on Use or Distribution

Paragraph 21: When the use or distribution of the auditor's report on the audited financial statements is intended solely for intended certain users, ~~restricted,~~ the auditor's report shall include a statement that the audited financial statements are prepared in accordance with a special purpose framework and that, as a result, the summary financial statements and related auditor's report may not be suitable for another purpose. The statement shall be included in a separate paragraph following the auditor's opinion and under the heading Other Matter –Intended Use. ~~the auditor shall restrict use or distribution of the auditor's report on the summary financial statements accordingly.~~

**GAO Comments Related to
ISA 800 (Revised) - Special Considerations--Audits of
Special Purpose Financial Statements and Specific Elements,
Accounts, or Items of a Financial Statement**

Special Purpose Financial Statement Titles

We recommend adding guidance to proposed ISA 800 advising users that terms such as *balance sheet*, *statement of financial position*, *income statement*, *statement of changes in equity*, and *cash flow statement* are generally applied only to general purpose financial statements. When forming an opinion on special purpose financial statements or a specific element, account or item of a financial statement, it is important for auditors to determine if the financial statements (or specific element, account or item of a financial statement) are suitably titled, for instance, with terms such as *statement of assets and liabilities arising from cash transactions* or *statement of income—statutory basis*. When the auditors believe that special purpose financial statements (or a specific element, account or item of a financial statement) are not suitably titled, the auditors should evaluate the effect this may have on their opinion.

For this reason, we recommend revising, in Illustrations 1 and 2 on pages 18-21, the titles used to describe special purpose financial statements. In these illustrations, we would replace *balance sheet*, *income statement*, and *cash flow statement* with titles such as *statement of assets and liabilities in accordance with section Z of the contract with DEF Company (or in accordance with the applicable income tax laws of Country X.)*