



**United States General Accounting Office  
Washington, DC 20548**

May 20, 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, DC 20004

**Subject: *Exposure Draft of Proposed Statements on Auditing and Attestation  
Standards Related to Auditing and Reporting on an Entity's Internal Control  
Over Financial Reporting***

This letter provides the U.S. General Accounting Office's (GAO) response to your March 19, 2003, letter requesting GAO's input on the AICPA's March 18, 2003, exposure draft containing three proposed standards for auditor reporting on internal control over financial reporting.

We have long believed that auditors have an important role in providing an opinion on the effectiveness of internal control over financial reporting and compliance with laws and regulations. For many years now, we have provided opinions on internal control effectiveness because of the importance of internal control to protecting the public's interest. For financial statement audits that we conduct—which include the U.S. government's consolidated financial statements, the financial statements of the Internal Revenue Service and Federal Deposit Insurance Corporation, the Schedules of Federal Debt managed by the Bureau of the Public Debt, and numerous small entities' operations and funds—we issue a separate opinion on the effectiveness of internal control over financial reporting and compliance with laws and regulations. Our reports have engendered major improvements in internal control. As you might expect, as part of the annual audit of our own financial statements, we practice what we recommend to others and contract with an independent public accounting firm for both an opinion on our financial statements and an opinion on the effectiveness of our internal control over financial reporting and compliance with laws and regulations.

Current guidance for audits of government agencies and programs requires auditor reporting on internal control, but not at the level of providing an opinion on internal control effectiveness. Our goal is to lead the way in establishing the appropriate level of auditor reporting on internal control for federal agencies, programs, and entities receiving significant amounts of federal funding.

In the area of internal control reporting, Section 404 of the Sarbanes-Oxley Act requires publicly traded companies to establish and maintain an adequate internal control structure and procedures for financial reporting and include in the annual report a statement of management's responsibility for and management's assessment of the effectiveness of those controls and procedures. In addition, the company's auditor is required to report on the assessment made by the management of the issuer on the effectiveness of internal control over financial reporting.

GAO strongly believes that, where appropriate, auditor reporting on internal control is a critical component of monitoring the effectiveness of an organization's internal control and accountability. By giving assurance about internal control, auditors can better serve their clients and other financial statement users and better protect the public interest by having a greater role in providing assurances of the effectiveness of internal control in deterring fraudulent financial reporting, protecting assets, and providing an early warning of internal control weaknesses. We believe auditor reporting on internal control is appropriate and necessary for publicly traded companies and major public entities. We also believe that such reporting is appropriate in other cases where management assessment and auditor examination and reporting on the effectiveness of internal control add value and mitigate risk in a cost beneficial manner.

Following are our comments on the three proposed standards in the AICPA's exposure draft:

**Proposed Statement on Auditing Standards (SAS): Auditing an Entity's Internal Control Over Financial Reporting in Conjunction with the Financial Statement Audit**

In October 2002, the Securities and Exchange Commission (SEC) published a proposed rule on the internal control reporting and disclosures required by section 404 of the Sarbanes-Oxley Act. To date, the SEC has not issued its final rule. Therefore, the AICPA's exposure draft makes assumptions about the anticipated contents that will ultimately be included in SEC's final rule.

The Sarbanes-Oxley Act gives the Public Company Accounting Oversight Board (PCAOB) the authority to set auditing standards to be used by registered public accounting firms in the preparation and issuance of audit reports required by the rules of the SEC. On April 25, 2003, in accordance with section 101(d) of the act, the SEC determined that the PCAOB is organized and has the capacity to carry out and enforce the act's requirements. On April 25, 2003, the PCAOB also adopted interim auditing and attestation standards as permitted by Section 103(a)(3)(B) of the act. In that regard, the PCAOB adopted, as interim auditing standards, the generally accepted auditing standards and standards on attestation engagements issued by the AICPA that were in existence as of April 16, 2003. The PCAOB also stated that the interim standards would remain in effect until modified or superseded, either by PCAOB action or by SEC action.

Because the AICPA's proposed SAS is specific to the requirement under Section 404 of the Sarbanes-Oxley Act, and because any such standards must be subject to the PCAOB's full rulemaking process, we are not providing specific comments on this proposed SAS at this time.

**Proposed Amendment to Statement on Auditing Standards No. 100, *Interim Financial Information***

We do not have any comments on the proposed amendment to SAS No. 100.

