



G A O

Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

December 22, 2009

Ms. Sherry Hazel
Audit and Attest Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Subject: AICPA Auditing Standards Board (ASB) September 2009 Exposure Draft for proposed Statements on Auditing Standards (SAS), entitled *Forming an Opinion and Reporting on Financial Statements; Modifications to the Opinion in the Independent Auditor's Report; and Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

This letter provides the U.S. Government Accountability Office's (GAO) comments on these three SASs.

Restricting the Use of an Auditor's Report

We are very concerned by the restricted use requirements and guidance in the proposed SAS on *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* because they are not consistent with requirements and guidance in *Government Auditing Standards*. Audited financial statements and related auditor reports of government entities are public documents. Government audits provide key information to stakeholders and the public and help maintain accountability for the use of public resources. Public access to these auditor reports is an important element of this process. By imposing a requirement for auditors to restrict the use of auditor reports, the ASB has created a practice problem for auditors of government entities whose audit reports and related communications are made public in accordance with *Government Auditing Standards* and often public disclosure laws or regulations. In attempting to satisfy both requirements, auditors sometimes issue illogical report language that includes the restricted use wording, followed by a statement that their report is a matter of public record.

We believe that auditor reports on general purpose financial statements should not be restricted, and the SAS should converge with the wording in the ISAs unless a departure to solve a practice problem specific to U.S. audits is needed. Specifically, paragraphs 9 and 10 and the related application material in paragraphs A14–A19 of the proposed SAS *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* include additional requirements and guidance for

when an auditor is required to or chooses to restrict the use of a report whereas ISA 706 has just one paragraph of application material on this issue.

We also disagree with characterizing as “by-product report” the additional reports issued as a result of procedures designed to enable the auditor to express an opinion on financial statements. Reports on internal controls over financial reporting and compliance with laws and regulations and provisions of contracts or grant agreements issued in accordance with *Government Auditing Standards* are an integral part of such an audit and important for assessing the results of the audit¹. Issuance of these reports is an important objective of audits performed in accordance with *Government Auditing Standards*.

Since much of the restricted use wording in the proposed SAS is consistent with extant AU section 532 and the changes we would like to see are beyond the scope of the clarity project, we strongly encourage the Board to create a task force to review and revise AU section 532. Such a task force should be instructed to adopt a comprehensive approach to resolve the practice problems created by extant AU section 532 and to accommodate the needs and concerns of both the private and the public sectors.

Until such time as AU section 532 is revised, we recommend the ASB adopt the following changes to the proposed SAS that will address some of our concerns. We have also provided proposed wording for these changes.

- The first sentence of paragraph 10 and paragraph 10c. discuss restricting the use of a report or “other written communication,” without defining or explaining what types of written communication to restrict or why they should be restricted. Applying a blanket restriction on “other written communication” is inappropriate and we recommend removing this phrase from paragraphs 10 and 10c or changing it from a requirement to optional application material.
- The last sentence of paragraph 11, “The auditor should not agree to add other parties as specified parties of a by-product report.” does not explain the reasons for the requirement or provide situations when it may be important. Such a blanket requirement is not practical and does not make sense in all situations. For example, restricting the use of reports on internal control related matters, unless the reports contain sensitive or confidential information, is not appropriate in all situations. The public interest is served by providing the public with reports related to internal control related matters of government entities. In the case of reports on compliance with aspects of contractual agreements, it may be appropriate to provide such information to owners, regulators, or the public. Since this requirement is not in extant AU 532 or ISA 706, we recommend removing this phrase from the proposed SAS or changing it from a requirement to optional application material.
- Since by-product reports are not discussed in ISA 706, we recommend replacing the term in paragraphs 10 and 11 and deleting paragraphs A16 – A19 of the proposed SAS *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditors Report*.

¹ GAO, *Government Auditing Standards* GAO-07-731G (Washington, D.C.: July 2007), Par. 5.09.

- Extant AU 532.18, which discusses informing entity management of limiting the intended use of the auditor’s report, is included in paragraph A15 of the proposed SAS, but note 6 to AU 532.18 was not added to the proposed SAS. The provisions of this note are important to thousands of government entities whose audited financial statements and the related auditors report are required by law or regulation to be publicly available. Accordingly, we recommend including this note as application material that would precede paragraph A10 of the proposed SAS.
- In paragraph A14, the second sentence states that *Circular – A133, Audits of States, Local Governments and Non-Profit Organizations* and *Government Auditing Standards* includes a restricted-use requirement when this is not the case. We therefore encourage deleting this sentence. Also, the first sentence of paragraph A14 should be deleted since it is confusing and repetitive of the third sentence.

