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Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

June 27, 2005

Ms. Sherry Boothe
Audit and Attest Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036

Subject: Proposed Statement on Auditing Standards-- *Amendment to Statements on Auditing Standards No. 69, the Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles, for Nongovernmental Entities*, dated May 9, 2005

Dear Ms. Boothe:

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Auditing Standards Board's (ASB) May 9, 2005 exposure draft of a proposed Statement on Auditing Standards (SAS) entitled *Amendment to Statements on Auditing Standards No. 69, the Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles, for Nongovernmental Entities*.

The proposed amendment to SAS 69, together with the Financial Accounting Standards Board's (FASB) proposed Statement of Financial Accounting Standards entitled *The Hierarchy of Generally Accepted Accounting Principles*, is an important step in recognizing the responsibility of the reporting entity, and not the auditor, for selecting and applying accounting principles and for the adequacy of financial statement disclosure. We strongly support the ASB's coordination with the FASB on this endeavor, and we encourage the ASB to seek convergence among all audit and accounting standard setters in recognizing common concepts for evaluating the "fair presentation" of financial statements.

Also, we strongly support the discussion of the auditor's judgments about fair presentation. Although based on a generally accepted accounting principles (GAAP) framework, the auditor's judgments about fair presentation include considerations beyond literal compliance with GAAP. Recently revised international audit standards provide for GAAP exceptions similar to Rule 203 of the AICPA Code of Professional Conduct when the financial statements would otherwise be misleading. The ASB's proposed standard includes guidance for applying Rule 203, which gives auditors the flexibility in rendering their opinion to consider unusual circumstances in which literal application of GAAP would result in misleading financial statements. However, we believe that this guidance for applying Rule 203 should pertain to audits of both governmental and nongovernmental entities rather than to just audits of governmental entities. In addition, we believe that nongovernmental audits are not so

significantly different from audits of governmental entities as to justify different treatment in the auditing standards. Even if the GAAP hierarchy for nongovernmental entities is moved from SAS 69 to a new FASB statement, we believe that the auditor continues to have a responsibility to evaluate financial statement presentation for both (1) conformity with GAAP and (2) fair presentation.

We understand from a recent phone conversation with ASB staff that the proposed amendment also will incorporate paragraphs .12 - .18 of current SAS 69 and that paragraph .18 will be modified to remove the first column pertaining to nongovernmental entities. We support retaining these paragraphs with the noted modifications in order to make the standard complete. These paragraphs contain critical information concerning the framework for selecting principles used in financial statement preparation for governmental entities and, therefore, should be retained in the amended standard.

Enclosures 1 and 2 to this letter detail GAO's comments on the following provisions of the ASB's proposed amendment:

- Additional criteria auditors should consider when evaluating the "fairness" of the overall financial statement presentation (see enclosure 1)
- Identifying the organizations designated by the American Institute of CPAs (AICPA) Council as sources of generally accepted accounting principles (see enclosure 2)

We also have enclosed our comments on the related FASB proposed statement for your consideration.

Thank you for the opportunity to provide our comments on these important issues. If you have any questions on our comments, we are available for further discussions. Please call me at (202) 512-5500 or Robert Dacey, Chief Accountant, at (202) 512-7439.

Sincerely yours,



David M. Walker
Comptroller General
of the United States

Enclosures - 3

cc:

Mr. Robert H. Herz, Chairman
Financial Accounting Standards Board

The Honorable William H. Donaldson, Chairman
Securities and Exchange Commission

The Honorable William J. McDonough, Chairman
Public Company Accounting Oversight Board

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

Additional Criteria Auditors Should Consider When Evaluating the “Fairness” of the Overall Financial Statement Presentation

As presently written, the proposed amendment provides certain criteria for auditors to consider when evaluating the “fairness” of the overall financial statement presentation. Since appropriate criteria are a critical part of evaluating financial statement presentations, we recommend adding to the proposed amendment additional criteria, which are discussed extensively in GAAP and generally accepted auditing standards (GAAS) literature, for auditors to consider in evaluating fair presentation. The additional criteria we suggest are underlined below in our proposed changes to paragraph .04.

