GAO
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Washington, DC 20548

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Mr. John A. Fogarty, Chair
Audit and Attest Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036

Subject: *Exposure Draft of Proposed Statements on Auditing Standards on Audit Risk, Dated June 15, 2005*

Dear Mr. Fogarty:

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Auditing Standards Board's (ASB) June 15, 2005, exposure draft of proposed Statements on Auditing Standards (SAS) on Audit Risk.

We commend the ASB's efforts to strengthen standards in the area of the auditors' assessment of the risks of material misstatement in a financial statement audit. We especially support the new emphasis on the linkage between the auditors' risk assessment and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. We are especially pleased that the proposed standards encourage auditor evaluation and testing of internal control by eliminating the option of defaulting to "maximum" risk without documenting the basis for that conclusion. In addition, we are pleased that the proposed standards clearly use "must" and "should" terminology and would require auditors to (1) quantify materiality, (2) quantify tolerable misstatement at less than materiality, and (3) communicate known and likely misstatements to management and to those charged with governance. These changes should enhance audit quality. We also commend the AICPA for its commitment to developing a related audit guide and training materials.

The Board has requested specific comments related to clarification of misstatements identified by the auditor and to evaluating audit findings. We have addressed these important issues in Enclosure 1 to this letter.

Our detailed comments on the proposed standards and amendments are included in Enclosure 2 to this letter. We ask that you consider closely our comment on the level of assurance provided in an audit, which is discussed on pages 1-2 (Enclosure 2) and is related to the amendments to SAS 1, and our comment on the need for auditors to evaluate the fair presentation of an entity's financial statements, which is discussed on pages 12-13 (Enclosure 2) and is related to the proposed standard on Performing

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

In Enclosure 3, we have repeated 2 recommendations from GAO's April 30, 2003, letter commenting on the ASB's original audit risk exposure draft dated December 2, 2002. We are pleased that the Board has incorporated in the proposed standards 9 of the 11 recommendations included in our April 30, 2003, letter. We are repeating the remaining 2 recommendations because we believe they are still relevant.

We appreciate the opportunity to express our views on these important matters and would be pleased to discuss them with you in further detail. Please contact Jeanette M. Franzel, Director, at (202) 512-9471, or franzelj@gao.gov or Gail Flister Vallieres, Senior Auditor, at (202) 512-9370, or vallieresg@gao.gov if you have questions or would like more information about the issues discussed in this letter. I can be reached at (202) 512-2600 or steinhoffj@gao.gov.

Sincerely yours,

Jeffrey C. Steinhoff
Managing Director
Financial Management and Assurance

Enclosures

cc:

The Honorable Christopher Cox, Chairman
Securities and Exchange Commission

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

Issues in ASB Explanatory Memorandum for Which ASB Requests Comments or Suggestions

The two questions posed by the Board in the June 15, 2005, exposure draft and GAO's responses are as follows:

ASB Issue 1: **Classification of misstatements identified by the auditor.** This proposed SAS [Audit Risk and Materiality in Conducting an Audit] provides guidance that the auditor should follow in communicating misstatements to management (paragraphs 43 through 48). Paragraph 45 of the exposure draft states that when communicating misstatements to management, the auditor should distinguish between known and likely misstatements and provides definitions of known and likely misstatements. The ASB concluded that likely misstatements should encompass misstatements that arise from differences between management's and the auditor's judgments concerning accounting estimates (for example, because an estimate included in the financial statements by management is outside of the reasonable range of outcomes the auditor has determined). This conclusion is a departure from the proposed International Standard on Auditing (ISA) 320 (revised), Materiality in the Identification and Evaluation of Misstatements, which states that such differences should be classified as known misstatements involving subjective decisions.

GAO Response to ASB Issue 1: We are concerned that calling all misstatements relating to estimates "likely misstatements" could result in inappropriate conclusions. The decisions related to known or likely misstatements involve judgment based on the relevance and reliability of the information used to prepare the estimates. For example, if an auditor finds computational errors in an estimate, the misstatement is probably a known misstatement. However, sometimes an auditor develops a statistical estimate that includes a range of reasonable outcomes against which the reasonableness of management's estimate is evaluated. In this case, the difference between management's estimate and the closest reasonable estimate in the auditor's range of estimates is a known misstatement, while the difference between the closest reasonable estimate in the auditor's range of estimates and the auditor's point estimate is a likely misstatement. In the above scenario, the difference between the auditor's point estimate and the furthest limits in the auditor's range of estimate represents possible further misstatement. This is consistent with statistical theory. Merely adjusting to the nearest limit in the auditor's range of estimates would consistently understate the misstatement.

