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Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

April 30, 2003

Mr. James S. Gerson, Chair
Auditing Standards Board
Mr. Charles E. Landes, Director
Audit and Attest Standards
American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

Re: Proposed Statements on Auditing Standards

Messrs. Gerson and Landes:

This letter provides GAO's comments on the AICPA's December 2, 2002, exposure draft of seven proposed Statements on Auditing Standards Related to Audit Risk. We commend the AICPA's efforts to enhance auditor assessment of risk and the linkage between the auditor's risk assessment and the performance of audit procedures. We agree with the AICPA's goal of developing stronger auditing standards that are intended to effect a substantial change in auditor performance and thereby improve audit effectiveness. We support the objectives of the exposure draft and are especially pleased that the proposed standards call for the following:

- Strengthening the requirement for auditors to understand and assess the entity and its environment, including internal control, and linking this understanding to risk assessment and the design of audit procedures.

- Eliminating the default of assessing inherent and control risk at the "maximum" by requiring auditors to document the basis for their risk assessment, regardless of the risk assessment level.

- Placing greater emphasis on testing financial statement disclosures for material misstatement.

GAO has specific recommendations for improving five of the proposed standards, as described in the five attachments. GAO's suggestions are aimed at achieving the AICPA's goal of stronger, more definitive auditing standards that will improve audit effectiveness. We are making specific recommendations for changes to the following proposed statements:

- Audit Risk and Materiality in Conducting an Audit (Attachment 1),
- Planning and Supervision (Attachment 2),

- Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (Attachment 3),
- Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (Attachment 4), and
- Amendment to Statement on Auditing Standards No. 39, Audit Sampling (Attachment 5).

GAO and the federal Inspector General community have already formally adopted many of the attached suggestions through the *Financial Audit Manual,* issued by the U.S. General Accounting Office and the President's Council on Integrity & Efficiency in July 2001 (GAO-01-765G). We thank you for considering our comments on these very important issues.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

Attachments - 5

cc: International Auditing and Assurance Standards Board of the International Federation of Accountants
Auditing Standards Committee of the International Organization of Supreme Audit Agencies
Public Company Accounting Oversight Board

Audit Risk and Materiality in Conducting an Audit

GAO Proposed Change:

Additional guidance should be included for applying the concept of materiality, including guidance on estimating materiality, determining an appropriate materiality base, and using materiality in audit planning and reporting. In particular, the standard should require auditors to quantify and document the consideration of materiality.

Rationale for and Benefits of Proposed Change:

A specific materiality framework will provide for a consistent flow of the auditor's materiality consideration from audit planning, through fieldwork, to evaluating audit results and reporting. Requiring auditors to document the method of determining planning materiality and their consideration of materiality throughout the audit should result in a more consistent application of the materiality concept throughout the audit by all levels of audit staff.

Suggested Wording of Proposed Change:

Paragraph 3. The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles, while other matters are not important. In performing the audit, the auditor is concerned with matters that could be material to the financial statements. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are not material to the financial statements are detected. **The auditor should document the planning materiality selected, the method of determining planning materiality, the auditor's consideration of materiality in designing the nature, timing, and extent of audit procedures, and the auditor's consideration of materiality in evaluating the results of these procedures.**

(New paragraphs to proceed paragraph 15.) **The auditor should estimate planning materiality in relation to the element of the financial statements that is most significant to the primary users of the statements (the materiality base). The auditor uses judgment in determining the appropriate element of the financial statements to use as the materiality base. Also, since the materiality base normally is determined using unaudited preliminary information in the planning phase, the auditor should estimate the year-end balance of the materiality base.**[1]

[1]Excerpted from U.S. General Accounting Office / President's Council on Integrity & Efficiency, *Financial Audit Manual* (GAO-01-765G July 2001), pgs. 230-3, ¶230.07 - 230.08.

Audit Risk and Materiality in Conducting an Audit (cont.)

Depending on the entity's particular circumstances, other elements of the financial statements that may be useful in making a quantitative assessment of the materiality of misstatements include income before or after taxes, current assets, net working capital, total assets, total revenues, gross profit, total equity, and cash flows from operations. The element or elements selected should consider, in the auditor's judgment, the measures most likely to be considered important by the financial statement users.[2]

Planning materiality generally should be a small percent of the materiality base and tolerable misstatement should be an amount less than planning materiality. Materiality should be used in determining the extent of specific audit procedures, including sample sizes, and in evaluating the results of audit procedures.

