



G A O

Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

December 15, 2009

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

Subject: AICPA Auditing Standards Board (ASB) September 2009 Exposure Draft of proposed Statement on Auditing Standards (SAS) *Audits of Group Financial Statements (Including the Work of Component Auditors)*.

This letter provides the U.S. Government Accountability Office's (GAO) comments on the ASB's proposed statement on auditing standards. GAO supports the proposed SAS and believes that it will help improve the quality of group audits. We believe that the option for a group auditor to refer to component auditors in the group auditor's report is necessary to help preserve transparency, maximize audit efficiency for the group auditor, and potentially reduce situations in which the group auditor must qualify or disclaim an audit opinion, as noted in our comments below. Our responses to the questions in the Board's Issues for Consideration and Specific Comments are provided in this letter. Editorial changes and other comments are included in the attachment to this letter.

Issues for Consideration

The Board asks respondents specifically to consider the following questions:

1. Should auditors be permitted to make reference to the audit of a component auditor in the auditor's report on the group financial statements?

We strongly support the option to allow the auditor to make reference to the audit of a component auditor in the auditor's report on group financial statements. When done in accordance with the requirements of this SAS, the option of making reference to other auditors (divided responsibility) can improve audit efficiency for the group auditor without sacrificing effectiveness. It also preserves transparency by explaining in the group auditor's report the portions of the audit performed by the component auditor.

Although this represents a difference from international standards, we believe this difference is necessary. In some situations, the group auditor's making reference to the audit of the component auditor is the only practical and/or feasible option for completing the audit. For example, a component of a government entity may be required by law or regulation to have its financial statements audited by auditors other than the group auditor, or management of the group may not have the authority

to select the component auditor. In such cases, making reference to the work of the component auditor is the best option available to the group auditor.

Conversely, eliminating the option of divided responsibility would cause an increase in situations in which the auditor must qualify or disclaim an audit opinion, rather than having the option of reporting on the group's financial statements and disclosing the division of responsibility among auditors. For example, the size, complexity, and diversity of the audit of the U.S. government, in which withdrawal is not a viable option, make eliminating the option to make reference to a component auditor problematic. The same situation holds true for large and complex state and local governments. For these reasons, we strongly believe that the option of referring to other auditors in the group auditor's report remains appropriate.

2. Does the illustrative auditor's report clearly articulate the degree of responsibility assumed by each auditor when reference to the audit of a component auditor is made?

The illustrative report, for use when making reference to the report of a component auditor, clearly articulates the degree of responsibility assumed by the group auditor and the component auditor under the proposed standard. It should, however, more accurately reflect that the group auditor's opinion, as it relates to the component entity, is "based on the component auditor's report," rather than "based **solely** on the component auditor's report." [bolding added for emphasis]

The proposed SAS is broader in scope than AU section 543. We agree that this scope expansion is necessary to help eliminate the inconsistent practices that are noted in the explanatory memorandum to the exposure draft. Although the proposed SAS expands the objective, requirements, and guidance for auditors of group financial statements when referring to component auditors, the illustrative report for use when making reference to the report of a component auditor is identical to extant AU 543.09. This may give auditors and report users the mistaken idea that the group auditor is only relying on the report of the other auditors, without any additional procedures.

The proposed SAS specifically articulates procedures necessary for the group auditor to perform in order to be involved with component auditors to the extent necessary for an effective audit. It also discusses the degree of involvement required when reference is made to a component auditor in the auditor's report.

For example, under the provisions of the proposed standard, when making reference to the work of a component auditor, the group auditor is required to comply with the following paragraphs, which require the group auditor to:

- **Paragraphs 48 – 49:** Request the component auditor to communicate (1) any significant risk of material misstatement of the group financial statements not identified by the group auditor and the component auditor's responses to such risks, (2) related parties not previously identified by group management or the group engagement team, and (3) matters relevant to the group engagement team's conclusions regarding the group audit, including the component auditor's overall findings, conclusions, or opinions.

- **Paragraph 52:** Evaluate a component auditor’s communication and discuss significant findings and issues arising from that evaluation with the component auditor, as appropriate.
- **Paragraph 55:** Evaluate whether sufficient appropriate audit evidence on which to base the group audit opinion has been obtained from the work performed by component auditors.

