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United States Government Accountability Office  
Washington, DC 20548

April 30, 2010

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Subject: Proposed Statement on Auditing Standards (SAS) *Audit Evidence – Specific Considerations for Selected Items*.

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Auditing Standard Board's (ASB) December 21, 2009 Exposure Draft for a proposed Statement on Auditing Standards (SAS) entitled *Audit Evidence – Specific Considerations for Selected Items*.

We support the proposed SAS and believe that it will help the auditor in obtaining sufficient appropriate audit evidence regarding (a) valuation of investments in securities and derivative instruments; (b) existence and condition of inventory; (c) completeness of litigation, claims, and assessments involving the entity; and (d) presentation and disclosure of segment information in an audit of financial statements. Our responses to the questions on the changes resulting from applying the clarity drafting conventions and converging with International Standard on Auditing (ISA) 501 are provided in this letter.

### **Issues for Consideration**

The Board asks respondents specifically to consider the following question:

**1. With respect to the change to paragraph 6 of extant AU section 337, the ASB seeks the views from responders about whether seeking direct communication with the entity's external legal counsel through a legal inquiry, based on the assessment of the risk of material [misstatement], is appropriate?**

Yes, we support a risk-based approach to seeking direct communication with the entity's external legal counsel. However, we are concerned that the conditional requirement in paragraph 18, requiring the auditor to request a legal letter only when certain conditions exist, is a significant change from the unconditional requirement in extant AU 337.06 that could significantly reduce auditor use of direct communication with the entity's external legal counsel. Since a letter of audit inquiry to the entity's legal counsel is the auditor's primary means of obtaining corroboration of information provided by management concerning litigation, claims, and assessments,

we are concerned that the proposed SAS could lead to a reduction in important audit evidence.

Instead, we propose changing paragraph 18 to require the auditor to request a legal letter unless certain conditions are satisfied. Although this proposed change would diverge from ISA 501, divergence from the ISA in this case is justified, due to a higher audit risk related to potential unrecorded liabilities related to litigation, claims, and assessments in the U.S. and the litigious U.S. business climate.

We also propose moving the application material in paragraph A43 to the requirement section of the SAS, and making these procedures with respect to litigation, claims, and assessments a requirement, consistent with extant AU 337.05. These procedures are important to the auditor's determination of the risk of material misstatement regarding litigation or claims that have been identified, and accordingly should be a presumptive requirement. We propose including this paragraph between paragraphs 16 and 17 of the proposed SAS.

Our proposed changes would be as follows:

**[New Paragraph – formerly paragraph A43]**

Management of an entity is the primary source of information about events or conditions considered in the financial accounting for and reporting of litigation, claims, and assessments because these matters are within the direct knowledge and, often, control of management. Accordingly, the auditor's procedures with respect to litigation, claims, and assessments ~~may~~ **should** include the following:

- Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel and obtain assurances from management that they have disclosed all such matters required to be disclosed by the applicable financial reporting framework.
- Examine documents in the entity's possession concerning litigation, claims, and assessments, including correspondence and invoices from legal counsel.
- Obtain a written representation from management. See paragraph 16 of the proposed SAS *Written Representations* for further guidance.

**18. ~~If~~ *Unless* the auditor assesses a *the* risk of material misstatement *at an acceptably low level* regarding litigation or claims that have been identified, ~~or when~~ *and* audit procedures performed ~~indicate~~ *detected no evidence indicating* that other material litigation or claims may exist, the auditor should, in addition to the procedures required by other SASs, seek direct communication with the entity's external legal counsel. The auditor should do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor. The**

auditor should request management to authorize the entity's external legal counsel to discuss applicable matters with the auditor. (Ref: par. A48–A56)

### **Responses to Specific Questions**

The Board is also seeking comments on the effect of applying the clarity drafting conventions to the proposed standard and converging it with the International Standards on Auditing. We provide the requested comments below.

#### **1. Are the auditor's objectives appropriate?**

We agree that the auditor's objectives are appropriate.

#### **2. Are the revisions made to converge the existing standards with ISA 501 appropriate?**

We agree with revisions made to converge the existing standard with ISA 501.

#### **3. Are the differences between the proposed SAS and ISA 501 identified in the exhibit, and other language changes, appropriate?**

We agree with differences between the proposed SAS and ISA 501, including the requirement for auditors to document their determination not to seek a legal letter, in addition to the language change noted above.

#### **4. Have considerations for audits of smaller, less complex entities and governmental entities been dealt with appropriately?**

Although the proposed SAS does not include considerations for audits of government entities, we agree that the governmental considerations have been dealt with appropriately and we are not aware of any that should be included in the proposed standard.

### **Additional Comments:**

The proposed SAS would be improved by further developing the introductory paragraph to explain the scope and applicability. Expanding the introduction will help auditors understand when to apply the provisions of this standard and encourage consistency of practice. A more detailed introduction may read:

#### **Introduction**

##### **Scope of This Statement on Auditing Standards**

1. This proposed Statement on Auditing Standards (SAS) addresses specific considerations of the auditor in obtaining sufficient appropriate evidence regarding certain aspects of (a) investments in securities and derivative

instruments; (b) inventory; (c) litigation, claims, and assessments involving the entity; and (d) segment information in an audit of financial statements. The AICPA standards *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted), *Audit Evidence* (Redrafted), and other relevant SASs address obtaining sufficient appropriate audit evidence to provide an opinion on the financial statements. The four topics stated above, however, warrant additional consideration due to their complexity and risk.

This SAS is applicable in audits that involve:

- a. auditing securities and derivative instruments that are (1) valued based on the investee's financial results (excluding investments accounted for using the equity method of accounting) or (2) measured or disclosed at fair value,
- b. attending physical inventory counting,
- c. identifying litigation, claims, and assessments which may give rise to a risk of material misstatement, or
- d. obtaining evidence relating to operating segments.

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

Sincerely yours,

A handwritten signature in black ink, appearing to read "James R. Dalkin". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

James R. Dalkin  
Director  
Financial Management and Assurance