[2]Suggested wording is parallel to the AICPA's proposed paragraph 70 in "Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained."

Planning and Supervision

GAO Proposed Change:

Paragraph 12 states that the auditors should consider the implications that non-audit services may have on the audit, but does not include the potential impact on independence as one of the implications. Because providing certain non-audit services can impact the auditor's independence, we suggest adding the sentence and the reference to independence shown in bold in paragraph 12. In addition, we suggest striking the language "and consider how the expected conduct and scope of the audit may be affected" because it implies that the auditor may be able to reduce the scope of the audit work based on the nonaudit services provided.

Rationale for and Benefits of Proposed Change:

These changes would make the Statement more consistent with the *Omnibus Proposal of Professional Ethics Division Interpretations and Rulings* dated March 19, 2003 and with GAO's Independence Standards.[1]

Suggested Wording of Proposed Change:

Paragraph 12. In discussing matters that may affect the audit with firm personnel responsible for providing nonaudit services to the entity, the auditor should consider the nature of nonaudit services that have been performed. The auditor should assess whether the services involve matters that might be expected to affect the entity's financial statement or the performance of the audit, for example, tax planning or recommendations on a cost accounting system. If the auditor decides that the performance of the nonaudit services or the information likely to have been gained from it may have implications for the audit, the auditor should discuss the matter with personnel who rendered the services. ~~and consider how the expected conduct and scope of the audit may be affected.~~ **The auditor should also consider whether the nonaudit services create impairments to independence in fact or appearance.** In some cases, the auditor may find it useful to review the pertinent documentation prepared for the nonaudit engagement as an aid in determining the nature of the services rendered or the possible audit implications.

[1] *Government Auditing Standards* (1994 revision), Amendment No. 3, *Independence* (GAO-02-388G) ¶3.17 – 3.26.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

GAO Proposed Change #1:

Guidance for the required discussions among the audit team should be expanded to include consideration of the following essential issues:

- areas of significant audit risk;
- unusual accounting procedures used by the client;
- important control systems;
- materiality at the financial statement level, the account balance level, the assertion level and in evaluating results; and
- how materiality will be used to determine the extent of testing.

Rationale for and Benefits of Proposed Change #1:

Additional guidance will improve the quality of the required discussions among the audit team and will help new audit team members achieve a better understanding of risks of material misstatement.

Suggested Wording of Proposed Change #1:

Paragraph 18. An objective of the discussion is to provide an opportunity for more experienced audit team members, including the auditor with final responsibility for the audit, to share their insights based on their knowledge of the entity and its environment, including its internal control, and for the team members to exchange information about the risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement. As required by SAS No. 99, particular emphasis should be given to the susceptibility of the entity's financial statements to fraud. **The audit team should also discuss other critical issues, including areas of significant audit risk, unusual accounting procedures used by the client; important control systems; materiality at the financial statement level, the account balance level, the assertion level; and how materiality will be used to determine the extent of testing.** The discussion also should address application of generally accepted accounting principles to the entity's facts and circumstances and in light of the entity's accounting policies. Based on these discussions, members of the audit team may gain a better understanding of the potential for material misstatement of the financial statements resulting from fraud or error in the specific areas of the audit assigned to them, and how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about audit procedures.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (cont.)

GAO Proposed Change #2:

Paragraph 3 states that "the requirements and guidance set forth in this standard are to be applied in conjunction with the requirements and guidance provided in other SASs. In particular, the auditor's considerations relevant to fraud are discussed in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA *Professional Standards, vol. 1,* AU Sec 316.)"

However, the "Risk Assessment Procedures" section of the proposed standard, as written, lacks any further mention of the auditor's assessment of fraud risk. The "Risk Assessment Procedures" section of the proposed standard should contain a direct link to the auditor's consideration of fraud.

Rationale for and Benefits of Proposed Change #2 :

Assessing fraud risk is an important part of the overall risk assessment process, and auditors will benefit from a clearer link to the requirements for considering fraud.

Suggested Wording of Proposed Change #2:

Paragraph 6. Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. **Throughout this process, the auditor should also follow the guidance in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit.*** As described in the proposed SAS *Audit Evidence*, audit procedures to obtain the understanding are referred to as *risk assessment procedures* because some of the information obtained by performing such procedures may be used by the auditor as audit evidence to support assessments of the risks of material misstatement of the financial statements. In addition, in performing risk assessment procedures, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions about the operating effectiveness of controls, even though such audit procedures were not specifically planned as substantive procedures or as test of controls. The auditor may choose to perform substantive procedures or tests of control concurrently with risk assessment procedures because it is efficient to do so.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (cont.)