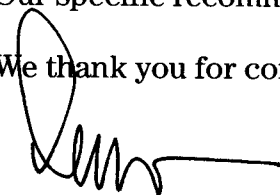
**Proposed SSAE: *Reporting on an Entity's Internal Control Over Financial Reporting***

This proposal applies to all engagements to examine the effectiveness of internal control over financial reporting. We are offering specific recommendations for changes to the proposed SSAE in order to

- achieve consistency with AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* and recognize the unique position of internal auditors and the contributions that internal auditors can make in the areas of evaluating the effectiveness of internal control, while distinguishing internal auditors from others who perform work on behalf of management;
- include the definition and objectives of internal controls over financial reporting in the independent accountant's report on internal controls, in order to strengthen user understanding of both the value and limitations of internal control over financial reporting; and
- retain the clearer, more concise definition of a material weakness as currently used in SSAE No. 10.

Our specific recommendations are included in the enclosure to this letter.

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



David M. Walker  
Comptroller General  
of the United States

Enclosure

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

**Proposed SSAE: *Reporting on an Entity's Internal Control Over Financial Reporting***

## GAO Proposed Change #1:

Paragraphs 51 and 74 – 76 do not recognize the unique position of internal auditors in evaluating the effectiveness of internal control and presume a lack of objectivity and independence on the part of the internal auditor. The proposed standard also equates the work of internal auditors to the work performed by outside consultants hired by management. We recommend that practitioners recognize the unique position of internal auditors and follow the steps outlined in AU Section 322.24 and use professional judgment to determine the level of reliance placed on the internal audit function in light of the facts and circumstances.

## Rationale for and Benefits of Proposed Change #1:

The proposed statement should allow practitioners to use professional judgment to evaluate the facts and circumstances of each engagement, since internal auditors can make significant contributions in evaluating the effectiveness of internal control. In addition, many internal auditors adhere to the *Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors, the objectives of which are to assure a level of independence and objectivity within the organization.

## Suggested Wording of Proposed Change #1:

Paragraph 51. Another factor the practitioner should consider when planning the engagement is whether the entity has an internal audit function. An important responsibility of the internal audit function is to monitor the performance of an entity's controls. One way internal auditors monitor such performance is by performing tests that provide evidence about the effectiveness of the design and operation of specific controls. The practitioner should determine to what extent internal auditors perform such procedures. The practitioner should not rely on the results of internal auditors' procedures as the principal evidence of the operating effectiveness of controls over significant accounts, classes of transactions, and disclosures. However, the practitioner may consider such work in determining the nature, timing and extent of his or her testing and should follow the guidance in paragraphs 74 through 76. ~~A practitioner should consider the guidance in SAS No. 65, *the Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA Professional Standards, vol. 1, AU sec 322.09-11) when assessing the competence and objectivity of internal auditors. SAS No. 65 (AU sec.322.27) also provides guidance on using internal auditors to provide direct assistance to the practitioner in supervising, reviewing, evaluating, and testing such work. the practitioner should recognize that a potential impairment of objectivity may exist when internal auditors perform a monitoring function within the entity's internal control.~~

Paragraph 74. Although the practitioner may consider the results of the responsible party's tests of the operating effectiveness of certain controls, it is the practitioner's responsibility to obtain sufficient evidence to support his or her opinion. The practitioner should not rely on the results of procedures performed by **the responsible party or others performing the work on behalf of the responsible party** as the principal evidence of the operating effectiveness of controls over significant accounts, classes of transactions, and disclosures. If the practitioner intends to use the results of tests performed by ~~others (such as internal audit management, other entity personnel, or third parties working under the direction of management, including other practitioners who may have been engaged to perform procedures as a basis for the responsible party's assertion about the effectiveness of internal control)~~ to alter the nature, timing, and extent of the tests of controls that the practitioner performs, the practitioner should:

- Reperform tests of controls on each significant account, class of transactions, and disclosure to corroborate the results of such tests; ~~or and also~~
- Perform independent tests of controls related to each significant account, class of transactions, and disclosure.

When evaluating whether sufficient evidence has been obtained, the practitioner should consider that evidence obtained through his or her direct personal knowledge, observation, reperformance, and inspection is more persuasive than information obtained indirectly, such as from management, internal auditors, or other personnel. Further, judgments about the sufficiency of evidence obtained and other factors affecting the practitioner's opinion, such as the materiality of identified control deficiencies, should be those of the practitioner.