To incorporate the suggestions noted above we recommend revising paragraphs 9 – 11 and A10 – A19 in the proposed SAS *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report* as follows:

Requirements

Restricting the Use of an Auditor’s Report

9. The auditor may be required to or may choose to restrict the use of a report. An auditor’s report that is restricted as to use should contain an other matter paragraph that includes the following elements: (Ref: par. A12–A15)

- a. A statement indicating that the report is intended solely for the information and use of the specified parties
- b. An identification of the specified parties to whom use is restricted
- c. A statement that the report is not intended to be and should not be used by anyone other than the specified parties.

10. The auditor should restrict the use of a report ~~or other written communication~~ in the following circumstances:

- a. When special purpose financial statements are prepared in accordance with a contractual basis of accounting;
- b. When special purpose financial statements are prepared in accordance with a regulatory basis of accounting and the financial statements together with the auditor’s report are not intended for general use; or
- c. When the report ~~or written communication~~ is issued in addition to the audit opinion as a by-product of an audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements, not to provide assurance on the specific subject matter of the report ~~or written communication~~. (Ref: par. A16–A19)

11. The use of ~~additional by-product~~ reports should be restricted to

- a. management, those charged with governance, others within the organization, and any specified governmental authorities to which the

auditor is required to report, when communicating internal control related matters identified in an audit (see AU section 325, Communicating Internal Control Related Matters Identified in an Audit [AICPA, Professional Standards, vol. 1]);

b. those charged with governance and, if appropriate, management, when communicating with those charged with governance (see AU section 380, The Auditor's Communication With Those Charged With Governance [AICPA, Professional Standards, vol. 1]);

c. in the case of reports on compliance with aspects of contractual agreements, to the parties to the contract or agreement.

~~The auditor should not agree to add other parties as specified parties of a by-product report.~~

Application and Other Explanatory Material

Restricting the Use of an Auditor's Report (Ref: par. 9-11)

[New paragraph to precede paragraph A10] In some cases, restricted-use reports filed with regulatory agencies are required by law or regulation to be made available to the public as a matter of public record. Also, a regulatory agency as part of its oversight responsibility for an entity may require access to restricted-use reports in which they are not named as a specified party. [AU 532.18, note 6]

Restriction on distribution or use of the auditor's report (Ref: par. 9)
A10. Auditor's reports on a complete set of general purpose financial statements ordinarily are not restricted as to use. However, nothing in GAAS precludes an auditor from restricting the use of any report.

A11. The need for restriction on the use of a report may result from a number of circumstances, including the purpose of the report, the nature of the procedures applied in its preparation, the basis of or assumptions used in its preparation, the extent to which the procedures performed generally are known or understood, and the potential for the report to be misunderstood when taken out of the context in which it was intended to be used.

A12. Financial statements prepared for a specific purpose may be prepared in accordance with a general purpose framework because the specified parties have determined that such general purpose financial statements meet their financial information needs. Because the auditor's report is intended for specific users, the auditor may consider it necessary in the circumstances to include an *other matter* paragraph, stating that the auditor's report is intended solely for the intended users and should not be distributed to or used by other parties.

Combined Reports Covering Both Restricted-Use and General-Use Subject Matter or Presentations

A13. If an auditor issues a single combined report covering both (a) subject matter or presentations that require a restriction on use to specified parties and (b) subject matter or presentations that ordinarily do not require such a restriction, the use of such a single combined report would be restricted to the specified parties.

~~A14. In some instances, a separate restricted-use report may be included in a document that also contains a general-use report. Such a requirement exists in audits performed in accordance with the U.S. Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, and U.S. General Accounting Office, Government Auditing Standards. The inclusion of a separate restricted-use report in a document that contains a general-use report does not affect the intended use of either report. The restricted-use report remains restricted as to use, and the general-use report continues to be for general use.~~

Limiting the Distribution of Reports

A15. An auditor may consider informing management that restricted-use reports are not intended for distribution to nonspecified parties, regardless of whether they are included in a document containing a separate general-use report. However, an auditor is not responsible for controlling management's distribution of restricted-use reports.

