



G A O

Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

September 16, 2011

Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, New York 10017

Subject: International Auditing and Assurance Standards Board (IAASB) May 2011 Consultation Paper entitled *“Enhancing the Value of Auditor Reporting: Exploring Options for Change.”*

This letter provides the U.S. Government Accountability Office’s (GAO) comments on the IAASB’s Consultation Paper on enhancing the value of the auditor’s report.

We support the general premise of enhancing the auditor’s report, and believe that this Consultation Paper is a positive step toward improving the transparency and relevance of these reports. We believe that several of the suggestions, specifically, those relating to an expanded description of the respective responsibilities of management and the auditors, an explanation of technical terms, the enhanced use of “Emphasis of Matter” and “Other Matter” paragraphs, and including a statement on the auditor’s responsibility for, or involvement with, other information, will help make the auditor’s report more useful to the reader. While we believe that the current “pass/fail” reporting model should be retained as an effective means to encourage management to provide all appropriate disclosures, the above suggestions for improving the auditor’s report – the auditor’s primary means of communicating audit results – should be considered. GAO and others in the federal audit community have had significant experience in enhanced reporting in these areas. Attached is an illustrative audit report from the GAO/PCIE *Financial Audit Manual*.¹

Consistent with both the auditing standards and years of accepted practice, management of the audited entity is responsible for the fair presentation of the entity’s financial statements, including disclosure of all information required by the applicable financial reporting framework, and the role of the auditor is to assess the fair presentation of the financial statements, including the completeness of management’s disclosures. If there is a situation in which management does not provide the required disclosures, or such disclosures are not fairly presented, then the auditor considers the effect on the auditor’s opinion and report.

¹ FAM/PCIE Section 595 A - Example of Unqualified Financial Statement, Internal Control Opinion, and Opinion on Substantial Compliance of Entity’s Systems with FFMLA GAO special publications website: (<http://www.gao.gov/special.pubs/gaopcie/>)

As we've stated in previous comment letters, we strongly believe auditing standard setters should work together to achieve core auditing standards that are universally accepted. This issue is an especially timely subject for discussion, as the Public Companies Accounting Oversight Board (PCAOB) has recently issued a concept release on possible revisions to PCAOB standards related to reports on audited financial statements. We encourage the IAASB, the PCAOB, and the Auditing Standards Board (ASB) to coordinate the development of potential new auditor reporting requirements with a goal of harmonizing the auditor's report to the maximum extent possible, based on common core auditing and reporting requirements. We believe that having different audit reports in the marketplace will create significant confusion to the users of the financial statements and may lessen, rather than enhance, users' understanding of the auditor's report. Only where there is a clear and compelling reason, should the individual standard-setting bodies develop differential standards necessary to meet the unique needs of their respective constituencies. The nature of any differences from core auditing standards and the basis for the differences should also be communicated.

Responses to Specific Questions

The board is seeking views on a number of areas where the IAASB would like to obtain a better understanding on the topic of auditor reporting. We provide our specific comments on auditor reporting below.

Questions 1 - 3: Issues Identified

We believe that the following issues identified in the Consultation Paper will help make the auditor's report more useful to the reader.

- a fuller explanation and expanded description of the respective responsibilities of management and the auditors,
- an explanation of technical terms used in the report,
- the enhanced use of "Emphasis of Matter" and "Other Matter" paragraphs to identify specific issues to which the auditor wishes to draw the users' attention, and
- including a statement in the auditor's report on the auditor's responsibility for, or involvement with, other information.

Our reasons for supporting these proposed changes are detailed in our responses to the subsequent questions.

Questions 4 - 5: Format and Structure of the Standard Auditor's Report

Format and Structure

While we believe that the current "pass/fail" reporting model should be retained, we support the general premise that the auditor's report could be improved so that it is more relevant and useful to the financial statement users. We believe the "pass/fail" model is clear, consistent, comparable, and easy for the investing public to digest. Further, we believe it is an important tool to encourage management to make all necessary disclosures.