Paragraphs 43–48 of the proposed standard should be revised to converge with ISA 320, and the illustration in paragraph 56 should be revised for consistency with this recommended change. More detailed guidance on auditors' consideration of known, likely, and possible further misstatements should be provided in the audit guide that the AICPA is drafting to assist auditors in implementing the revised standards.

ASB Issue 2: **Evaluating audit findings.** Paragraph 51 of the proposed SAS [Audit Risk and Materiality in Conducting an Audit] states, among other things, that in evaluating audit findings, auditors should consider the effect of misstatements related to prior periods; and paragraph 52 states that in aggregating misstatements, the auditor should consider the cumulative uncorrected misstatements that apply to the balance sheet, including misstatements arising in the current period, on the current period financial statements, and propose any necessary adjustments to reduce the amount of uncorrected misstatements to less than materiality.

The issue of how to evaluate uncorrected misstatements related to prior periods has been highly controversial and often is referred to as the "iron curtain/rollover" issue. The ASB is proposing that the auditor follow the iron curtain approach, unless the 'rollover' method indicates a larger uncorrected error amount. The iron curtain method considers what is necessary to correct errors in the ending balance sheet, even if they arose in whole or in part in prior years. The rollover method considers errors only in the most recent income statement.

The Securities and Exchange Commission has undertaken a study of this issue and its findings are expected soon. The ASB will monitor any SEC actions and findings and will consider those, for the sake of consistency, in its deliberations after the exposure period concludes.

<u>GAO Response to ASB Issue 2:</u> Rather than allowing auditors to follow the cumulative (iron curtain) approach, unless the current period (rollover) method indicates a larger uncorrected error amount, the standard should require consideration of materiality using both methods. If the effects of misstatements are not material under either method, there should be no problem. However, because net current period results may not be the proper materiality base, the approach proposed by the Board may not be appropriate in all situations. Also, "larger adjustment" is not adequately defined in terms of what measure "larger" is applied to.

In addition, this issue needs further development and clarification in the proposed standard or an appendix to the proposed standard and also in the audit guide that is being developed to help auditors properly implement this change. Both the cumulative and the current period methods are commonly used in practice and the choice of method can significantly affect the auditors' proposed adjustment decisions. The proposed standard should provide a more detailed explanation of the difference between the two approaches to evaluating the potential effects of prior period misstatements. For example, the discussion in paragraph 52 could be moved to a new subsection on prior period misstatements that would follow paragraph 60. This new subsection could be worded as follows:

<u>The Effect of Misstatements Related to Prior Periods</u>

> [From paragraph 52.] In aggregating misstatements, the auditor should include the effect on the current period's financial statements of ~~those~~ prior <u>and current</u> period misstatements. In doing this, the auditor should consider both the cumulative uncorrected misstatements that apply to the balance sheet <u>(cumulative or iron curtain method), and the</u> ~~including~~ misstatements arising in

the current period (current period or rollover method). The auditor should apply both methods. If unadjusted misstatement(s) are material under either method, the auditor must determine the implications for the auditor's report. ~~on the current period financial statements and propose any necessary adjustments to reduce the amount of uncorrected misstatements to less than materiality.[19] For example if a liability is understated as a result of misstatements that -relate to prior and current periods, the auditor should consider the amount that would correct the liability, not just the amount that relates to the current period.[20]~~ The auditor should also consider that more than one account may contain accumulated misstatements as a result of prior period uncorrected misstatements. ~~differences.~~

The cumulative approach compares the *total amount of misstatement* at the end of the current period to net income, while the current period approach compares the *amount of misstatement added in the current period* to net income. The current period method recognizes that prior misstatements may be offset or reversed in the current period, while the cumulative approach does not.

For example, assume that inventory is overstated by $10 million as of the end of 20x1 and by $15 million as of the end of 20x2. Using the cumulative method, the auditor would consider whether $15 million is material, specifically with respect to inventory, the balance sheet, and to current period results. Using the rollover method, the auditor would consider whether (1) $15 million is material to inventory and the balance sheet, (2) $5 million ($15 million misstatement less the $10 million reversing effect of the prior period misstatement) is material to current period results, and (3) $10 million is material to beginning equity.

The auditor should include all prior period misstatements, unless inconsequential, that affect the current period financial statements in (1) the accumulation of misstatements, (2) the communication to management, (3) communications to those charged with governance, (4) the management representation letter, and (5) the overall evaluation of the fair presentation of the financial statements.

[19] The materiality used for this assessment should be relevant to the final financial statements, which may differ from planning materiality. Some entities base this assessment of materiality on income, and other entities (for example, not-for-profit or governmental entities) use other relevant bases of measurement. The auditor uses the same materiality base for these comparisons as he or she used in planning the engagement, updated to reflect period-end financial information.

