



441 G St. N.W.
Washington, DC 20548

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Sherry Hazel
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

GAO's Response to the American Institute of Certified Public Accountants' November 2017 Exposure Draft, *Proposed Statements on Auditing Standards – Auditor Reporting and Proposed Amendments – Addressing Disclosures in the Audit of Financial Statements*

Dear Ms. Hazel:

This letter provides GAO's response to the exposure draft, *Proposed Statements on Auditing Standards – Auditor Reporting and Proposed Amendments – Addressing Disclosures in the Audit of Financial Statements*. GAO promulgates generally accepted government auditing standards (GAGAS), which provide professional standards for auditors of government entities in the United States.

We support the American Institute of Certified Public Accountants' (AICPA) efforts to improve the quality of financial reporting and increase the confidence users have in the audit of the financial statements. We also support the AICPA and its Auditing Standards Board's (ASB) efforts to converge its standards with those of the International Auditing and Assurance Standards Board. We note that governmental entities may have unique considerations when reporting on their financial statements due to the nature of government auditing and the reporting requirements provided by GAGAS as well as laws and regulations.

As noted in our response to questions in the enclosure, we are concerned about the inconsistencies that the proposed Statement on Auditing Standards (SAS) *Forming an Opinion and Reporting on Financial Statements* would create with the reporting requirements in AU-C 940 *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*. We urge the ASB to promptly begin a project to align the reporting requirements of AU-C 940 with the proposed SAS.

Also, we believe that the proposed new requirement that prohibits the auditor from reporting on "Other Information" when the auditor disclaims an opinion on financial statements is problematic in the federal government environment. Given the extent of other information in government financial reports, we believe that it is important to emphasize to the users of the financial statements that the auditors did not audit and do not express an opinion or provide any assurance on other information contained in the annual report. We also believe that the users of financial statements should be cautioned that scope limitation as well as any significant deficiencies or material weaknesses found may affect the reliability of other information. Based on experience reporting on "Other Information" in the federal government environment when the auditor disclaims an opinion, we believe that such reporting promotes transparency and is clear to the reader. To provide users with context for understanding other information contained in the report, the ASB, in our view, should revise the standard or provide application guidance to allow

government auditors to include an "Other Information" section in the auditor's report when auditors disclaim an opinion.

The AICPA is seeking comment on a number of questions related to the proposed standards and amendments. Our responses to the questions follow in an enclosure to this letter.

Thank you for the opportunity to comment on these important issues. If you have questions about this letter or would like to discuss any of the matters it addresses, please contact me at (202) 512-3133 or dalkinj@gao.gov.

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 at the end.

James R. Dalkin
Director
Financial Management and Assurance

Enclosure

Response to Questions

Proposed Statement on Auditing Standards *Forming an Opinion and Reporting on Financial Statements* (AU-C section 700)

1. Are the proposed revisions to existing requirements clear and understandable, and is the application material helpful in supporting the application of those requirements?

We believe the proposed revisions to the existing requirements are clear and understandable and the application material is helpful in supporting the application of those requirements. We support the Auditing Standards Board's (ASB) efforts to converge with the standards promulgated by the International Auditing and Assurance Standards Board (IAASB) and the Public Company Accounting Oversight Board (PCAOB).

Regarding the requirements for ordering and presentation of the audit report, we support the use of descriptive headers identifying the different elements in the audit report to facilitate the user's identification of the elements. Given that the proposed standards allow the auditor to present sections of the report in any order following the "Basis of Opinion" section, we believe the headers will be especially helpful to report users by clearly indicating the essence of each section.

However, we are concerned about the inconsistencies the reporting requirements in the proposed Statement on Auditing Standards (SAS) *Forming an Opinion and Reporting on Financial Statements* would create with the reporting requirements in AU-C 940 *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*. Inconsistent requirements would reduce the clarity and usability of reports on integrated audits. We urge the ASB to promptly begin a project to align the reporting requirement in AU-C 940 with the reporting requirements in the proposed SAS.

We suggest that the ASB consider adding more application guidance to assist auditors in complying with the requirement for the auditor to evaluate whether the information presented in the financial statements is relevant, reliable, comparable, and understandable (see paragraph 13d). While we acknowledge that the International Standards on Auditing do not include this type of application material, we believe that auditors in the United States could benefit from additional descriptions and explanations of the terms "relevant," "reliable," and "comparable" and how the auditor would apply the concepts.

In addition, we suggest the ASB make the following edits to paragraph A3:

For audits of governmental entities, the objectives of a financial statement audit are often broader than forming and expressing an opinion on the financial statements. ~~Law, regulation, 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 noncompliance with applicable laws and regulations or reporting material weaknesses and significant deficiencies in internal control over financial reporting noted during the audit. ~~Such r~~Reporting on compliance with laws, regulations, and provisions of contracts or grant agreements and internal control over financial reporting is an integral part of an audit conducted in accordance with *Government Auditing Standards*.