GAO Proposed Change #3 :

We recommend adding a new paragraph that would treat consideration of fraud in a similar manner as paragraph 11 treats SAS No. 56, *Analytical Procedures*.

Rationale for and Benefits of Proposed Change #3 :

Consideration of fraud is a key part of the auditor's risk assessment process, and should be included in that section of the standards.

Suggested Wording of Proposed Change #3 :

We suggest adding the following paragraph after paragraph 11.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit,* requires that the auditor specifically assess the risk of material misstatement of the financial statements due to fraud and states that the auditor should consider that assessment in designing audit procedures to be performed. In making this assessment, the auditor should also consider fraud risk factors that relate to both material misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets in each of the following categories: (1) management's characteristics and influence over the control environment, (2) industry conditions, (3) operating characteristics and financial stability, (4) susceptibility of assets to misappropriations, and (5) controls. The auditor's response to the fraud risk assessment is influenced by the nature and significance of the risk factors identified as being present. In some circumstances, the auditor may conclude that the conditions indicate a need to modify audit procedures. In these circumstances, the auditor should consider whether the assessment of the risk of material misstatement due to fraud calls for an overall response, one that is specific to a particular account balance, class of transactions or assertions, or both. However, since such risk factors do not necessarily indicate the existence of fraud, the results of the fraud risk assessment provide only a broad initial indication about whether a material misstatement due to fraud may exist. Accordingly, the auditor should consider the results of the fraud risk assessment performed during planning along with other information gathered in identifying the risks of material misstatements.[1]

[1]Excerpted from SAS No. 99, *Consideration of Fraud in a Financial Statement Audit.*

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (cont.)

GAO Proposed Change #4 :

In paragraph 113(d), we recommend adding the language shown in bold to further enhance the linkage between the auditor's understanding of the entity and its control environment, and the auditor's assessment of risk.

Rationale for and Benefits of Proposed Change #4 :

Documenting the basis for the risk assessment will enhance the linkage between the auditor's understanding of the entity and the risk assessment.

Suggested Wording of Proposed Change #4:

Paragraph 113. The auditor should document:

a. The discussion among the audit team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud, including how and when the discussion occurred, the audit team members who participated, and the subject matter discussed.

b. The understanding obtained regarding each of the aspects of the entity and its environment identified in paragraph 25, including each of the components of internal control identified in paragraph 49, to assess risks of material misstatement of the financial statements; the sources of information from which the understanding was obtained; and the risk assessment procedures.

c. The risks identified as a result of the requirements in paragraphs 102 and 108 and the controls related to those risks that were evaluated.

d. The results of the risk assessment both at the financial statement level and at the assertion level, **and the basis for the risk assessment.**

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (cont.)

GAO Proposed Change #5 :

The wording in numerous paragraphs of this Statement is ambiguous regarding whether certain procedures are required. The wording should clearly state that certain indicated procedures are required.

Rationale for and Benefits of Proposed Change #5 :

Adding the word "should" to the standards, as indicated below, will clearly convey that auditors are required to perform these audit procedures. As presently written, the reader may misinterpret the procedures as being merely descriptive.

Suggested Wording of Proposed Change #5:

Paragraph 9. In determining the others within the entity to whom inquiries may be directed, and the extent of those inquiries, the auditor **should** consider~~s~~ what information may be obtained that would help in identifying risks of material misstatement. For example, inquiries directed to in-house legal counsel **should include** ~~may relate to~~ such matters as litigation, compliance with laws and regulations, warranties, post-sales obligations, and the meaning of contract terms. Inquiries directed to internal audit personnel may relate to their activities concerning the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to any findings from these activities. Inquiries directed to sales personnel may relate to changes in the entity's sales trends or contractual arrangements with major customers.

Paragraph 10. The auditor **should** also consider~~s~~ whether inquiries of others outside the entity may be helpful in obtaining an understanding of the entity and its environment and in identifying risks of material misstatement. For example, the auditor **should** ~~may~~ consider **the need** ~~that in a particular case it is appropriate~~ to make inquiries of the entity's external legal counsel, customers, and suppliers, or valuation specialists that the entity has used.

