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Subject: AICPA Auditing Standards Board (ASB) February 2009 Exposure Draft of proposed redrafted Statements on Auditing Standards (SAS) on risk assessment.

This letter provides the U.S. Government Accountability Office's (GAO) comments on the ASB's proposed risk assessment standards. Generally, we support the proposed standards, which are consistent with relevant International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB).

The Board is seeking comments on the effect of applying the clarity drafting conventions to the proposed standards and converging them with the International Standards on Auditing. We provide the requested comments below, along with recommended wording changes.

Responses to Specific Questions

(1) Are the auditor's objectives appropriate?

We believe that the auditor's objectives stated in the proposed standards are appropriate.

(2) Are revisions from the existing standards to converge with the ISAs appropriate?

Except as noted below, we agree with the revisions from the existing standards to converge with the ISAs.

- Definition of Performance Materiality:

  The proposed SAS on *Materiality in Planning and Performing an Audit* introduces a new term "performance materiality" from the corresponding ISA 320. We believe that the ASB should clarify the requirement in paragraph 10 to better communicate the use of performance materiality in testing and the application of performance materiality to classes of transactions, account balances, or disclosures. Accordingly, we recommend making the following revision to paragraph 10 of the proposed SAS:

> **Requirements**
> **Determining Materiality and Performance Materiality When Planning the Audit**
>
> 10. When establishing the overall audit strategy, the auditor should determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, one or more particular classes of transactions, account balances, or disclosures exist for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users~~, then, taken on the basis of~~ based on the financial statements, the auditor should also determine the performance materiality level or levels to be applied to those particular classes of transactions, account balances, or disclosures. (Ref: par. A2–A13)

- While we agree with the changes to existing standards to converge with the ISA, we noted that certain revisions will lead to changes in U. S. audit practice. We encourage the ASB to highlight such revisions in a transmittal letter or other explanatory material when the new standards are issued. A complete list of significant revisions would help users implement the new standards consistently and effectively. The reasoning behind each change and the anticipated impact on audit practice resulting from the change should accompany the list.

  We raise this issue because the explanatory material issued with the exposure drafts did not address the following two significant revisions:

  - The proposed SAS *Materiality in Planning and Performing an Audit* introduces the new term "performance materiality," as we noted above. As auditors incorporate this new term into their audit tools and methodologies, it is likely to change the established manner in which they communicate and document their consideration of materiality throughout the audit process. The explanatory memo and supplemental material issued with the proposed SAS explain neither the reasoning behind the introduction of this new term nor its practice implications.

  - The discussion of known and likely misstatements in extant AU 312 is not included in the proposed audit risk standards. Instead, this discussion has been replaced with the guidance in paragraph A3 of the proposed standard, *Evaluation of Misstatements Identified During the Audit*, which discusses the option of classifying misstatements as factual, judgmental, or projected. If adopted, this change could affect how auditors evaluate audit evidence and communicate misstatements to management. Readers, however, are not alerted to the change in the materials that accompany the exposure draft.

We encourage the ASB to discuss these significant changes and all others in the transmittal letter issued with the final standards.

(3) Are the differences between the proposed SASs and the ISAs appropriate?

We believe that the differences between the proposed SASs and the ISAs are appropriate.

(4) Have considerations for audits of smaller, less complex entities and governmental entities been dealt with appropriately?

Overall, we agree with the considerations for audits of governmental entities. We noted, however, that the proposed SAS *Materiality in Planning and Performing an Audit*, paragraph A11, provides explanatory material specific to governmental entities on the use of benchmarks in determining materiality. We recommend adding to that paragraph guidance on applying appropriate benchmarks to each opinion unit of a state or local government. This could be done by referring to the discussion in paragraph A3 of the same proposed standard as follows:

> A11. In an audit of a governmental entity, total cost or net cost (expenses less revenues or expenditure less receipts) may be an appropriate benchmark~~s~~ for program activities. Where a governmental entity has custody of public assets, assets may be an appropriate benchmark. In the context of paragraph A3, auditors of state and local governments would apply appropriate benchmarks to each opinion unit of a state or local government.

