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Comptroller General of the United States

United States Government Accountability Office
Washington, DC 20548

October 31, 2005

Mr. John Fogarty, Chair
Auditing Standards Board
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Subject: Proposed Statement on Auditing Standards –*Communication of Internal Control Related Matters Noted in an Audit*, (to supersede Statement on Auditing Standards No. 60, *Communication of Internal Control Related Matters Noted in an Audit*)

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Auditing Standards Board's (ASB) September 1, 2005, exposure draft of a proposed Statement on Auditing Standard (SAS) entitled *Communication of Internal Control Related Matters Noted in an Audit.*

We commend the ASB for the many provisions in the proposed standard that would add clarity and rigor to auditor internal control communications in the United States. Overall, we support the proposed standard. We are especially pleased that the proposed standard would require auditors to communicate in writing to management and those charged with governance all significant deficiencies and material weaknesses in internal control over financial reporting that were noted during the audit. The proposed standard goes on to state that these matters should be communicated even if they were previously communicated to these parties in connection with previous audits. This requirement is consistent with the longstanding requirement of *Government Auditing Standards*.

We also support the provisions in the proposed standard that recognize that (1) the significance of a deficiency in internal control depends on the potential for misstatement, not on whether a misstatement has actually occurred, and (2) the body to whom internal control matters are communicated may take different forms. In addition, we believe that the ASB's decision to incorporate terminology and definitions used by the PCAOB will enhance consistency of practice among auditors in the United States.

While we support the thrust of the exposure draft, we urge the ASB to remove the "Framework for Evaluating Control Deficiencies" from the proposed standard and issue the Framework as separate guidance. We are making this suggestion for several reasons: (1) the role of the Framework in the hierarchy of Generally

Accepted Auditing Standards (GAAS) is unclear; (2) the Framework needs to be updated to reflect the relevant requirements and terminology from the new standards on audit risk, when finalized; and (3) the Framework, if retained, should be further developed in several technical areas.

The enclosure to this letter details GAO's comments on specific provisions of the proposed standard.

We thank you for considering our comments on this important proposed standard as we work together on issues of mutual interest to the accountability profession.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

Enclosure

cc:

The Honorable Christopher Cox, 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

Recommendations related to the Proposed Standard

Definitions of "Those Charged with Governance" and "Management"

The definition of "those charged with governance" in paragraph 1 of the proposed standard would be improved by including responsibilities related to internal control, since these responsibilities are of critical importance. In addition, the proposed standard would be improved by including a definition for the term "management." We recommend adopting the language used in paragraph 7 of proposed International Standard on Auditing (ISA) 260 (revised), issued by the International Auditing and Assurance Standards Board, with inclusion of internal control responsibilities, as follows:

> This Statement establishes standards and provides guidance for communicating matters related to an entity's internal control over financial reporting observed during an audit of financial statements. The internal control related matters specified by this Statement should be communicated to management and those charged with governance. The term *those charged with governance* refers to the person(s) with responsibility for overseeing (*a*) the strategic direction of the entity and (*b*) the entity's financial reporting and disclosure process, including related internal control over financial reporting. In most entities, governance is a collective responsibility that may be carried out by a board of directors, a committee of the board of directors (for example, an audit committee), management, a committee of management (for example, a finance or budget committee), partners, or equivalent persons. In some smaller entities, one person may be charged with governance, for example, the owner in an owner managed entity, or a sole trustee. Therefore, in some cases management and those charged with governance are the same people.
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> "Management" means the person(s) who have executive responsibility for the conduct of the entity's operations. In some entities, management includes some or all of those charged with governance, e.g., executive directors, or owner-managers. Management is responsible for preparing the financial statements, including designing, implementing, and maintaining internal control over financial reporting overseen by those charged with governance, and in some cases management is also responsible for approving the financial statements (in other cases those charged with governance have this responsibility).