By-Product Reports (Ref: par. 10)

~~A16. An auditor may issue certain reports on matters coming to his or her attention during the course of an audit of financial statements. Such reports include but are not limited to, reports issued pursuant to the following:~~

- ~~• AU section 325, *Communicating Internal Control Related Matters Identified in an Audit*;~~
- ~~• AU section 380, *The Auditor's Communication With Those Charged With Governance*; or~~
- ~~• *Proposed SAS Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements*.~~

~~A17. Reports issued pursuant to the aforementioned auditing standards are based on the results of procedures designed to enable an auditor to express an opinion on the financial statements as a whole, not to provide assurance on the specific subject matter of the report. These reports are by-products of an audit of financial statements and are referred to as by-product reports.~~

~~A18. Because the issuance of the by-product report is not the primary objective of the engagement, an audit generally includes only limited procedures directed toward the subject matter of the by-product report. Accordingly, because of the potential for misinterpretation or misunderstanding of the limited degree of assurance associated with a by-product report, the use of such reports is restricted as required by paragraph 10(b). For example, a report issued under AU section 325 is required to be~~

~~restricted because the purpose of the engagement is to report on an entity's financial statements, not to provide an opinion on its internal control.~~

~~A19. An auditor may issue a by-product report in connection with other engagements conducted in accordance with generally accepted auditing standards, such as an engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement.~~

Form and Content of the Auditor's Report

The board has asked responders to comment on the form and content of the auditor's report in the proposed SAS *Forming an Opinion and Reporting on Financial Statements*. Our responses to the questions posed on page 13 of the exposure draft are as follows:

(1) We believe that the additional sections in the auditor's report discussing the auditor's responsibility and management's responsibility are appropriate for auditors in the U.S.

(2) We believe that the inclusion of sectional heading in the auditor's report will be helpful for readers and will make the auditor's report more readable and easier to understand.

(3) We do not anticipate any serious practice issues arising if the ASB requires different yet similar wording in the auditor's report than that required by PCAOB standards. Any potential disadvantages that may result from differences with PCAOB reporting standards would be unlikely to justify retaining the report wording in the extant standards. However, educating readers of audit reports about the nature and significance of these differences will be important to help the readers understand the new wording of the auditor's report.

While overall we support the proposed changes to the auditor's report, we recognize this will not overcome the expectation gap. Accordingly, we encourage the ASB to carefully evaluate the findings of the auditor's research report project and to continue seeking ways to communicate more effectively with audit report users.

Comments on Changes Resulting from Applying the Clarity Drafting Conventions and Convergence with ISA Nos. 700, 705, 706 and 710

Our comments on changes resulting from applying the clarity drafting conventions and from converging with the International Standards on Auditing (ISAs) are detailed below.

(1) We believe that the objectives to be achieved by the auditor as stated in each of the proposed SASs are appropriate.

(2) We agree with the revisions made to the existing standards to converge with ISA Nos. 700, 705, 706 and 710.

(3) Except as noted in our comments below, we agree with the differences between the proposed SASs and ISA Nos. 700, 705, 706 and 710.

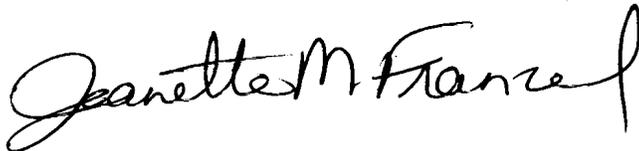
(4) We agree with the governmental considerations included in the proposed standards and we recommend including an additional one to the SAS *Forming an Opinion and Reporting on Financial Statements*. This consideration for governmental entities would be referenced to paragraph 7 and would provide important guidance on the broader audit objectives in audits of government entities. We suggest wording this government consideration as follows:

Considerations Specific to Government Entities (Ref: par 7)

For audits of government entities, the objectives of a financial audit are often broader than forming and expressing an opinion on the financial statements. Laws, regulations, and Government Auditing Standards require that the auditor satisfy additional objectives. These additional objectives include audit and reporting responsibilities, for example, relating to reporting instances of non-compliance with applicable laws and regulations and/or reporting material weaknesses and significant deficiencies in internal control noted during the audit. Such reporting on compliance and internal control is an integral part of a GAGAS audit.

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

Sincerely yours,

A handwritten signature in black ink that reads "Jeanette M. Franzel". The signature is written in a cursive, flowing style.

Jeanette Franzel
Managing Director
Financial Management and Assurance