Paragraph 21. In addition, audit team members **should** communicate and share information obtained throughout the audit that may affect the assessment of the risks of material misstatement due to fraud or error or the audit procedures performed to address the risks.

Paragraph 23. If the auditor intends to use information about the entity and its environment obtained in prior periods, he or she should determine whether changes have occurred that may affect the relevance of such information in the current audit.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (cont.)

For example, audit procedures performed in previous audits may provide audit evidence about the entity's organizational structure, business, and controls, as well as information about past misstatements in the financial statements and whether or not they were corrected on a timely basis, which assists the auditor in assessing risks of material misstatement. However, such information may have been rendered irrelevant by changes in the entity or its environment. The auditor **should** make~~s~~ inquiries and perform~~s~~ other appropriate risk assessment procedures, such as walk-throughs of systems, to determine whether changes have occurred that may affect the relevance of such information.

Paragraph 24. When relevant to the audit, the auditor **should** also consider~~s~~ other information such as that obtained from the auditor's client acceptance and continuance process or, where practicable, experience gained on other engagements performed for the entity, for example, engagements to review interim financial information.

Paragraph 29. The industry in which the entity operates may be subject to specific risks arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and costs that give rise to risks of material misstatement of the financial statements. In such cases, the auditor **should** consider~~s~~ whether the audit team includes members with sufficient relevant knowledge and experience.

Paragraph 32. The auditor should obtain an understanding of the entity's application of accounting policies. The auditor should consider whether the entity's selection and application of accounting policies are appropriate for its business and consistent with generally accepted accounting principles including accounting practices common to the industry, or with a comprehensive basis of accounting other than generally accepted accounting principles. The understanding **should** encompasse~~s~~ the methods the entity uses to account for significant and unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. Significant accounting policies include policies in such areas as revenue recognition, off-balance-sheet financing, and accounting for equity investments. The auditor **should** also identifi~~es~~**y** financial reporting standards and regulations that are new to the entity and consider~~s~~ when and how the entity will adopt such requirements.

Paragraph 33. The presentation of financial statements in conformity with generally accepted accounting principles **should** include~~s~~ adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (cont.)

statements and their appended notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth. The auditor **should** consider~~s~~ whether a particular matter should be disclosed by the entity in light of the circumstances and facts of which the auditor is aware at the time.

Paragraph 41. The auditor **should** inquire~~s~~ about business risks that management has identified and consider~~s~~ whether they may result in material misstatement of the financial statements. During the audit, the auditor may identify risks of material misstatement that management failed to identify. In such cases, the auditor **should** consider~~s~~ why the entity's risk assessment process failed to identify those risks and whether the process is appropriate to its circumstances.

Paragraph 46. Performance measures, whether external or internal, create pressures on management that, in turn, may motivate management to misstate the financial statements. The auditor **should** consider~~s~~ whether such pressures have created risks of material misstatement (see SAS No. 99).

Paragraph 47. In many entities, much of the information used in performance measurement may be produced by the entity's information system. If management assumes that data used for reviewing the entity's performance are accurate without having a basis for that assumption, errors may exist in the information, potentially leading management to incorrect conclusions about performance. When the auditor intends to make use of the performance measures for the purpose of the audit (for example, for analytical procedures), the auditor **should** consider~~s~~ whether the information related to management's review of the entity's performance provides a reliable basis and is sufficiently precise for such a purpose. If making use of performance measures, the auditor **should** consider~~s~~ whether they are precise enough to detect material misstatements.

Paragraph 70. In understanding the control environment, the auditor **should** obtain~~s~~ audit evidence about its implementation. For example, through inquiries of management and employees, the auditor **should** ~~may~~ obtain an understanding of how management communicates to employees its views on business practices and ethical behavior, and how management demonstrates behavior consistent with these views. The auditor considers whether management may have established a formal code of conduct but nevertheless acts in a manner that condones violations of that code or authorizes exceptions to it.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (cont.)

Paragraph 71. When obtaining an understanding of the control environment, the auditor **should** also consider~~s~~ the collective effect on the control environment of strengths and weaknesses in various control environment elements. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, owner-manager controls may mitigate a lack of segregation of duties in a small business, or an active and independent board of directors may influence the philosophy and operating style of senior management in larger entities. Alternatively, management's failure to commit sufficient resources to address security risks presented by IT may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or by allowing unauthorized transactions to be processed. Similarly, human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may not mitigate a strong bias by top management to overstate earnings.