The expanded scope of the proposed SAS and its clear description of the degree of involvement required of the group auditor when making reference to the work of a component auditor are of such importance, that we believe it is misleading for the group auditor to state that the opinion related to the balances of the component entity is based **solely** on the report of the other auditors. Accordingly, we recommend deleting the word “solely” from the illustrative report as follows:

Exhibit F: Example of an Opinion Where the Group Engagement Partner Is Making Reference to the Audit of the Component Auditor (Ref: par. A52)

Independent Auditor’s Report

We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20...., and the related consolidated statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us and our opinion, insofar as it relates to the amounts included for B Company, is based ~~solely~~ on the report of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20...., and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

3. Does the proposed SAS make appropriate distinctions between what is required of the auditor when making reference and when not making reference?

The proposed SAS generally makes appropriate distinctions of auditor requirements that apply only when assuming responsibility for the work of other auditors; however, clearer, more consistent labeling of these distinctions would help reduce confusion as to when the different requirements apply. For example, the requirements in paragraph 33 – 39 are appropriately identified by the italicized heading *Requirements When Assuming Responsibility: Determining the Type of Work to Be Performed on the Financial Information of Components* (Ref: par. 33–39). However, the italicized sub-heading immediately preceding paragraph 38, *Involvement in the Work Performed by Component Auditors* (Ref: par. A70–A71) may incorrectly lead the auditor to believe that this subheading indicates a break in the sequence of paragraphs that apply when the auditor assumes responsibility for the work of component auditors. A better method of labeling or formatting should be applied to clearly identify these paragraphs.

Additionally, the proposed SAS does not consistently identify in the application materials the guidance that applies only when assuming responsibility. Paragraphs A61 – A62 and A78 are preceded by italicized headings that identify them as applying only when assuming responsibility. It is unclear, however, if these headings also apply to paragraphs A63 – A71. Although paragraphs A74 – A77 would apply only when assuming responsibility, this is not indicated in the proposed SAS. The application paragraphs should be clearly labeled to make appropriate distinctions and identify the guidance for auditors to follow when making reference to the work of other auditors.

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 believe that the auditor’s objectives when conducting an audit of group financial statements are appropriate as written. These objectives are generally consistent with the objectives of ISA 600, with the exception of the option to determine whether to make reference to the audit of a component auditor in the auditor’s report on the group financial statements, and we agree with this divergence from ISA 600.

2. Are the revisions made to converge the existing standard with ISA 600 appropriate?

We agree with the revisions from the existing standard to converge with the ISA.

3. Are the differences between the proposed SAS and ISA 600 identified in exhibit H, and other language changes, appropriate?

We agree that the differences between the proposed SAS and ISA 600 identified in exhibit H, and other language changes, between the proposed SAS and ISA 600 are appropriate.

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

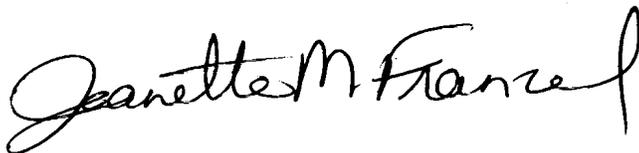
Yes, these considerations are appropriate as written.

5. Is the impact assessment found on page 13 helpful to respondents in their consideration of the proposed SAS?

The impact assessment is helpful to respondents who wish to understand the rationale and logic behind the Board's suggested revisions, identify incremental difference between the extant and proposed new standard, or assess the impact of these differences. However, the assessment could be used more effectively as a tool to solicit feedback from stakeholders by using open-ended questions to solicit stakeholders' feedback concerning the potential impact of the proposed statement. A preface explaining the purpose and intended use of the assessment would assist users in understanding the document.

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 style with a large, looped initial "J".

Jeanette Franzel
Managing Director
Financial Management and Assurance

Attachment

GAO Suggested Editorial and Other Changes to Proposed SAS *Audits of Group Financial Statements (Including the Work of Component Auditors)*