We also recommend moving the location in the proposed amendment of the discussion of certain provisions of rule 203 of the AICPA Code of Professional Conduct from paragraph .08a, where it refers only to governmental entities, to the end of paragraph .04 where it would apply to both governmental and nongovernmental entities. This change would be consistent with paragraphs 12 – 14 of International Standard on Auditing (ISA) 700, *The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements*. This ISA instructs auditors, when forming an opinion as to whether financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework, to consider whether

- the accounting policies selected and applied are consistent with the financial reporting framework and are appropriate in the circumstances;
- the accounting estimates made by management are reasonable in the circumstances;
- the information presented is relevant, reliable, comparable, and understandable; and
- the financial statements provide sufficient disclosures to enable users to understand the effect of material transactions and events.

Our proposed changes would read as follows:

.04 The auditor’s opinion that financial statements present fairly an entity’s financial position, results of operations, and cash flows in conformity with generally accepted accounting principles should be based on his or her judgment as to whether (a) the accounting principles selected and applied have general acceptance; (b) the accounting principles are appropriate in the circumstances; (c) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation (see section 431); (d) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed (see section 431); and (e) the financial statements reflect the underlying transactions and events in a manner that

presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.²

In evaluating the “fairness” of the overall financial statement presentation, auditors also should consider significant qualitative factors, such as

- the relevance, reliability, comparability, and understandability of the financial statements;
- management’s selection and application of significant accounting policies, as well as the effect of the policies on the overall presentation;
- the impact of management judgments and estimates on the overall presentation;
- the impact of uncorrected misstatements, if any;
- evidence of possible fraud or intentional misstatement;
- other matters known by the auditors that could affect the recognition, measurement, and disclosure of financial statement information; and
- any relevant subsequent events.

Rule 203 provides that an auditor should not express an unqualified opinion if the financial statements contain a material departure from such pronouncements unless, due to unusual circumstances, adherence to the pronouncements would make the statements misleading. Rule 203 implies that application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows, in conformity with generally accepted accounting principles. Nevertheless, rule 203 provides for the possibility that literal application of such a pronouncement might, in unusual circumstances, result in misleading financial statements. (See SAS No. 58, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 508.14 and .15.) [This paragraph appears in paragraph .08 a. of the proposed amendment]

² The concept of materiality is inherent in the auditor’s judgments. That concept involves qualitative as well as quantitative judgments (see sections 150.04, 312.10, and 508.36).

Identifying the Organizations Designated by the American Institute of CPAs (AICPA) Council as Sources of Generally Accepted Accounting Principles

We believe that the clarity and usefulness of the proposed amendment would be improved by identifying the bodies designated by the AICPA Council, pursuant to rule 203 of the AICPA Code of Professional Conduct, to establish generally accepted accounting principles, as follows (our suggested additions are underlined)

Sources of Generally Accepted Accounting Principles

.08 Rule 203-2.03 of the AICPA Code of Professional Conduct recognizes the following bodies to establish accounting principles:

- for U.S. nongovernmental entities, the Financial Accounting Standards Board (FASB);
- for U.S. state and local governmental entities,^x the Governmental Accounting Standards Board (GASB);
- for U.S. federal governmental entities,^{xx} the Federal Accounting Standards Advisory Board (FASAB).