***(Proposed new paragraph to follow paragraph 74)  
Using the Results of Internal Auditors***

**The auditor should perform procedures to evaluate the quality and effectiveness of the internal auditor's work, as described in AU section 322, that significantly affects the nature, timing, and extent of the auditor's procedures for determining the operating effectiveness of control over significant accounts, classes of transactions, and disclosures. The nature and extent of the procedures the auditor should perform when making this evaluation are a matter of judgment depending on the extent of the effect of the internal auditor's work on the auditor's procedures for determining the effectiveness of internal control over financial reporting.**

**In developing the evaluation procedures, the auditor should consider such factors as whether the internal auditor's**

- **scope of work is appropriate to meet the objectives,**
- **audit programs are adequate,**
- **audit documentation adequately documents work performed, including evidence of supervision and review,**
- **conclusions are appropriate in the circumstances, and**
- **reports are consistent with the results of the work performed.**

**In making the evaluation, the auditor should test some of the internal auditor's work related to the significant control objectives. These tests may be accomplished by either (a) examining some of the controls that the internal auditors examined or (b) examining similar controls not actually examined by the internal auditors. In reaching conclusions about the internal auditor's work, the auditor should compare the results of his or her tests with the results of the internal auditors' work. The extent of this testing will depend on the circumstances and should be sufficient to enable the auditor to make an evaluation of the overall quality and effectiveness of the internal audit work being considered by the auditor.<sup>1</sup>**

Paragraph 75. In considering the results of tests of the operating effectiveness of controls performed by others, the practitioner also considers such matters as:

- The materiality of the account balances, classes of transactions, and disclosures that the controls address
- The objectivity and competence of the individuals performing the tests of controls
- The degree of subjectivity involved in evaluating evidence about the effectiveness of the controls
- The pervasiveness of the controls

Paragraph 76. Evaluating evidence about the control environment, including fraud **prevention and detection** programs and controls, often involves a high degree of subjectivity. The practitioner should not use the results of tests performed by **the responsible party or others performing the work on behalf of the responsible party** in testing and in evaluating evidence about the control environment. **When using the work of internal auditors in these areas, the practitioner should follow the guidance in the previous paragraphs and in AU section 322.** ~~The practitioner also should limit his or her use of the work of others in areas such as the following:~~

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<sup>1</sup>This proposed wording is consistent with AU section 322 paragraphs 24-26, adapted for an examination of the effectiveness of internal control.

- ~~Controls that have a pervasive effect on the financial statements, such as general controls on which the operating effectiveness of other controls depend~~
- ~~Controls over significant nonroutine and nonsystematic transactions (such as accounts involving judgments and estimates)~~
- ~~Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications)~~

#### GAO Proposed Change #2:

Paragraphs 97-114 on reporting standards require a paragraph in the independent accountant's report explaining the inherent limitations of internal controls over financial reporting. This should be preceded by the definition and objectives of internal control over financial reporting in preventing and detecting significant deficiencies (formerly reportable conditions) and material weaknesses before they occur.

#### Rationale for and Benefits of Proposed Change #2:

Additional wording to include the definition and objectives of internal control over financial reporting will help strengthen user understanding of the value and limitations of internal controls over financial reporting.

#### Suggested Wording of Proposed Change #2:

Paragraphs 97i and 99i. A paragraph stating that

- **effective internal control over financial reporting is critical to the ability of the responsible party to provide reasonable assurance that (1) transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and (2) receipts and expenditures are made in accordance with authorization of management and directors,**<sup>2</sup>
- **effective control also is essential for preventing and detecting material misstatements in the financial statements, and**

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<sup>2</sup>This definition of internal control over financial reporting could differ, depending on whether the engagement is subject to Sarbanes-Oxley requirements or is conducted under other generally accepted criteria, such as the framework of internal control established in the Committee of Sponsoring Organizations of the Treadway Commission's report, *Internal Control—Integrated Framework* (COSO report). If other criteria are used, the language describing internal control over financial reporting should be modified accordingly.

- because of inherent limitations of internal control over financial reporting, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected and also stating that projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Paragraph 98. [**Standard definition, objectives, and inherent limitations paragraph**]

**Effective internal control over financial reporting is critical to the ability of W Company's management to provide reasonable assurance that (1) transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and (2) receipts and expenditures of W Company are made in accordance with authorization of management and directors of W Company.<sup>3</sup> Effective control also is essential for preventing and detecting material misstatements in W Company's financial statements.** Because of the inherent limitations of internal control over financial reporting, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

GAO Proposed Change #3:

The proposed standard should retain the definition of material weakness currently used in SSAE No. 10, AU Sec. 501.55.

Rationale for and Benefits of Proposed Change #3:

The current definition is more clear and concise than the proposed definition and uses language more understandable to the general public.

Suggested Wording of Proposed Change #3:

Paragraph 105. [*Explanatory paragraph*]

A material weakness is a **condition that** ~~significant deficiency in one or more of the internal control components that alone or in the aggregate precludes the entity's internal control from~~ **providing reasonable assurance** ~~reducing to an appropriately low level the risk that material misstatements in the financial statements will not be prevented or detected on a timely basis.~~ A significant deficiency is an internal control deficiency that could adversely affect the entity's ability to initiate, record, process, and report financial

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<sup>3</sup>See footnote 2.



data consistent with the assertions of management in the financial statements. The following material weakness has been identified.