Suggested Editorial and Other Changes	Reasoning for Suggested Changes
<p>Impact Assessment Template Footnote * - Direction and Magnitude of Impact (page 13 of the Exposure Draft)</p> <p><u>* The extent (magnitude) of the impact is measured in qualitative terms using a simple five point directional scale. The scale takes account of the nature (increase or decrease) and relative magnitude of the impact (small or large). Thus, the five points are large positive, small positive, none, small negative, and large negative.</u> * Large positive, small positive, none, small negative, and large negative.</p>	<p>The Impact Assessment Template would benefit from a more comprehensive definition of both direction and magnitude in the footnote to the table.</p>
<p>Introduction Scope of This Proposed Statement on Auditing Standards</p> <p>4. In accordance with the proposed SAS <i>Quality Control for an Audit of Financial Statements</i>, the group engagement partner is required to be satisfied that those performing the group audit engagement, including component auditors, collectively possess the appropriate competence and capabilities. The group engagement partner also is responsible for the direction, supervision, and performance of the group audit engagement.</p> <p><u>In this SAS, requirements to be undertaken by the group engagement partner are addressed to the group engagement partner. When the group engagement team may assist the group engagement partner in fulfilling a requirement, the requirement is addressed to the group engagement team.</u></p>	<p>The proposed SAS distinguishes between the requirements to be undertaken by the group engagement partner and requirements for which the group engagement team can assist the group engagement partner. We suggest explaining this in paragraph 4 (introduction) to the SAS.</p>
<p>Definitions</p> <p>10. Group engagement team. Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors,</p>	<p>These changes will make the definition of “Group engagement team” more clear and concise.</p>

GAO Suggested Editorial and Other Changes to Proposed SAS *Audits of Group Financial Statements (Including the Work of Component Auditors)*

Suggested Editorial and Other Changes	Reasoning for Suggested Changes
<p>perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming <u>a group audit opinion</u>. an opinion on the group financial statements.</p>	
<p><u>Joint Auditors. Two or more auditors who perform an audit in which all participating auditors sign the report in their individual capacities. Each individual or firm signing the audit report is considered to be separately expressing the opinion(s) in the report, since professional standards do not provide for two or more auditors to divide the responsibility for an audit of the basic financial statements of a single entity.</u></p>	<p>The definition of group engagement partner, in paragraph 10 of the proposed standard, discusses “joint auditor” without explaining or defining the term. Adding a definition of “joint auditor” assists users by explaining the relationship between and the responsibilities of the joint auditors.</p>
<p>Acceptance and Continuance</p> <p><u>15. In some circumstances, the group engagement partner may conclude that, due to restrictions imposed by group management or any other reason, it will not be possible for the group engagement team to obtain sufficient appropriate audit evidence through the group engagement team's work or involvement in the work of component auditors. If the group engagement partner concludes that the possible effect of this inability will result in a disclaimer of opinion on the group financial statements,⁵</u></p> <p>In some circumstances, the group engagement partner may conclude that it will not be possible, due to</p> <ul style="list-style-type: none"> • restrictions imposed by group management or • any other reason, <p>for the group engagement team to obtain sufficient appropriate audit evidence through the group engagement team's</p> <ul style="list-style-type: none"> • work or • involvement in the work of component 	<p>These changes will provide a more appropriate lead-in and make the paragraph easier to understand and apply.</p>

GAO Suggested Editorial and Other Changes to Proposed SAS *Audits of Group Financial Statements* (Including the Work of Component Auditors)

Suggested Editorial and Other Changes	Reasoning for Suggested Changes
<p style="color: red;">auditors, and the possible effect of this inability will result in a disclaimer of opinion on the group financial statements)⁵ :</p> <p style="color: red;">In such circumstances, the group engagement partner should</p> <ul style="list-style-type: none"> • in the case of a new engagement, not accept the engagement or, • in the case of a continuing engagement, withdraw from the engagement or • when law or regulation prohibits an auditor from declining or withdrawing from an engagement, having performed the audit of the group financial statements to the extent possible, disclaim an opinion on the group financial statements. (Ref: par. A18–A23) 	
<p><i>Terms of Engagement</i></p> <p>16. The group engagement partner <u>should reach agreement with group management or those charged with governance of the group as to should agree upon</u> the terms of the group audit engagement, in accordance with the proposed SAS <i>Terms of Engagement</i>. (Ref: par. A24–A25)</p>	<p>The proposed wording better describes what is expected of the group auditor.</p>
<p>Determining Whether to Make Reference to a Component Auditor in the Auditor’s Report on the Group Financial Statements</p> <p>24. The group engagement partner should not make reference to the audit of a component auditor unless</p> <ol style="list-style-type: none"> a. the component’s financial statements are prepared using the same financial reporting framework as the group financial statements, <u>and</u> (Ref: par. A49) b. the component auditor has performed an audit on the financial statements of the component in accordance with GAAS and has issued an auditor’s report that is not restricted as to use.¹⁰ 	<p>The proposed language indicates that all conditions must be met; the current wording may be interpreted as providing alternative conditions.</p>