Paragraph 77. The auditor **should** also obtain~~s~~ an understanding of how the incorrect processing of transactions is resolved, for example, whether there is an automated suspense file and how it is used by the entity to ensure that suspense items are cleared out on a timely basis, and how system overrides or bypasses to controls are processed and accounted for.

Paragraph 79. The auditor **should** obtain~~s~~ an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances. This includes obtaining an understanding of how transactions are generated within the entity's business processes. An entity's business processes are the activities designed to develop, purchase, produce, sell, and distribute an entity's products and services; ensure compliance with laws and regulations; and record information, including accounting and financial reporting information.

Paragraph 94. The auditor **should** use~~s~~ information gathered by performing risk assessment procedures to obtain an understanding of the entity and its environment, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor **should** use~~s~~ the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed. When the risk assessment is based on an expectation that controls are operating effectively to prevent or detect a material misstatement at the assertion level, the auditor is required to perform tests of controls to obtain audit evidence that the controls are operating effectively, as described in the proposed SAS *Performing Procedures.*

Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained

GAO Proposed Change #1:

The discussion of evaluating audit findings in paragraphs 69 – 82 of the proposed statement should clarify the requirement for the auditor to evaluate the uncertainty remaining after considering the impact of known and likely misstatements. This uncertainty relates to the imprecision of audit procedures, including sampling uncertainty, imprecision of analytical procedures, and untested items. The auditor should document this consideration of known and likely misstatement and other uncertainties resulting from the imprecision of audit procedures.

Rationale for and Benefits of Proposed Change #1:

GAO's recommended changes would provide for a more rigorous assessment of the risk of material misstatement of the financial statements.

Suggested Wording of Proposed Change #1:

Paragraph 82. If the auditor concludes that the effects of likely misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, the auditor should recognize that they could still be materially misstated because of further misstatement **remaining undetected. The undetected misstatement could exist, for example, due to the imprecision of audit procedures, including sampling uncertainty, imprecision of analytical procedures, and untested items.**[1] As the aggregate likely misstatements increase, the risk that the financial statements may be materially misstated also increases. The auditor can reduce this risk of material misstatement by modifying the nature, timing, and extent of planned audit procedures in performing the audit. (See the proposed SAS *Audit Risk and Materiality in Conducting an Audit*, paragraph 30.) Nevertheless, if the auditor believes that such risk is unacceptably high, the auditor should perform additional audit procedures or satisfy himself or herself that the entity has adjusted the financial statements to reduce the risk of material misstatement to an appropriate level. **The auditor should document this consideration of known and likely misstatements and uncertainties resulting from the imprecision of audit procedures.**

[1]Excerpted from U.S. General Accounting Office / President's Council on Integrity & Efficiency, *Financial Audit Manual* (GAO-01-765G July 2001), pg. 540-5, ¶540.11.

Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (cont.)

GAO Proposed Change #2:

The discussion of rotating tests of the operating effectiveness of controls in paragraphs 39 - 41 should be expanded to discuss

- conditions for rotating control tests,
- situations when rotation testing is not appropriate, and
- documentation requirements.

Rationale for and Benefits of Proposed Change #2:

GAO's recommended changes will improve the linkage between assessed risks and the nature, timing, and extent of audit procedures and will encourage more systematic consideration of the frequency of tests of controls.

Suggested Wording of Proposed Change #2:

Paragraph 39. If the auditor plans to rely on controls that management indicates have not changed since they were last tested, the auditor should test the operating effectiveness of such controls at least every third audit. In considering the length of the time period that may elapse before retesting a control, the auditor considers the control environment, the entity's monitoring of controls, general IT controls, and the effectiveness of the control and its application by the entity. However, the auditor is required to retest a control being relied on at least every third audit, because the longer the time elapsed since the control was tested, the less audit evidence is provided about its operating effectiveness in the current audit period. Factors that decrease the period for retesting include a weak control environment, manual controls, personnel changes, or weak general controls. The higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time elapsed is likely to be.

Accordingly, the auditor should use rotation only when the following conditions exist:

1. **The auditor possesses a "foundation" of audit evidence on which to develop current audit conclusions.**

2. **Control risk is evaluated as low; the control environment, risk assessment, communication, and monitoring are strong; and inherent and fraud risk factors are low.**

Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (cont.)