GAO Comments on Individual Proposed Standards and Amendments

The following are GAO's comments on the specific proposed standards and amendments in the June 15, 2005, exposure draft. Our comments are keyed to the paragraph numbers in the proposed standards and amendments. Our recommended rewording of the standards and amendments is indicated by underlining our proposed additions and strikethrough for proposed deletions.

<u>Amendment to "Due Professional Care in the Performance of Work" of Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures</u>

We commend the Board for the changes proposed in the Amendment to SAS No. 1, especially the language that suggests that "reasonable assurance" implies a high level of assurance. However, the Amendment should be revised to make it more consistent with the International Auditing and Assurance Standards Board (IAASB) and the Public Company Accounting Oversight Board (PCAOB) usage of the term "reasonable assurance."

In its Glossary of Terms, the IAASB defines reasonable assurance as "a high, but not absolute, level of assurance, expressed positively in the auditor's report as reasonable assurance, that the information subject to audit is free of material misstatement."

The PCAOB's discussion of reasonable assurance, in paragraph 17 of Auditing Standard No. 2, states that "Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of *reasonable assurance*. The concept of reasonable assurance is built into the definition of internal control over financial reporting and also is integral to the auditor's opinion. Reasonable assurance includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance."

We believe the following language would be more consistent with the concepts included in the IAASB's and PCAOB's discussion of reasonable assurance. The proposed Amendment to SAS 1 should be revised as follows:

> 10. While exercising due professional care, the auditor must plan and perform the audit to obtain sufficient appropriate evidence <u>to be able to draw reasonable conclusions on which to base an audit opinion. Reasonable assurance is obtained when the auditor concludes there is a remote likelihood that the financial statements are materially misstated (whether caused by error or fraud)</u> ~~so that audit~~<u>and audit</u> risk <u>is</u> ~~will be~~ limited to a low level.[1] ~~that is, in his or her professional judgment, appropriate for expressing an opinion on the financial statements~~. <u>Reasonable assurance therefore represents a high level of assurance.</u> The high level of assurance that is intended to be obtained by the auditor is expressed in the auditor's report as obtaining reasonable assurance about whether the financial statements are free of material misstatement<u>.</u> ~~(whether caused by error or fraud).~~ Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, an audit

conducted in accordance with generally accepted auditing standards may not detect a material misstatement.

1 ***A low level of audit risk means that there is a remote likelihood that an auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated whether caused by error or fraud.***

In order to make sure that this meaning of reasonable assurance is communicated consistently throughout the auditing standards, the above wording should be repeated at least once in each standard that uses the reasonable assurance concept, or SAS 1 should be referenced or footnoted in each standard in which the reasonable assurance concept is used.

Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards

The revisions to the general and field work standards will make the standards more understandable and therefore easier for auditors to implement. However, the new clarified terminology (must, should, and active voice) that is used in this amendment and in four of the ten basic standards also should be applied to the remaining six standards so that the ten core standards are presented consistently. The rewritten standards likely will need to be exposed for comment.

Audit Evidence

1. In paragraph 8, the fourth bullet states that audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium. Paragraph 9 of the proposed standard then discusses the need for auditors to consider the reliability of electronic documentation. To further develop this guidance, the following should be added to paragraph 9 of the proposed standard or included in a separate paragraph following paragraph 9: "Auditors should consider the impact of IT general, application, and user controls on the reliability of electronic data. If other evidence supports the reliability of the electronic information, the auditor should include this other evidence in the audit documentation."

2. Paragraph 16 on audit assertions should explain that in designing audit tests, the auditor recognizes the relationships of accounts and assertions in a double entry system of accounting. For example, a test of accounts receivable for existence usually provides evidence of the occurrence of revenues. A test of revenue for occurrence usually provides evidence about the existence of accounts receivable. Separating the assertions of existence and occurrence in this situation could cause auditors to miss these relationships.

3. Paragraph 22 discusses 2 sets of circumstances in which tests of controls are necessary. It would be helpful to have examples of both circumstances included in the audit guide that will be issued after these proposed standards are adopted.

4. Paragraphs 34 and 35 discuss responses to inquiries. These paragraphs should be cross-referenced to the fraud standard since inquiry is required in the fraud standard and is critical to detecting fraud indicators.

5. Paragraph 41 discusses scanning procedures. The discussion in this paragraph should mention that use of computer assisted audit techniques as a scanning procedure can help identify anomalies.