Explanations of Management and Auditor Responsibilities

We support a fuller explanation and expanded description of the respective responsibilities of management and the auditor, especially with respect to fraud, risk, non-financial disclosures, the extent of internal control testing, and auditor independence. Providing an expanded description of the auditor's responsibilities regarding fraud, and the extent of the auditor's internal control testing could be especially helpful in addressing the "expectation gap." Further, we believe that this expanded description could be positioned in an appendix to the report instead of relocating it to a separate document. As an example, GAO provides an expanded description of the respective responsibilities of management and the auditor in an Objectives, Scope, and Methodology section of the auditor's report that follows our opinion or in an appendix to the auditor's report. We believe that such an expanded discussion assists the readers' understanding of the auditor's report.

Use of Technical Language

We support providing an explanation of technical terms that are used in the auditor's report in footnotes or in a separate appendix to the report, as we believe that explanations of technical terms may assist readers' understanding of the auditor's report. When technical terms are used in GAO reports, they are usually defined in the footnotes or in a separate appendix that defines and describes the technical terms, and we believe that this explanation of the terms used assists the readers' understanding of the auditor's report.

Questions 6 - 7: Other Information in Documents Containing Audited Financial Statements

We support including a statement in the auditor's report on the auditor's responsibility for, or involvement with, other information in documents containing audited financial statements to help the reader obtain an appropriate understanding of this responsibility. If drafted appropriately, such a statement should not confuse readers or imply a higher level of responsibility for this other information. At GAO, we disclose our responsibility for this other information as part of our Objectives, Scope, and Methodology section of the auditor's report.

Questions 8 - 10: Auditor Commentary on Matters Significant to Users' Understanding of the Audited Financial Statements, or of the Audit

Auditor Insights and Perceptions

We do not support providing an expanded commentary of auditor insights and perceptions about areas with increased risk of material misstatement or qualitative aspects of accounting policies. Such a commentary must remain the responsibility of management and those charged with governance. A requirement for auditor commentary on these matters could result in unintended consequences, such as situations in which users are faced with the challenge of interpreting competing disclosures. If the auditor believes it necessary to provide commentary on matters significant to the user's understanding, we support the use of "Emphasis of Matter" and "Other Matter" paragraphs, as discussed below.

"Emphasis of Matter" and "Other Matter" Paragraphs

We support the greater use of "Emphasis of Matter" and "Other Matter" paragraphs, especially to call the user's attention to the most significant matters in the financial statements or any other matter that is significant to the users' understanding of the audit, the auditor's responsibilities, or the auditor's report. These issues might

include reference to management's discussion of critical accounting judgments and estimates and other areas with significant measurement uncertainty. GAO has frequently used "Emphasis of Matter" and "Other Matter" paragraphs to highlight significant uncertainties and risks that are significant to the users' understanding of the financial statements. In these cases, if management has not already disclosed the relevant information, we suggest that such information also be presented as part of management's disclosures.

If the IAASB decides to encourage greater use of "Emphasis of Matter" and "Other Matter" paragraphs, we encourage the IAASB to provide additional guidance on the use of the paragraphs, including when they might be appropriate and factors to consider in writing such paragraphs. Issuing such guidance would encourage greater consistency of practice when auditors use these paragraphs. This guidance might also suggest that when using "Emphasis of Matter" and "Other Matter" paragraphs, the practitioner might want to create a neutral framework so that the "Emphasis of Matter" and "Other Matter" paragraphs are not perceived as reporting problems or negative matters. For example, we have used the following wording to introduce an "Emphasis of Matter" paragraph *"the following items deserve emphasis in order to put the information contained in the financial statements into context."*

Questions 11 - 13: An Enhanced Corporate Governance Model: Role of Those Charged with Governance Regarding Financial Reporting and the External Audit

Effective two-way communication between the auditor and those charged with governance is important and necessary to develop an understanding of matters related to the audit and to maintain a constructive working relationship between the auditor and those charged with governance. Those charged with governance are responsible for sharing auditor communications with users as appropriate. Auditor disclosure of information shared with those charged with governance may jeopardize relationships essential to audit quality, cause the parties to be less candid, and may inhibit effective two way communications between the auditors and those charged with governance. For these reasons, we continue to believe that any enhanced reporting in this area should be provided by management and those charged with governance.