Materiality

Paragraph 4 of the proposed standard contains several troublesome issues. For instance, we believe that the example stating that 20 percent of overall financial statement materiality, absent other factors, may be considered inconsequential, is arbitrary and risks becoming the "default" percentage that auditors would use in evaluating materiality. We believe, therefore, that the percentage should be removed from the proposed standard. Also, the discussion does not give adequate consideration to the qualitative aspects of materiality that auditors have an obligation to consider. These qualitative aspects are as important as quantitative considerations and have particular importance in a governmental environment. Finally, the introduction of a definition for "inconsequential" misstatements that differs from the definition auditors use when establishing a threshold for accumulating and evaluating uncorrected likely misstatements will likely result in confusion and inconsistency of practice. To improve the quality of the guidance and to correct these issues, we recommend the following changes to paragraph 4:

> **4.** A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person would not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential. ~~For example, a potential misstatement of less than 20 percent of overall financial statement materiality, absent other factors, may be considered inconsequential. However, a potential misstatement that is less than 20 percent of overall materiality may be considered more than inconsequential as a result of qualitative factors. The phrase "more than inconsequential" as used in the definition of significant deficiency describes the magnitude of potential misstatements that might occur as a result of a significant deficiency and serves as a threshold for evaluating whether a control deficiency or combination of control deficiencies is a significant deficiency. *Inconsequential* in this context is not the same concept as the threshold the auditor establishes in an audit of financial statements for accumulating uncorrected likely misstatements to determine whether such misstatements, either individually or when aggregated with other misstatements, are material to the financial statements. (See footnote 14 of paragraph 43 in SAS No. XXX, *Audit Risk and Materiality in Conducting an Audit*.)~~
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> In evaluating the significance of a potential misstatement, auditors should consider both quantitative and qualitative factors. Quantitative factors include both magnitude and likelihood, as discussed in paragraph 6 of this statement. Qualitative factors involve the nature of the potential misstatement and 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; (3) misstatements that offset one another in the aggregate but are individually significant; and (4) susceptibility to fraud, waste, abuse, or noncompliance with applicable laws and regulations.

Other Comments and Recommendations

- We believe that paragraph 7 is confusing and does not provide clear, logical guidance. For instance, the fourth sentence states that when evaluating the reason for a deviation, auditors should consider whether the control is automated or manual, but it doesn't make clear why this distinction is important. In addition, the second sentence introduces the term “nonnegligible,” but does not define the term. We recommend replacing “nonnegligible” with the following wording:

> “…For example, if the auditor designs a test in which he or she selects a sample of 25 items and expects no deviations, the finding of one deviation would be considered a deviation rate that does not achieve the desired level of confidence ~~nonnegligible deviation rate~~ because, based on the results of the auditor’s test of the sample, the desired level of confidence has not been obtained…”

- We agree with the intent, in paragraph 9, for auditors to “step back” and reconsider in a broader context the deficiencies not initially deemed to be significant deficiencies. However, the introduction of the term “person with general business knowledge and experience” for considering whether a deficiency is a significant deficiency is confusing. Since the term is not defined and may differ from the “reasonable person test” in paragraph 4 and elsewhere in the standards, we believe this new term should be replaced with or supported by more contextual information to clearly differentiate from the “reasonable person test.”

- Paragraphs 11 and 15 of the proposed standard should be revised to indicate that the auditors’ control evaluation should be performed for the relevant assertions related to each material account balance, class of transaction, and disclosure.

- In paragraph 16, “those charged with governance” should be added to the last sentence in order to broaden the guidance and to remind auditors of the internal control responsibilities of audit committees, boards of directors, and their equivalents, as follows:

> **16.** When making arrangements for, or during the audit, the auditor and client may discuss the entity’s internal control and concerns regarding its functioning. A client may request, for example, that the auditor:
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> • Be alert to and communicate internal control matters that are not required to be communicated by this Statement, such as matters related to operational or administrative efficiencies.
> • Further investigate matters, and identify and communicate underlying causes.
> • Communicate other items of potential benefit to the entity.
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> Under these arrangements, it is possible that the auditor may be asked to visit specific locations, assess specific controls, or undertake specific procedures not otherwise planned. Also, the auditor is not precluded from communicating matters that he or she views to be of value to management and those charged with governance in the absence of any specific request to do so.