Audit Risk and Materiality in Conducting an Audit

1. The qualitative and quantitative aspects of materiality should be more clearly explained by adding three new paragraphs that would follow paragraph 4, as illustrated below:

> 4. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users who will rely on the financial statements. The perceived needs of users are recognized in the discussion of materiality in Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, which defines *materiality* as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." That discussion recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. Even though quantitatively immaterial, certain types of misstatements could have a material impact on or warrant disclosure in the financial statements for qualitative reasons.
>
> Qualitative considerations could include (1) account balances or transactions that are considered sensitive to users of the financial statements; (2) misstatements that have a significant effect on the entity's performance indicators; or (3) misstatements that offset one another in the aggregate but are individually significant.
>
> The auditor should apply the concept of materiality throughout the overall audit in such a manner that overall audit risk is reduced to an acceptably low level. There are various materiality measures that the auditor may use for audit planning, disclosure, and evaluation. Even if the entity adjusts the financial statements for known and likely misstatements, the auditor should consider the risk that possible further misstatements could exceed

materiality. (See paragraph 9 for discussion of known, likely, and further misstatements.)

2. Paragraphs 9, 64, and 65 of the proposed standard do not discuss adequately possible further misstatements or explain that the auditor's consideration of possible further misstatements is a part of the planning and evaluation process. Paragraph 9 also should discuss the need for auditors to discuss the effect of misstatements identified in prior periods. These paragraphs should be strengthened and rewritten to read as follows:

    9. Misstatements are of three types: known, likely, and possible further. Known misstatements are the misstatements specifically identified by the auditor. For example, if the auditor finds that the entity did not record an unpaid invoice for goods received or services rendered prior to the end of the period presented, this would be a known misstatement. ~~Misstatements may be of two types: known and likely. Known misstatements consist of the amount of misstatements specifically identified. For example, the failure to accrue an unpaid invoice for goods received or services rendered prior to the end of the period presented would be a known misstatement.~~ Likely misstatements represent the auditor's best estimate of the total misstatements in the account balances or classes of transactions that the auditor has examined.[8] Misstatements also include the effect of misstatements identified in prior periods (see paragraph 52). In addition to known and likely misstatements, the auditor should consider the risk of possible further misstatements. Because the auditor estimates likely misstatements, it is possible that the financial statements may contain possible further misstatements in addition to the auditor's estimate of likely misstatements. (See paragraphs 64-65)

    64. If the auditor concludes that the effects of uncorrected misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, they could still be materially misstated because of further misstatement remaining undetected. As the aggregate misstatements approach materiality, the risk that the financial statements may be materially misstated also increases; consequently, the auditor should also consider the effect of undetected misstatements in concluding whether the financial statements are fairly stated.

    For example, if the auditor determined that materiality was $200,000 and aggregate likely misstatement was $20,000, the auditor may conclude that there is an acceptably low risk of possible further error of $180,000 and that the likely error is sufficiently less than materiality so that the risk that the financial statements are materially misstated is sufficiently low to express an

[8] Likely misstatements in an account balance or class of transactions include any known misstatements in that balance or class.

opinion. On the other hand, if the auditor determined that likely misstatement was $150,000, the auditor might not have sufficient confidence that further misstatement could not exceed $50,000, the difference between the $200,000 established materiality and the $150,000 likely misstatement. In that case, the auditor may need to request that the likely misstatement be corrected and/or perform additional audit procedures to reduce the risk associated with possible further misstatements.

65. The auditor can reduce audit risk by modifying the nature, timing, and extent of planned audit procedures in performing the audit. If the auditor believes that the risk of further misstatement ~~such risk~~ is unacceptably high, the auditor should discuss the matter with management and seek additional evidence that will reduce the risk. If the auditor still believes that the risk of further misstatement is unacceptably high, the auditor should consider the implications for the auditors' opinion. ~~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.~~[25]

3. Paragraph 7 lists types of potential misstatements. The following example should be added as item h:

7.h. rare circumstances in which literal application of GAAP might lead to misleading balances or disclosures in the financial statements

4. Paragraph 10, which discusses immaterial misstatements states that generally errors that are not material are not significant to the audit, and it implies that when an auditor determines a misstatement to be immaterial, no more work is necessary. However, all misstatements (whether caused by error or fraud) should be considered for qualitative implications and effects on the financial statements. For these reasons, the first 2 sentences of paragraph 10 should be deleted. The last sentence of paragraph 10 should be moved the end of paragraph 8 and revised as follows:

~~In contrast, when fraud is detected~~ When the auditor encounters evidence of potential fraud, regardless of its materiality, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

[25] See paragraphs 71 through 77 of the proposed SAS Performance Procedures, with respect to the auditor's evaluation of the sufficiency and appropriateness of audit evidence obtained.