Questions 14 - 15: Other Assurance or Related Services on Information Not Within the Current Scope of the Financial Statement Audit

We caution against requiring auditors to provide assurance or related services on information not within the current scope of the financial statement audit. We believe the ability to provide assurance is fully dependent on the scope of the reporting and its relationship to the financial audit procedures and the availability of criteria. An auditor must be able to audit against criteria to sufficiently provide assurance. Some information may be better suited for audit procedures. For example, an auditor may be able to determine whether performance measures have been properly calculated, although the procedures required to provide assurance in that area may differ significantly from, and be unrelated to, the financial audit scope and procedures. As we've seen, however, auditors are able to report on internal controls as part of a financial audit. Other information such as whether an organization fosters strong governance cannot be easily audited as part of a financial audit, and it is unclear

whether criteria exists that could be consistently applied across entities and different industries.

Another consideration is the cost to provide assurance on information outside the financial statements, and whether appropriate benefits would accrue to the financial reporting and auditing processes. Requiring the auditors to provide assurance on information outside the financial statements (e.g., corporate governance arrangements, key performance indicators, and other information) may be challenging in practice; involving significant additional cost while providing limited additional user benefit.

Questions 16 - 19: Implications of Change and Potential Implementation Challenges

Implications of Change

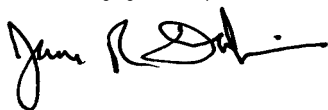
We believe that an expanded description of the respective responsibilities of management and the auditors, an explanation of technical terms, the enhanced use of “Emphasis of Matter” and “Other Matter” paragraphs, and including a statement on the auditor’s responsibility for, or involvement with, other information will help make the auditor’s report more useful to the reader and may help to reduce the “expectations gap.” Such explanations and expanded descriptions would not change the auditor’s responsibility, but would clarify the auditor’s communication with the reader and lead to a fuller understanding of the auditor’s report.

Implementation Guidance

If the Board decides to undertake a standard-setting project on auditor reports to include consideration of the areas discussed above, we encourage the IAASB to develop enhanced guidance for implementing such new requirements and information in coordination with other standard setting bodies, as appropriate. For example, other standard setters responsible for financial reporting frameworks could develop guidance concerning any additional required disclosures, and the IAASB could develop guidance and criteria to help the auditor evaluate management’s disclosures. Absent this guidance, there may be a lack of conformity across auditor’s reports that confuses the user and diminishes the usefulness of the report.

We thank you for considering our comments on this important issue as the IAASB considers possible options to enhance the value of auditor reporting.

Sincerely yours,



James R. Dalkin
Director
Financial Management and Assurance

Enclosure: FAM Section 595A - Example of Unqualified Auditor’s Report

cc: Office of the Secretary, Public Company Accounting Oversight Board

Example 1 - Unqualified Financial Statement, Internal Control Opinion, and Opinion on Substantial Compliance of Entity's Systems with FFMIA

[Addressee]

In accordance with [cite audit authority] we are responsible for conducting audits of [full name of entity]. In our audits of the [entity] for fiscal year(s) [cite], we found

- the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles,
- [entity] had effective internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations,
- [entity's] financial management systems substantially complied with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA),² [for CFO Act agencies, omit for non-CFO Act agencies] and³
- no reportable noncompliance with laws and regulations we tested.

The following sections discuss in more detail (1) these conclusions, (2) our conclusions on Management's Discussion and Analysis and other supplementary information, (3) our audit objectives, scope, and methodology, and (4) agency comments and our evaluation.

Opinion on Financial Statements

The financial statements including the accompanying notes present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, [entity's] assets, liabilities, and net position as of September 30, 20XX [and 20X1]; the financial condition of [entity's] social insurance programs (if applicable) as of [the specified date]; and net costs; changes in net position; budgetary resources; and custodial activity (if applicable)⁴ for the year[s] then ended.

Opinion on Internal Control

[Entity] maintained, in all material respects, effective internal control over financial reporting (including safeguarding assets) and compliance as of [end of fiscal year] that provided reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements would be prevented or detected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. 3512 (c), (d), the Federal Managers' Financial Integrity Act, and the Office of Management and Budget (OMB) Circular No. A-123, *Management's Responsibility for Internal Control*, [or other criteria].

² OMB audit guidance provides guidance for reporting on FFMIA compliance without expressing an opinion.

³ Non-GAO auditors may combine bullets 3 and 4.

⁴ This list assumes the entity follows U.S. GAAP issued by FASAB. If the entity follows U.S. GAAP issued by FASB (government corporations and others such as the U.S. Postal Service), modify the list accordingly.