3. **Financial reporting controls over all significant cycles/applications have been evaluated and tested during a sufficiently recent period (no more than 3 years).**

4. **No specific reporting or risk issues preclude the use of rotation.**

For any rotation-testing plan, the auditor should document:

- **the schedule for testing all significant cycles/applications,**
- **the rationale for using the specific plan,**
- **any limitations on the use of such a plan, and**
- **any other significant aspects, including descriptions of any modifications to rotation plans established in previous years.**[2]

[2]Excerpted from U.S. General Accounting Office / President's Council on Integrity & Efficiency, *Financial Audit Manual* (GAO-01-765G July 2001), pgs. 395.G-2 – 395.G-4, ¶395.03 – 395.07.

Amendment to Statement on Auditing Standards No. 39, *Audit Sampling*

GAO Proposed Change #1:

We recommend that the proposed amendment to SAS No. 39 (AU Section 350.46) require that, when the auditor determines that a sample is needed, the auditor use a statistical approach to audit sampling unless the auditor documents the rationale for using a nonstatistical approach and justifies the adequacy of the nonstatistical sample for meeting the test objective. This would not prohibit the auditor from using a nonstatistical sampling approach to audit testing.

Rationale for and Benefits of Proposed Change #1:

Under the third standard of fieldwork, "Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit."
Under AU section 350.24, "Sample items should be selected in such a way that the sample can be expected to be representative of the population."

GAO's recommended changes will encourage use of a statistical approach when the auditor determines that a sample is needed. GAO's proposed changes emphasize existing requirements to evaluate the sufficiency of evidence and the representative nature of the sample when using sampling, and provide guidance on appropriate conditions for using each approach. GAO's changes would make clear that statistical sampling and nonstatistical sampling are not equally effective.

Suggested Wording of Proposed Change #1:

Paragraph 46. Statistical sampling helps the auditor (a) to design an efficient sample, (b) to measure the sufficiency of the evidential matter obtained, and (c) to evaluate the sample results. By using statistical theory, the auditor can quantify sampling risk to assist himself in limiting it to a level he considers acceptable. **Because statistical sampling often provides more reliable evidence for drawing conclusions about a population, the auditor should use a statistical approach to audit sampling when the auditor determines that a sample is needed unless the auditor documents the rationale for using a nonstatistical approach. The auditor using nonstatistical sampling also should document the justification for the adequacy of the sample size for meeting the test objective. This does not prohibit the auditor from using a nonstatistical sampling approach to audit testing.** However, statistical sampling involves additional costs of training auditors, designing individual samples to meet statistical requirements, and selecting the items to be examined. Because either nonstatistical or statistical sampling can provide sufficient evidential matter, the auditor chooses between them after considering their relative cost and effectiveness in the circumstances.

Amendment to Statement on Auditing Standards No. 39, *Audit Sampling (cont.)*

Because nonstatistical sampling is often less effective than statistical sampling, the auditor should use professional judgment in determining whether to use a statistical or nonstatistical approach. A statistical approach to sampling often results in more reliable audit evidence because a statistical approach permits the auditor to: (1) objectively determine if sufficient evidence is obtained and (2) objectively select a representative sample of items for testing. A statistical approach generally should be used when more reliable audit evidence is needed, such as when:

- **Controls/transactions/account balances being tested are material.**
- **Risk of material misstatement is high.**

A nonstatistical approach may be used when less reliable evidence is deemed sufficient, such as when:

- **Controls/ transactions/account balances are not material.**
- **Risk of material misstatement is low (based on an effective test of controls).**
- **Due to the nature of the population, the balance can be adequately audited by testing a nonstatistical sample.**

Amendment to Statement on Auditing Standards No. 39, *Audit Sampling (cont.)*

GAO Proposed Change #2:

Paragraph 7 on page 3 of the proposed statement states that "…In addition, sampling may not apply to tests of **certain documented controls or to tests of program change controls**…." The proposed statement should either: (1) provide a more detailed explanation and examples of the "certain documented controls and program change control tests" to which sampling would not apply or (2) delete the reference to "certain documented controls and program change controls" from the proposed statement.

Rationale for and Benefits of Proposed Change #2:

Sampling frequently applies to tests of documented controls and program change controls. For instance, if an entity maintains a listing or log of program changes implemented during the year and the auditor decides to test controls over all documented program changes, then the auditor could select a sample from the program changes that were documented in the log.

Suggested Wording of Proposed Change #2:

We recommend deleting or clarifying the reference to tests of certain documented controls and program change controls in paragraph 7.