5. In paragraph 18, the guidance on materiality may be inconsistent with the guidance in paragraphs 34-36. Paragraph 18 should be deleted or conformed to those paragraphs.

6. Paragraphs 34-36 on tolerable misstatement should be cross referenced to paragraph 17 of the proposed amendment to SAS No. 39, Audit Sampling, which provides additional guidance on this issue.

7. Paragraph 37 seems to suggest that auditors need only obtain reasonable assurance of detecting misstatements that are quantitatively material to the financial statements. However, auditors also need to obtain reasonable assurance of detecting qualitatively material misstatements.

   In addition, paragraph 37 contradicts the requirement detailed in paragraph 61 of the proposed standard, that auditors should consider qualitative misstatements when determining if financial statements are free from material misstatements. The paragraph also does not relate to the tolerable misstatement heading under which it appears. Since paragraph 37 would establish a requirement that auditors would be obliged to follow in all instances, as indicated by use of the verb "must," paragraph 37 should be deleted from the proposed standard.

8. Paragraph 39 discusses how an auditor's judgments about materiality may change as an audit progresses. The proposed standard also should discuss qualitative factors that the auditor might not detect until after the start of the audit, since these qualitative factors could cause the auditor to adjust materiality during the audit. The language in paragraph 39 should be revised to discuss the qualitative factors and to provide a logical transition to paragraph 40, as follows:

   > 39. Because it is not feasible for the auditor to anticipate all the circumstances that may ultimately influence judgments about materiality in evaluating the audit findings at the completion of the audit, the auditor's judgment about materiality for planning purposes may differ from the judgment about materiality used in evaluating the audit findings. For example, while performing the audit, the auditor may become aware of additional quantitative or qualitative factors that were not initially considered but that could be important to users of the financial statements and that should be considered in making judgments about materiality when evaluating audit findings.

9. Paragraph 46, on communication of material misstatements to management, should be revised as follows:

   > The auditor should request management to make the adjustments needed to correct all known misstatements, including the effects of prior period misstatements (see par 52), ~~other than~~ except those the auditor believes are trivial.

10. Paragraph 67 discusses communications with those charged with governance but does not link this standard and the recently proposed revisions to SAS 60. If there are misstatements, the auditor should consider whether the entity has an internal control deficiency that, under the proposed revisions to SAS 60, should be communicated in writing to those charged with governance. Paragraph 67 should be revised as follows:

    67. Standards and guidance regarding communications about materiality and misstatements to those charged with governance are set out in SAS No. 61, Communications With Audit Committees (AICPA, Professional Standards, vol.1, sec. 380). In addition, SAS No. 60, Communications of Internal Control Related Matters Noted in an Audit, advises auditors to communicate significant deficiencies in internal control in writing to those charged with governance (AICPA, Professional Standards, vol. 1, sec. 325).

11. Paragraph 69 discusses items for auditors to document. The last bullet in paragraph 69 should include a presumptive requirement for auditors to document why management decided not to correct the misstatements as well as the cause of the misstatements if the auditors are able to determine this. Paragraph 69 should be revised as follows:

    69. The auditor also should document all uncorrected misstatements as well as ~~Uncorrected misstatements should be documented in a manner that allow the auditor to:~~
    a. ~~Separately consider~~ the effects of known, ~~and~~ likely, and possible further misstatements;
    b. ~~Consider~~ the aggregate effect of known, likely, and possible further misstatements on the financial statements; ~~and~~
    c. ~~Consider the~~ qualitative factors that are relevant to the auditor's consideration of whether the misstatements are material (see paragraph 61);
    d. the reasons management provides for not correcting misstatements and whether the auditor agrees or disagrees with management's reasons; and
    e. the underlying weakness that allowed the misstatement to occur, if the auditor is able to determine this.

Planning and Supervision

1. Paragraph 3 presents a good discussion of the importance of understanding the entity and its environment, including internal control, for planning and performing an audit.

2. Appendix Sections A.2–A.4 include lists of matters the auditor "may consider" when establishing the audit scope and when ascertaining the engagement reporting objectives, timing of the audit, and nature of required communications.

Two items from the list— statutory or regulatory audit requirements, such as OMB Circular A-133, and setting materiality for the financial statements for planning purposes— are very important. The auditor's consideration of these items should be made a presumptive requirement indicated by the wording "the auditor should consider" rather than an optional consideration indicated by the wording "the auditor may consider."