For nongovernmental entities, the Financial Accounting Standards Board (FASB) is responsible for identifying the source of accounting principles and the framework for selecting the principles used in the preparation of financial statements that are presented in conformity with generally accepted accounting principles in the United States.³

For governmental entities, the sources of established accounting principles that are generally accepted in the United States of America are –

- a. Accounting principles promulgated by a body designated by the AICPA Council to establish such principles, pursuant to rule 203 of the AICPA Code of Professional Conduct. ~~Rule 203 provides that an auditor should not express an unqualified opinion if the financial statements contain a material departure from such pronouncements unless, due to unusual circumstances, adherence to the pronouncements would make the statements misleading. Rule 203 implies that application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows, in conformity with generally accepted accounting principles. Nevertheless,~~

^x State and local governmental entities include public benefit corporations and authorities; public employee retirement systems; and governmental utilities, hospitals, and other health care providers, and colleges and universities. [This footnote currently appears as note 5 to AU 411.12.]

^{xx} Federal Accounting Standards Advisory Board (FASAB) Concepts Statement No. 2, *Entity and Display*, defines federal governmental entities. [This footnote currently appears as note 8 to AU 411.14.]

³ The hierarchy of generally accepted accounting principles for nongovernmental entities is contained in FASB Statement No. 1XX.

~~rule 203 provides for the possibility that literal application of such a pronouncement might, in unusual circumstances, result in misleading financial statements. (See SAS No. 58, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 508.14 and 15.)~~

[We propose moving this strike-through section to paragraph .04 of the proposed amendment.]

b. Pronouncements of bodies, composed of expert accountants, that deliberate accounting issues in public forums for the purpose of establishing accounting principles or describing existing accounting practices that are generally accepted, provided those pronouncements have been exposed for public comment and have been cleared by a body referred to in category (a).⁴

c. Pronouncements of bodies, organized by a body referred to in category (a) and composed of expert accountants, that deliberate accounting issues in public forums for the purpose of interpreting or establishing accounting principles or describing existing accounting practices that are generally accepted, or pronouncements referred to in category (b) that have been cleared by a body referred to in category (a) but have not been exposed for public comment.

d. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry, or the knowledgeable application to specific circumstances of pronouncements that are generally accepted.

⁴ For purposes of this section, the word cleared means that a body referred to in subparagraphs (a) has indicated that it does not object to the issuance of the proposed pronouncement.



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Technical Director
Financial Accounting Standards Board
File Reference No. 1300-001
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Subject: Exposure Draft *The Hierarchy of Generally Accepted Accounting Principles*

Dear Ms. Bielstein:

The U.S. Government Accountability Office has reviewed the Financial Accounting Standards Board (FASB) Exposure Draft entitled *The Hierarchy of Generally Accepted Accounting Principles*. We are pleased to provide our comments on this very important issue.

We support the FASB's efforts to improve the quality of financial accounting standards and its initiative to move the GAAP hierarchy into the accounting literature. We agree that the enterprise and not the auditor is responsible for selecting and applying accounting principles for financial statements to be presented fairly and in conformity with GAAP.

At the same time, we strongly believe that the standard should also include a requirement for the enterprise to consider fair presentation, which is also discussed in SAS 69, and provide guidance for making judgments about it. We believe fair presentation includes considerations beyond literal compliance with the specific requirements of individual accounting and reporting standards and, consequently, that the enterprise has a responsibility to evaluate financial statement presentation for both (1) conformity with the individual standards and (2) overall fair presentation. If literal compliance with the individual accounting and financial reporting standards would lead to misleading financial statements and therefore preclude fair presentation, the enterprise should depart from the individual standards to the extent necessary to achieve fair presentation. While we view instances of such departure to achieve fair presentation as limited to rare circumstances, such as new legislation or new forms of business transactions, we consider this an important concept for FASB to incorporate in its GAAP hierarchy.