Systems' Compliance with FFMIA Requirements [Omit this section for non-CFO act entities]

[Entity's] financial management systems, as of [end of fiscal year], substantially complied with the following requirements of FFMIA: (1) federal financial management systems requirements, (2) federal accounting standards, and (3) the *U.S. Government Standard General Ledger* (SGL) at the transaction level. Our opinion is based on criteria established under FFMIA, OMB Circular No. A-127, *Financial Management Systems* (which includes the Joint Financial Management Improvement Program/Office of Federal Financial Management series of system requirements documents), U.S. generally accepted accounting principles, and the SGL.⁵

Compliance With Laws and Regulations

Our tests of the [entity's] compliance with selected provisions of laws and regulations for fiscal year 20XX disclosed no instances of noncompliance that would be reportable under U.S. generally accepted government auditing standards or OMB audit guidance. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

Consistency of Other Information

The [entity's] Management's Discussion and Analysis, required supplementary information (including stewardship information), and other accompanying information contain a wide range of information, some of which is not directly related to the financial statements.⁶ We do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with [name of entity] officials. On the basis of this limited work, we found no material inconsistencies with the financial statements, U.S. generally accepted accounting principles, or OMB guidance.

Objectives, Scope, and Methodology

[Entity] management is responsible for (1) preparing the financial statements in conformity with U.S. generally accepted accounting principles, (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act are met, (3) ensuring that the [entity's] financial management systems substantially comply with FFMIA requirements (for CFO Act agencies), and (4) complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the [entity's] financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles and (2) [entity]

⁵ Non-GAO auditors may combine this information with compliance with laws and regulations.

⁶ The Annual Financial Statement that includes the MD&A, any RSSI, RSI, and OAI, may be included in a larger document such as a Performance and Accountability Report (PAR). Depending on the presentation of these items in the PAR, the auditor may find it useful to refer to the specific page numbers on which this information appears. Additionally, there may be additional information presented in the PAR on which the auditor may need to provide an additional disclaimer. This disclaimer may be worded as "The other accompanying information included on pages XX, XX, and XX of this PAR is presented for purposes of additional analysis and is not a required part of the financial statements. This information has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it."

management maintained effective internal control, the objectives of which are as follows:

- Financial reporting: Transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.
- Compliance with laws and regulations: Transactions are executed in accordance with (1) laws governing the use of budget authority, (2) other laws and regulations that could have a direct and material effect on the financial statements, and (3) any other laws, regulations, and government-wide policies identified by OMB audit guidance.

We are also responsible for (1) testing whether [entity's] financial management systems substantially comply with the three FFMIA requirements [omit for non-CFO Act agencies], (2) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (3) performing limited procedures with respect to certain other information appearing in the Annual Financial Statement.

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the financial statements;
- obtained an understanding of the entity and its operations, including its internal control related to financial reporting (including safeguarding assets), and compliance with laws and regulations (including execution of transactions in accordance with budget authority);
- tested relevant internal controls over financial reporting and compliance, and evaluated the design and operating effectiveness of internal control;
- considered the design of the process for evaluating and reporting on internal control and financial management systems under the Federal Managers' Financial Integrity Act;
- tested whether [entity's] financial management systems substantially complied with the three FFMIA requirements [omit for non-CFO Act agencies]; and
- tested compliance with selected provisions of the following laws and regulations: [list laws and regulations]

We did not evaluate all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate.

We did not test compliance with all laws and regulations applicable to [entity]. We limited our tests of compliance to selected provisions of laws and regulations that have a direct and material effect on the financial statements and those required by OMB audit guidance that we deemed applicable to the [entity's] financial statements for the fiscal year ended [date]. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

We performed our audit in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

Agency Comments and Our Evaluation

In commenting on a draft of this report (see appendix x), [entity] concurred [or partially concurred, or did not concur] with the facts and conclusions in our report. Discuss agency comments with auditor evaluation if agency partially concurred or did not concur.⁷

[Auditor's signature]

[Date of audit completion]

⁷ If the entity's comments include discussions of corrective action plans or other matters as discussed in FAM 580.84, example wording is: "We did not perform audit procedures on [entity's] written response to the significant deficiencies [and material weaknesses, if applicable] and, accordingly, we express no opinion on it."