<u>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</u>

1. The last bullet in paragraph 11 of the proposed standard equates tracing transactions through the system with walkthroughs. Although this is the same language that is used in ISA 315.11, it is an incomplete description of a walkthrough. The Public Company Accounting Oversight Board (PCAOB) provided a more thorough description of walkthroughs in paragraphs 80–81 of Auditing Standard (AS) No. 2. To ensure that the proposed standard indicates that walkthroughs include questioning the entity's personnel, observing procedures being performed, determining whether procedures are performed as originally understood and on a timely basis, and being alert for exceptions to the company's prescribed procedures and controls, the proposed standard should incorporate language from AS No. 2, as follows:

    <u>PCAOB AS No 2 : Paragraph 80.</u> The auditor's walkthrough should encompass the entire process of initiating, authorizing, recording, processing, and reporting individual transactions and controls for each of the significant processes identified, including controls intended to address the risk of fraud. During the walkthrough, at each point at which important processing procedures or controls occur, the auditor should question the company's personnel about their understanding of what is required by the company's prescribed procedures and controls and determine whether the processing procedures are performed as originally understood and on a timely basis. (Controls might not be performed regularly but still be timely.) During the walkthrough, the auditor should be alert for exceptions to the company's prescribed procedures and controls.

    <u>PCAOB AS No 2 : Paragraph 81.</u> While performing a walkthrough, the auditor should evaluate the quality of the evidence obtained and perform walkthrough procedures that produce a level of evidence consistent with the objectives listed in paragraph 79. [of PCAOB Auditing Standard No. 2.] Rather than reviewing copies of documents and making inquiries of a single person at the company, the auditor should follow the process flow of actual transactions using the same documents and information technology that company personnel use and make inquiries of relevant personnel involved in significant aspects of the process or controls. To corroborate information at various points in the walkthrough, the auditor might ask personnel to describe their

understanding of the previous and succeeding processing or control activities and to demonstrate what they do. In addition, inquiries should include follow-up questions that could help identify the abuse of controls or indicators of fraud.

2. Paragraph 3 provides guidance on the importance of obtaining an understanding of the entity and its environment. Complex and unusual transactions should be added to the list of areas where special audit consideration may be necessary in the third bullet of paragraph 3.

3. Paragraph 6 states that the auditor is not required to perform all the risk assessment procedures, including analytical procedures. However, as discussed in paragraph 9, the auditor is required to apply analytical procedures in planning the audit to assist in understanding the entity and its environment and to identify areas that may represent specific risks relevant to the audit. This apparent conflict could be reconciled with some cross referencing and the addition of an explanation.

4. The illustration paragraph 47 is missing the concept of safeguarding of assets, which runs across all objectives of internal control. While the text does discuss the safeguarding of assets in paragraph 52, the discussion is removed from the illustration, which lessens the importance of the point that is raised in this paragraph—that is, the auditor should consider safeguarding controls since those controls could be relevant to the financial statement audit. Therefore, safeguarding of assets should be added back to the illustration in paragraph 47.

5. Paragraph 56 does not sufficiently address the issue of computer 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 56 should be revised to incorporate these concepts, as follows:

    56. Obtaining an understanding of an entity's controls is not sufficient to serve as testing the operating effectiveness of controls. ~~unless there is some automation that provides for the consistent application of the operation of the control (manual and automated elements of internal control relevant to the audit are further described below).~~ For example, obtaining audit evidence about the implementation of a ~~manually operated~~ 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. ~~However,~~ 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~~, because of the inherent consistency of IT processing,~~ performing audit procedures to determine whether an automated control has been implemented may provide some

evidence of ~~serve as a test of~~ that control's operating effectiveness. ~~depending on the auditor's assessment and testing of controls such as those over program changes.~~ However, 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. The operating effectiveness of such an automated control also depends on the auditor's assessment of the operating effectiveness of IT general controls. For example, the auditor should consider the effectiveness of IT general controls that would prevent management overrides or other unauthorized changes to applications or data that would preclude or impair the operation of the automated control. Tests of the operating effectiveness of controls are further described in the proposed SAS *Performing Procedures*.

In addition, the standard should discuss the auditor's assessment of IT general controls in a clear and consistent manner. As drafted, the standard might lead auditors to perform insufficient tests of IT general controls. The standard should clearly indicate that to assess the effectiveness of an automated control, the auditor should assess the effectiveness of IT general controls that could override or impair the effectiveness of the automated control. While such IT general controls would include program change controls, they also would include other IT general controls, such as access, segregation of duties, and security management controls.

The last sentence of paragraph 95 should be deleted from the proposed standard on "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," since this sentence also provides guidance related to automated controls that may be misleading.