GAO Suggested Editorial and Other Changes to Proposed SAS *Audits of Group Financial Statements (Including the Work of Component Auditors)*

Suggested Editorial and Other Changes	Reasoning for Suggested Changes
<p>Components That Are Not Significant Components</p> <p>37. In some circumstances, the group engagement team may determine that sufficient appropriate audit evidence on which to base the group audit opinion will not be obtained from <u>any of</u> the following:</p> <ul style="list-style-type: none"> a. The work performed on the financial information of significant components b. The work performed on group-wide controls and the consolidation process c. The analytical procedures performed at group level 	<p>We suggest adding clarifying language to convey that none of the alternatives will provide sufficient appropriate audit evidence.</p>
<p>Documentation</p> <p>61. The group engagement team should include the following matters in the audit documentation:</p> <ul style="list-style-type: none"> a. An analysis of components indicating those that are significant and those for which reference to the reports of component auditors were made in the auditor’s report on the group financial statements and the type of work performed on the financial information of the components b. The nature, timing, and extent of the group engagement team’s involvement in the work performed by the component auditors on significant components, including, when applicable, the group engagement team’s review of relevant parts of the component auditors’ audit documentation and conclusions thereon c. Written communications between the group engagement team and the component auditors about the group engagement team’s requirements d. For those components for which the auditor is making reference to the audit of a component auditor, the financial statements of the component and the report of the component auditor thereon 	<p>Requiring auditors to document their evaluation of the sufficiency and appropriateness of audit evidence and the effect on the group audit opinion of any uncorrected misstatements would provide essential support for the auditor’s opinion.</p>

GAO Suggested Editorial and Other Changes to Proposed SAS *Audits of Group Financial Statements (Including the Work of Component Auditors)*

Suggested Editorial and Other Changes	Reasoning for Suggested Changes
<p><u>e. The auditor’s conclusions and reasoning resulting from the evaluation of whether sufficient appropriate audit evidence on which to base the group audit opinion has been obtained (Ref: par. 55)</u></p> <p><u>f. The auditor’s conclusions and reasoning resulting from the evaluation of the effect on the group audit opinion of any uncorrected misstatements (Ref: par. 56).</u></p>	
<p><i>Reporting When Making Reference</i> (Ref: par. 26)</p> <p>A50. The disclosure of the magnitude of the portion of the financial statements audited by a component auditor may be achieved by stating the dollar amounts or percentages of total assets and total revenues and, if appropriate, other criteria that clearly describe the portion of the financial statements audited by a component auditor. When two or more component auditors participate in the audit, the <u>dollar amounts or percentages covered by the component auditors</u> may be stated in the aggregate.</p>	<p>The proposed change will clarify that either the aggregate dollar amounts or the aggregate percentages audited by the component auditors may be disclosed when two or more component auditors participate in the audit.</p>
<p>A51. Reference in the auditor’s report on the group financial statements to the fact that part of the audit was <u>conducted made</u> by a component auditor is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors who conducted the audits of various components of the group financial statements.</p>	<p>Revising the first sentence of paragraph A51 will improve the wording.</p>
<p>A57. Component materiality is determined by considering all components, regardless of whether the group engagement partner is making reference to the audit of a component auditor. Component materiality for those components whose financial information will be audited or reviewed as part of the group audit, in accordance with paragraphs 34, 35(a), and 37, is communicated to the component auditor and is</p>	<p>Using the active voice in the last sentence of paragraph A57 will make the guidance easier for auditors to understand.</p>

GAO Suggested Editorial and Other Changes to Proposed SAS *Audits of Group Financial Statements (Including the Work of Component Auditors)*

Suggested Editorial and Other Changes	Reasoning for Suggested Changes
<p>used by the component auditor to evaluate whether uncorrected detected misstatements are material, individually or in the aggregate. <u>If the group auditor is making reference to the audit of a component auditor, then the group auditor need not communicate component materiality to the component auditor. Component materiality for those components for which the group engagement partner is making reference to the audit of a component auditor need not be communicated to the component auditor.</u></p>	