We believe that the International Accounting Standards Board (IASB) has incorporated this fair-presentation concept into its standards. International Accounting Standard (IAS) 1, *Presentation of Financial Statements*, notes that fair presentation requires the faithful representation of the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income, and expenses set out in its framework.¹ Applying IAS, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation. IAS 1 also provides an exemption from following the standards when, in those extremely rare cases, circumstances arise in which management concludes that compliance with a requirement in a Standard or Interpretation would be so misleading that it would not achieve fair presentation. IAS 1 also provides requirements describing the nature of the departure, the reasons why treatment under the standards would be misleading, treatment used, and the impact. According to IAS 1, an item of information would conflict with the objective of financial statements, and therefore be misleading, when it does not represent faithfully the transactions, other events, and conditions that it either purports to represent or could reasonably be expected to represent and, consequently, it would be likely to influence economic decisions made by users of financial statements.

Also, in the context of the Sarbanes-Oxley Act of 2002 (Act), the Securities and Exchange Commission staff noted in its August 2002 release on the certification of company reports² that management has to accept responsibility for ensuring that the financial information provided to investors fairly presents the company's financial position, results of operations, and cash flows. The SEC stated that it believes that fair presentation, as used in management's annual and quarterly certifications, was intended to "provide assurances that the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles."³ More specifically, the SEC stated that, in its view, a "fair presentation' of an issuer's financial condition, results of operations and cash flows encompasses the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations, and cash flows."⁴

If the board should decide not to include fair presentation in the standard at this time, we believe that the board should nonetheless include language similar to the AICPA's Rule 203, to allow the enterprises the flexibility to depart from GAAP when necessary to achieve fair presentation. Without such flexibility, the enterprise could find themselves in the untenable position of preparing financial statements in conformity with GAAP, but that are not fairly presented.

¹IAS 1.13-22, *2005 International Financial Reporting Standards*, International Accounting Standards Committee Foundation.

²Securities and Exchange Commission, Release Nos. 33-8124, 34-46427, IC-25722; File No. S7-21-02, *Certification of Disclosure in Companies' Quarterly and Annual Reports*.

³*Certification of Disclosure*, II.B.3 "Content of Certification."

⁴*Certification of Disclosure*, II.B.3 "Content of Certification."

In conclusion, we strongly encourage the FASB to broaden the scope of its project to include fair presentation in the GAAP hierarchy along the lines of the IASB and the SEC. Key criteria to consider in evaluating fair presentation, which are covered extensively in GAAP and GAAS literature, include (1) selection and application of significant accounting principles and policies, (2) consideration of adequate disclosure, (3) the impact of uncorrected misstatements, if any, (4) making reasonable estimates, (5) presenting information in a manner that provides relevant, reliable, consistent, comparable, and understandable information, (6) the impact of management judgment on overall presentation, (7) any relevant subsequent events, and (8) consideration of whether literal compliance with GAAP results in financial statements that are not misleading.

We acknowledge the FASB's intention to make improvements to the GAAP hierarchy at the conclusion of its codification and retrieval project, which we understand will be in 5 years. However, we strongly urge the FASB to not wait until then to bring fair presentation into its final GAAP hierarchy. We believe this would improve overall transparency of financial reporting and also have a positive effect toward hastening convergence with the IASB's concepts and standards.

As the FASB continues on its codification and retrieval project, we believe that it should ensure that other concepts in the auditing standards that may affect judgments about fair presentation are appropriately incorporated. For example, the auditing standards contain significant discussions about areas such as related parties and going concern that may not be articulated as clearly in FASB standards but are critical to the preparation and reporting of fairly presented financial statements.

In coordinating its efforts with the FASB proposal, the AICPA has proposed amending Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles, For NonGovernmental Entities*, which deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. For your convenience, we have enclosed our comments on the AICPA proposal.

* * * * *

We appreciate the opportunity to express our views and would be pleased to further discuss our comments with you at a convenient time. If I can be of further assistance, please call me at (202) 512-5500 or Robert Dacey, Chief Accountant, at (202) 512-7439.

Sincerely yours,



David M. Walker
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Enclosure

cc:

The Honorable William H. Donaldson, Chairman
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The Honorable William J. McDonough, Chairman
Public Company Accounting Oversight Board

Mr. John A. Fogarty
Chair, Auditing Standards Board

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