6. Paragraph 70, on obtaining sufficient knowledge of the control environment, does not address the situation when the auditor (either internal or external) may have made recommendations in the past that management has not acted upon. A sentence should be added at the end of paragraph 70 to address this issue, as follows:

    70. The auditor should obtain sufficient knowledge of the control environment to understand the attitudes, awareness, and actions of those charged with governance concerning the entity's internal control and its importance in achieving reliable financial reporting. In understanding the control environment, the auditor should concentrate on the implementation of controls because controls may be established but not acted upon. The auditor also should perform additional procedures to determine whether management has taken action to correct internal control deficiencies communicated in the prior audit and, if applicable, the reasons why deficiencies have not been corrected.

7. In paragraph 76, the standard should make the point more clearly that auditors cannot assess control risk as low based solely on global or companywide controls, such as the control environment. Paragraph 76 should be revised, as follows:

   76. The control environment in itself does not prevent or detect and correct a material misstatement in classes of transactions, account balances, and disclosures and relevant assertions. The auditor, therefore, should not assess the risk of material misstatement as low based solely on an entity's control environment but also should consider the effect of other components of internal control in conjunction with the control environment when assessing the risks of material misstatement; for example, the monitoring of controls and the operation of specific control activities.

8. Paragraph 87, on obtaining an understanding of the financial reporting process, does not mention the financial closing process. Without this as an essential element of the financial reporting process, the auditor's understanding of an entity's procedures for preparing financial statements and related disclosures is missing. A discussion of the financial closing process should be added to paragraph 87.

9. The discussion of significant risks that require special audit consideration in paragraph 112 lacks clarity. In particular, the requirement established in the second sentence of this paragraph that "the auditor should exclude the effect of identified controls related to the [significant] risk…," is unclear and therefore, auditors would have difficulty satisfying this requirement. We recognize that the wording in paragraph 112 is the same wording as is used in ISA 315.109; however, we believe that clarity is more important than convergence with the ISAs. Accordingly, paragraph 112 should be revised by deleting the first, second, and fourth sentences and moving the fifth sentence to follow paragraph 111, as follows:

   Significant Risks That Require Special Audit Consideration

   111. As part of the risk assessment described in paragraph 103, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as "significant risks"). Paragraphs 46 and 54 of the proposed SAS *Performing Procedures* describe the consequences for further audit procedures of identifying a risk as significant.

   In considering the nature of the risks, the auditor should consider a number of matters including the following:

   - Whether the risk is a risk of fraud.
   - Whether the risk is related to recent significant economic, accounting, or other developments and, therefore, requires specific attention.
   - The complexity of transactions.

- Whether the risk involves significant transactions with related parties.
- The degree of subjectivity in the measurement of financial information related to the risks, especially those involving a wide range of measurement uncertainty.
- Whether the risk involves significant nonroutine transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

~~112. The determination of significant risks, which arise on most audits, is a matter for the auditor's professional judgment. In exercising this judgment, the auditor should exclude the effect of identified controls related to the risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration.~~ Routine, noncomplex transactions that are subject to systematic processing are less likely to give rise to significant risks because they have lower inherent risks. ~~On the other hand, significant risks are often derived from business risks that may result in a material misstatement. In considering the nature of the risks, the auditor should consider a number of matters including the following:~~

- ~~Whether the risk is a risk of fraud.~~
- ~~Whether the risk is related to recent significant economic, accounting, or other developments and, therefore, requires specific attention.~~
- ~~The complexity of transactions.~~
- ~~Whether the risk involves significant transactions with related parties.~~
- ~~The degree of subjectivity in the measurement of financial information related to the risks especially those involving a wide range of measurement uncertainty.~~
- ~~Whether the risk involves significant nonroutine transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.~~

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

1. Paragraph 70 discusses the importance of auditors' evaluating the overall presentation of the financial statements and related disclosures for compliance with generally accepted accounting principles (GAAP). This should be expanded to discuss the need for auditors to consider during their evaluation other matters beyond literal compliance with GAAP, specifically unusual circumstances in which literal application of GAAP would result in misleading financial statements. Paragraph 70 could also include reference to Rule 203 of the AICPA Code of Professional Conduct, 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. GAO's views on the importance

of this issue are discussed in more detail in our June 27, 2005, letter commenting on the ASB's Proposed Statement on Auditing Standards—Amendment to Statements on Auditing Standard No. 69, the Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles, for Nongovernmental Entities.

2. Paragraphs 28, 37, and 50 do not adequately address the impact that IT general control weaknesses could have on the effectiveness of automated controls. It is important that such references be consistent to avoid auditor misunderstandings. These paragraphs should be changed, as follows:

    - In paragraph 28, since this is the first discussion of IT controls in the proposed standard, replace the second sentence with: "For example, evidence about the implementation of a control may provide evidence about the operating effectiveness of a control at a point in time. However, further audit evidence would be needed for the operating effectiveness of the control during the audit period."

