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Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

August 2, 2005

Mr. James M. Sylph
Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, NY 10017

Subject: Proposed International Standard on Auditing (ISA) 600, *The Audit of Group Financial Statements*

Dear Mr. Sylph:

This letter provides the U.S. Government Accountability Office's (GAO) comments on the International Auditing and Assurance Standards Board's (IAASB) proposed ISA 600, which was issued in March 2005.

We have a serious concern about whether this proposed standard is viable in audits of large, complex, and diverse entities, whether in the public or private sector. We also have particular concerns about the implications for large public sector entities, such as national and state governments. The absence of alternatives could serve as a significant disincentive to large public entities that might otherwise want to adopt IAASB standards.

We understand from discussions with IAASB staff that the IAASB's intent is to not allow reference to other auditors in the group auditors' report. We are very concerned that the proposed standard does not clearly articulate this important issue. More importantly, we strongly disagree with the IAASB's position on this matter, since we believe that the flexibility to refer to another auditor in the group auditors' report is essential to preserving transparency to the users of group financial statements, maximizing audit efficiency, and providing auditors and audited entities with practical options, especially when entities are large, complex, and diverse in nature, including national governments. Standards in the United States promulgated by the Government Accounting Standards Board and similarly by the Federal Accounting Standards Advisory Board define the criteria for components that are to be included in the financial statements of federal, state, or local government financial reporting entities. This has resulted in the frequent inclusion of components whose financial statements are audited due to legislative or other requirements by auditors other than the principal auditor engaged by the group financial reporting entity. Also, certain U.S. federal departments and agencies and a number of state and local governments require that the auditor proposing to perform audits of the group financial statements provide for minority or smaller firms, or both, to participate in the conduct of the group audit.

Given the size and complexities of the U.S. government as well as large state and local governments, it is frequently impractical, inefficient, or uneconomical for group auditors to review the other auditors' workpapers or to perform significant other procedures on the financial information of the component that was audited by other auditors. In addition, there may be circumstances in which the group auditors decide, regardless of any other considerations, to make reference in their reports to the audits of other auditors in order to clearly indicate the division of responsibility. For example, in the United States, over 90 percent of the 50 state auditors make reference in their reports to other auditors for certain component entities that are included in the financial statements of the state governments. At the federal government level in the United States, the flexibility to refer to other auditors in the group auditors' report is essential to the auditors of the large and complex federal departments and agencies as well as at the U.S. government consolidated level. For instance, at the U.S. federal government level, several hundred different component-level audits are involved. For these reasons, we strongly believe that government auditors in the United States will need the continued flexibility of referring to other auditors in the group auditors' report.

In addition, we are concerned about the IAASB's intent that group auditors be required to perform the same level of audit procedures over other auditors' work regardless of whether group auditors are allowed under the standard to refer to the other auditors' work in the group auditors' report. In determining the nature, timing, and extent of the group auditors' involvement with other auditors, we believe that group auditors should be allowed the option to consider whether or not to refer to other auditors in their reports. When group auditors refer to other auditors, the group auditors should be able to reduce their level of involvement in the other auditors' work.

We also believe that group auditors should be able to use judgment in determining significant components rather than using the fixed 20 percent discussed in the proposed standard. In deciding what is significant, the proposed standard should require group auditors to use a risk-based approach and consider, among other things, the materiality of the portion of the financial statements the group auditors have audited in comparison with the portion audited by other auditors, the extent of the group auditors' knowledge of the overall financial statements, and the importance of the components audited in relation to the group financial statements as a whole rather than using a 20 percent benchmark. As an example, if we applied the proposed 20 percent standard in our audit of the U.S. government's consolidated financial statements, certain of the material financial statement line items would not be required to be audited by the group auditor as no one component represents 20 percent of the consolidated financial statement line item amount.

GAO commends the IAASB's efforts to strengthen the standards and guidance for group audits. We support the concept of a more risk-based approach for assessing the risks of material misstatements of the group financial statements at the group level and believe that the standard should be clear in that regard. We believe that a risk-based approach should be used by the group auditor in determining the level of review and testing of the other auditors' work to be performed by the group auditor.

We offer the following responses to the questions raised on page 6 of the Explanatory Memorandum to the proposed standard, along with additional GAO recommendations related to proposed ISA 600.

Questions Raised in IAASB Explanatory Memorandum

IAASB Question 1: Is the approach to the work of other auditors practical, having regard to the elimination of the divided responsibility option?

GAO Response to Question 1: No. As noted above, we believe that the elimination of the divided responsibility option is not practical or viable for audits conducted in the U.S. and in particular for U.S. public sector entities.

IAASB Question 2: Are the revised standards and guidance on accepting or continuing an engagement to audit group financial statements appropriate?

GAO Response to Question 2: The guidance on accepting or continuing a group audit engagement in the proposed standard, while a good start, requires further development. In particular, the discussion should be expanded to require auditors to obtain a full understanding and proper identification of the completeness of the reporting entity. For example, the proposed standard should discuss the need for auditors to consider the possible existence of undisclosed subsidiaries and joint ventures in commercial enterprises along with affiliated entities such as college foundations and quasi-governmental corporations in governmental entities.