Other Comments

- Paragraph A22 of the application and other explanatory materials accompanying the proposed SAS *Evaluation of Misstatements Identified During the Audit* discusses the cumulative effect of immaterial uncorrected misstatements related to prior periods. The guidance in paragraph A22 indicates that "different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements are available." This paragraph, which uses language similar to that in the corresponding ISA 450, does not incorporate key guidance from SEC's *Staff Accounting Bulletin No. 108*, which states:

  > The staff believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The staff believes that this can be accomplished by quantifying an error under both the rollover and iron curtain approaches as described above and by evaluating the error measured under each approach. Thus, a registrant's financial statements would require adjustment when either approach results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors.* [Underlining added for emphasis.]

  The proposed standard could be improved, in our view, by incorporating key guidance from the *Staff Accounting Bulletin*. Accordingly, we recommend the following addition to the guidance in paragraph A22 of the proposed SAS *Evaluation*

* "Iron curtain" refers to a cumulative, balance sheet oriented approach to determining materiality, while "rollover" refers to a current period, income statement oriented approach.

of Misstatements Identified During the Audit to make it consistent with the *Staff Accounting Bulletin*.

> A22. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. Different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements are available. Using the same evaluation approach provides consistency from period to period. By quantifying an error under both the rollover (income statement) and iron curtain (cumulative, balance sheet) approaches, evaluating the error measured under both approaches, and adjusting the financial statements when either approach results in a material misstatement, both the current and prior year effects of the misstatement will be addressed.

- In the proposed SAS *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatements*, the Application and Other Explanatory Material does not sufficiently address the issue of information systems security as essential to the understanding and assessment of internal control. The basic principles for manual and automated controls are the same—that auditors should obtain evidence that the control operated effectively for the entire period being audited. Paragraph A65 should be revised to incorporate these concepts as follows:

> A65. Obtaining an understanding of an entity's controls, whether manual or IT based, is not sufficient to test their operating effectiveness. ~~unless some automation provides for the consistent operation of the controls.~~ For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. Similar to manual controls, determining whether an automated control has been implemented is not, by itself, a sufficient test of the operating effectiveness of a control.
>
> ~~However, b~~Because of the inherent consistency of IT processing (see paragraph A51), IT enables an entity to process large volumes of data consistently and enhances the entity's ability to monitor the performance of control activities and to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems. Therefore, performing audit procedures to determine whether an automated control has been implemented may ~~serve as a test~~provide some evidence of that control's operating effectiveness. However, the operating effectiveness of such an automated control~~,~~ depends~~ing~~ on ~~the auditor's assessment~~the operating effectiveness of IT general controls. For example, the auditor may consider the effectiveness of IT general controls that would prevent management overrides or other unauthorized changes to data that would preclude or impair the operation of the automated control.~~and testing of controls such as those over program changes.~~ Tests of the operating effectiveness of controls are further described in paragraphs 9–18 of the proposed SAS, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

- The first sentence of paragraph 6 of the proposed SAS on *Materiality in Planning and Performing an Audit* should be revised to emphasize that materiality determinations should include both quantitative and qualitative considerations. We recommend doing this by making the following revision to this sentence:

> 6. In planning the audit, the auditor makes judgments about the size and nature of

misstatements that will be considered material.

- In our December 23, 2008, comment letter on the proposed SAS *Overall Objectives of the Independent Auditor and the Conduct of an Audit In Accordance with Generally Accepted Auditing Standards*, we expressed our concern about including extensive guidance related to audit evidence and audit risk in that standard. Paragraphs A31-A34 of that standard provide detailed guidance on the sufficiency and appropriateness of audit evidence that is more suitable to the redrafted SAS *Audit Evidence*. Paragraphs A35-A47 of the proposed *Overall Objectives* standard include a comprehensive discussion of audit risk considerations that are more appropriate to the redrafted SAS *Materiality in Planning and Performing an Audit*. As discussed in our previous letter, we recommend moving these paragraphs from the proposed *Overall Objectives* standard to the redrafted audit risk standards.

- Auditors using the proposed standards may benefit from use of the AICPA's *Audit Risk Assessment Guide*, which provides detailed guidance on planning and performing risk assessment procedures, developing an understanding of the client, evaluating audit findings, audit evidence, and control deficiencies, and many other areas relevant to the new risk assessment standards. We recommend adding an appendix to the proposed SAS *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatements* that refers readers to the *Audit Risk Assessment* guide.

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

Sincerely yours,

Jeanette M Franzel

Jeanette Franzel
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