- The proposed standard should indicate that the auditor's communication on internal control related matters noted in an audit should be made regardless of the type of opinion or disclaimer issued. We suggest adding a footnote to paragraph 17 to make this clarification, as follows:

 17. Control deficiencies noted by the auditor that are considered to be significant deficiencies or material weaknesses under this Statement should be communicated in writing to management and those charged with governance as a part of each audit,[xxx] even if they previously have been communicated to these parties in connection with previous audits. Such written communication is best made by the delivery date of the auditor's report on the audited financial statements, but should be made no later than 60 days following the report release date.

 xxx This applies to any situation when auditors issue an opinion or disclaimer on financial statements.

Recommendations related to the Proposed Framework

The "Framework for Evaluating Control Deficiencies" has useful information for providing guidance on evaluating the significant control deficiencies in various situations. In particular, we believe that the description of evaluating IT general controls is helpful. We believe, however, that the document should not be included as an appendix to the proposed standard for the reasons stated in our letter. In addition the following issues should be addressed if the Framework is published elsewhere:

Clarify the Role of the Framework in Generally Accepted Auditing Standards (GAAS)

The role of the Framework in the hierarchy of GAAS needs to be clarified if the Framework is retained. For instance, it is unclear whether auditors would have to follow all guidance in the Framework and whether "must" statements in the Framework would become requirements and "should" statements would become presumptive requirements if the Framework were made a permanent appendix to the proposed standard.

Conform the Framework with the new Audit Risk Standards

The Framework does not conform with the new audit risk standards that were recently exposed in draft by the ASB. We recommend updating the Framework to reflect the relevant requirements and terminology from the new standards on audit risk when finalized.

Other issues that need to be resolved or further developed

- The Framework introduces new terminology that is not defined. It also provides definitions that differ from established definitions for existing terminology. For instance:

    - "de minimis" is used near the bottom of page 24, but the proposed Framework does not explain how this relates to previously introduced concepts such as inconsequential.

    - "exception" is discussed at length beginning on page 21, but the Framework does not explain what would be considered an exception.

    - "three-way match over time," used in the paragraph titled "Relationship between ITGC's and application controls" on page 25, is not explained.

    - The definition of statistical sampling provided on page 22, "a statistical sample (1) is selected on a random or other basis that results in a sample that is representative of the population and (2) is evaluated statistically", is not consistent with other standards. For instance, SAS 39 (AU 350.02) defines audit sampling as "the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class." The AICPA Audit Guide on Audit Sampling, however, defines statistical sampling as "Audit sampling that uses the laws of probability for selecting and evaluating a sample from a population for the purpose of reaching a conclusion about the population." The definition of key terms should be consistent among the standards in order to encourage consistency of practice.

- The examples of evaluating the significance of internal control deficiencies included in this Framework do not adequately explain inherent assumptions. For example, Situation 3A does not describe the assumption that there are no weaknesses in general controls that would allow an individual to circumvent the application controls (e.g., change the data or application access controls at an operating system level.) Also, situation 4A assumes, but does not state, that general controls are effective in preventing or detecting an individual from otherwise changing the data outside of the application.

- The discussion of qualitative factors in the last paragraph of page 23 should be developed. The wording we suggested above for paragraph 4 of the proposed standard could be used here also, as follows:

    Qualitative factors involve the nature of the misstatement and 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; (3) misstatements that offset one another in the aggregate but are individually significant; and (4) susceptibility to fraud, waste, abuse, or noncompliance with applicable laws and regulations

- At the top of page 31, the proposed Framework suggests a percentage threshold for determining if a potential misstatement is inconsequential. We believe the percentage threshold is arbitrary and risks becoming the “default” percentage that auditors would use in evaluating materiality. We recommend, therefore, removing the percentage threshold from the Framework.

- We believe that the requirement in paragraph 17 for auditors to make the required communication no later than 60 days following the report release date is too rigid and probably is unenforceable. Therefore, we recommend providing auditors more flexibility, such as by stating that auditors should make the communication “within a reasonable amount of time, for instance, within 60 days following the report release date.”