The discussion of access to information on page 5 of the Explanatory Memorandum and in paragraph 18 of the proposed standard indicates that group auditors should not accept engagements if the group auditors' access to other auditors and their work will be restricted. In cases where there are legal or practical impediments to having access to other auditors and their work, the option for referring to other auditors in the group auditor report or "divided auditor responsibility" would provide a mechanism for issuing an audit opinion that clearly indicates that the group auditor is relying on the component auditor's report in forming an opinion on the group financial statements. Rather than issuing a qualified opinion or a disclaimer, the magnitude of the portion of the financial statements audited by other auditors would also be disclosed in the group auditors' report.

IAASB Question 3: Do the revised standards and guidance on access to information, given various laws of jurisdictions, give rise to any unnecessary foreseeable difficulty?

GAO Response to Question 3: Yes. As discussed above, the proposal to eliminate the option of using divided responsibility among auditors likely will cause an increase in situations in which the auditor must qualify or disclaim an audit opinion, rather than having the option of reporting on an entity's financial statements and disclosing the division of responsibility among auditors. This proposal also is likely to result in more situations in which the entire group is audited by one firm, thus resulting in more audits being done by the larger firms.

IAASB Question 4: Is the proposal to move the guidance originally contained in the proposed IAPS to the proposed ISA appropriate? (Any suggestions to the contrary would have to be accompanied by a description of an alternative, and how that alternative maintains the requirements of the proposed ISA.)

GAO Response to Question 4: Yes. We concur with the proposal to incorporate the standard and the guidance in a single document.

Additional GAO Comments

Delete the Distinction between Related Auditors and Other Auditors (paragraphs 27 – 38)

The distinction between "related," "unrelated," and "other" auditors is confusing and potentially allows for too much reliance in the case of "related" auditors. In practice, there can be a high degree of variation in quality control among "related" audit firms, and, therefore, the assumption that the group auditor can ordinarily rely on the quality control policies and procedures of a "related" audit firm may not be valid (paragraph 31.). The group auditor should determine the level of oversight and involvement with other auditors based on audit risk and the experience and knowledge of the other auditors. Therefore, we believe that a separate evaluation should be done of other auditors whether or not they are "related." We also believe that the distinction made between "related" and "unrelated" auditors in the risk assessment process (paragraphs 61 – 64) often will not be valid unless supported by such an assessment. In our reviews of the work of other auditors, we have found wide variances in the quality control practices and procedures even among different offices of the same firm.

Modify Guidance on Auditors' Materiality Determination (paragraph 46)

Paragraph 46 of the proposed standard states that "the group auditor determines materiality levels for the group financial statements as a whole when establishing the overall audit strategy for the audit of the group financial statements." We believe that this methodology is not complete, since there may be different materiality considerations for individual components within the group. For example, if the auditor for an individual component will provide an opinion on the component entity financial statements, that auditor should set materiality based on the component entity's financial statements, not the group financial statements. Also, the guidance does not consider the qualitative aspects in determining materiality levels for the consolidated group. The group auditor may not know of all relevant qualitative factors for all component entities and, therefore, could not determine the appropriate materiality levels for the audits of the consolidated group.

Instead of the above noted language, the standard should indicate that the group auditor and the component auditors should agree on a common methodology for determining materiality levels to be used for all components and for the group financial statements as well as materiality levels needed to audit group financial statements. These materiality levels needed to audit group financial statements may be reduced, but not increased, by the other auditors.

Unadjusted Misstatements (paragraphs 88 and 89)

In paragraphs 88 and 89, the proposed standard indicates that

> 88. The group auditor considers whether matters communicated by another auditor are of such a nature and significance in relation to the group financial statements that a modification of the auditor's opinion on the group financial statements is required.
>
> 89. Uncorrected misstatements that are material to the financial information of the component may be immaterial when aggregated at the group level. As a result, they may not affect the group auditor's opinion on the group financial statements. Conversely, uncorrected misstatements that are immaterial to the financial information of the component may be material when aggregated with uncorrected immaterial misstatements of the financial information of other components. The group auditor considers the aggregated effect of the uncorrected immaterial misstatements of the financial information of the components on the group audit opinion.

These paragraphs should be further developed to require group management to aggregate as well as evaluate the uncorrected immaterial misstatements of the components and determine whether they are material to the group financial statements. Group auditors should request a summary of unadjusted misstatements to the consolidated financial statements from group management and the other auditors. Group auditors also should evaluate the effects of all known and likely unadjusted misstatements and then perform the overall evaluation in accordance with our April 29, 2005, letter commenting on the IAASB proposed revisions to International Standard on Auditing (ISA) No. 320 - *Materiality in the Identification and Evaluation of Misstatements.*

Component Management Representations and, Where Applicable, Legal Representations

The proposed standard should indicate that group auditors and group management, as well as component auditors, should receive copies of component management's representations and also any legal representations where required by national audit standards.

Delete Reference to Review Procedures (paragraph 55)

Paragraph 55 of the proposed standard states that work on components that are not significant in the aggregate could include certain limited audit procedures or a review of the component's financial information. We believe that the term "review" should be replaced with "analyzed" or "evaluated" in order to avoid having readers erroneously believe that review procedures performed in accordance with

International Standards on Review Engagements were acceptable or necessary in the circumstances.

We appreciate the opportunity to express our views on these important matters and would be pleased to discuss them with you in further detail.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

Enclosure

cc:
Mr. Kjell Larsson
Auditor General of Sweden and
Chair of the INTOSAI Financial Audit Working Group

Cynthia A. Glassman, Acting Chairman
U.S. Securities and Exchange Commission

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

Mr. John Fogarty, Chair
U.S. Auditing Standards Board