    - In the fourth sentence of paragraph 37, replace the clause "pertaining to the modification and use of that computer program during the audit period" with "that would prevent management overrides or other unauthorized changes to computer applications or data that could preclude or impair the operation of the automated control."

    - In paragraph 50, add the following phrase at the end of fourth sentence, so that it will read as follows:

        > Such tests might include determining that changes to the program are not made without being subject to the appropriate program change ~~controls, that~~controls, that the authorized version of the program is used for processing transactions, and that other relevant general controls, such as access controls that prevent or detect unauthorized access to relevant data and applications, are effective.

3. The last two sentences of paragraph10, on designing audit procedures responsive to the risk of material misstatement, should be deleted since this issue is adequately discussed in paragraph 56 of the proposed standard. As an alternative, the last two sentences of paragraph 10 could be rewritten to include the concepts discussed in paragraph 56.

4. Paragraph 20 discusses the need for auditors to consider the extent of further audit procedures. The concepts of tolerable misstatement and expected misstatement should be included in the discussion of extent of further audit procedures, as follows:

20. Extent refers to the quantity of a specific audit procedure to be performed, for example, a sample size or the number of observations of a control activity. The extent of an audit procedure is determined by the judgment of the auditor after considering the tolerable misstatement, the expected misstatement, ~~materiality,~~ the assessed risk of material misstatement, and the overall audit risk. ~~degree of assurance the auditor plans to obtain~~. In particular, the auditor ordinarily increases the extent of audit procedures as the risk of material misstatement increases. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk and reliable; therefore, the nature of the audit procedure is the most important consideration.

5. Two additional documentation requirements should be added to paragraph 78, as follows:

- known, likely, and possible further misstatements, and
- a conclusion as to whether sufficient procedures were performed.

Recommendations from GAO's April 30, 2003, Comment Letter

The following are recommendations from GAO's April 30, 2003, comment letter, which the Board did not incorporate into the June 15, 2005, exposure draft. We are repeating these recommendations because we believe they are still relevant to improving audit quality.

<u>Amendment to Statement on Auditing Standards No. 39, Audit Sampling</u>

Use of statistical approach to audit sampling: In our April 30, 2003, letter commenting on the ASB's original audit risk proposed standards, we recommended that SAS 39 be revised to require auditors to use a statistical approach for audit sampling or to document the rationale for using a nonstatistical approach. Although the Board limited its consideration of SAS 39 to conforming changes related to the proposed standards included in this exposure draft, we still believe that SAS 39 should include this requirement and we encourage the Board to reconsider our earlier comment, repeated below, in conjunction with the Audit Risk exposure draft or in a future revising of SAS 39.

> Statistical sampling often provides more reliable evidence for drawing conclusions about a population than nonstatistical approaches to sampling. Therefore, when auditors use a nonstatistical approach to sampling, they should document their rationale for using a nonstatistical approach and their justification for the adequacy of the sample size for meeting the test objective. This, however, does not prohibit the auditor from using a nonstatistical sampling approach to audit testing.
>
> Auditors 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 auditors to: (1) objectively determine whether sufficient evidence is obtained and (2) objectively select a representative sample of items for testing.
>
> Auditors should consider using a statistical approach to sampling when more reliable audit evidence is needed, such as when:
>
> - controls/transactions/account balances being tested are material, and/or
> - the risk of material misstatement is high.
>
> Auditors should consider using a nonstatistical approach to sampling when less reliable evidence is deemed sufficient, such as when:
>
> - controls/ transactions/account balances are not material,
> - the risk of material misstatement is low (based on an effective test of controls), and/or
> - due to the nature of the population, the balance can be adequately audited by testing a nonstatistical sample.

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

The guidance on rotating tests of the operating effectiveness of controls in paragraphs 41–46, while more thorough than the guidance provided in the previous proposed standard, still needs additional clarity and rigor. The requirements that were included in the recommendations in our April 30, 2003, comment letter should be added between paragraphs 44 and 45 of the proposed standard, as follows:

> Accordingly, auditors should use rotation only when the following conditions exist:
>
> - The auditor possesses a foundation of audit evidence on which to develop current audit conclusions.
> - Risk of material misstatement is evaluated as low.
> - The control environment, risk assessment, communication, and monitoring are strong, and inherent and fraud risk factors are low.
> - Financial reporting controls over all significant cycles/applications have been evaluated and tested during a sufficiently recent period (no more than 3 years).
> - 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.[25]

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