2. **Are the descriptions of the responsibilities of management and the auditor relating to going concern (paragraphs 31b and 36biv) useful and understandable, in view of the calls for more information in the auditor's report about their respective responsibilities in this area? Would any modifications to the descriptions of management's responsibility be necessary for any specific financial reporting framework? Are there any concerns about possible confusion or misinterpretation about the auditor's responsibilities, in particular the requirement to conclude on the entity's ability to continue as a going concern, recognizing that the description is consistent with the requirement in paragraph .20 of AU-C section 570 (SAS No. 132)?**

We generally believe the descriptions of the responsibilities of management and the auditor related to going concern are useful and understandable. At this time, we have not identified any additional concerns about possible confusion or misinterpretation about the auditor's responsibilities. Nevertheless, in our view, the ASB should add application guidance that recognizes that statements about an entity's ability to continue as a going concern may not be applicable in certain government environments. This nonapplicability is specifically discussed in the federal government's financial reporting framework.

3. **Will the requirement to identify those responsible for the oversight of the financial reporting process present any practical difficulties when those responsible for the oversight of the financial reporting process are also responsible for preparation of the financial statements (as may be the case, for example, in a small owner-managed entity)?**

As noted above, we support the ASB's efforts to converge its standards with the standards promulgated by the IAASB. While there may be practical difficulties in identifying those responsible for the oversight of the financial reporting process, we believe that judgment will assist auditors in complying with this requirement.

4. **Does the expanded description of the auditor's responsibilities, including the key features of the audit, provide useful information and greater transparency into what an audit is and what the auditor does? Are there any aspects of the auditor's responsibilities that should be added?**

We believe that the improved description of the responsibilities of the auditor and the key features of the audit will enhance the usefulness of the auditor's report for users of the financial statements. We have not identified any aspects of the auditor's responsibilities that should be added.

Proposed SAS *Communicating Key Audit Matters in the Independent Auditor's Report* (proposed new AU-C section 701)

5. **What are your views regarding whether the requirements and guidance in the proposed SAS will be helpful for auditors in determining and communicating Key Audit Matters (KAM)?**

We generally agree that the requirements and guidance in the proposed SAS will be helpful for auditors in determining and communicating KAMs. We agree that communicating KAMs should not be required for audits of nonissuers. We will assess whether generally accepted government auditing standards should provide requirements for communicating KAMs.

Also, we suggest that the ASB consider using the term “intended users” consistently throughout the standards. For example, the term “user” rather than “intended user” is used in paragraph 35(c) in the proposed SAS and paragraph A3 of SAS *Communicating Key Audit Matters in the Independent Auditor’s Report*. It is unclear whether these two terms have different meanings.

6. Is it sufficiently clear that the communication of KAMs is not required for audits of nonissuers?

No, we suggest that the language in paragraph A7 be incorporated into the scope of the SAS to sufficiently clarify that the communication of KAMs is not required for audits of nonissuers.

Proposed SAS *Modifications to the Opinion in the Independent Auditor’s Report* (AU-C section 705)

7. Are the revisions to existing requirements clear and understandable, and is the application material helpful in supporting the application of those requirements?

We believe the proposed revisions to the existing requirements are generally clear and understandable and the application material is helpful in supporting the application of those requirements. However, we note that the proposed new requirement in paragraph 30—which states that when the auditor disclaims an opinion on the financial statements, the auditor’s report should not include an “Other Information” section—is problematic in the federal government environment. Given the extent of other information in government financial reports, we believe that it is important to emphasize to the users of the financial statements that the auditors did not audit and do not express an opinion or provide any assurance on other information contained in the annual report. We also believe that the users of financial statements should be cautioned that the scope limitation as well as any significant deficiencies or material weaknesses found may affect the reliability of the other information. Based on experience reporting on “Other Information” in the federal government environment when the auditor disclaims an opinion, we believe that such reporting promotes transparency and is clear to the reader. To provide users with context for understanding other information contained in the report, the ASB, in our view, should revise the standard or provide application guidance to allow government auditors to include an “Other Information” section with the appropriate caveats in the auditor’s report when they disclaim an opinion.

Proposed SAS *Emphasis-of-Matter and Other-Matter Paragraphs in the Independent Auditor’s Report* (AU-C section 706)

8. Are the revisions to existing requirements clear and understandable, and is the application material helpful in supporting the application of those requirements?

We agree that the revisions to existing requirements are clear and understandable and the application guidance is helpful in supporting the application of those requirements.

9. Is the interrelationship between emphasis-of-matter or other-matter paragraphs and KAMs clear and understandable, recognizing that the communication of KAMs is not required for audits of nonissuers? If not, what additional guidance would be helpful?

We believe that the interrelationship between emphasis-of-matter or other-matter paragraphs and KAMs are clear and understandable.

Significant Proposed Amendments to Existing Auditor Reporting Standards

- 10. Should the requirement in AU-C section 260 be more specific regarding the timing of communication about certain matters with those charged with governance, including whether there should be a requirement for certain communications to be made prior to issuance of the auditor's report?**

We agree with the ASB's conclusion that flexibility in the timing of communications is appropriate given the variety of circumstances that may be encountered by auditors of nonissuers.

- 11. Please provide your views on the following:**

a. Would including the city and state of the addressee in the auditor's report be beneficial to users of the financial statements?

b. What would the practical implications be if such a requirement were adopted?

We believe the best approach is to allow flexibility for the auditor to determine whether the benefits of including the city and state of the addressee in the auditor's report outweigh the difficulties of determining such information.

Proposed Amendments Addressing Disclosures in the Audit of Financial Statements

- 12. Are the proposed changes appropriate and sufficient for purposes of enhancing the focus of the auditor on disclosures and, thereby, further enhancing audit quality?**

We believe the proposed changes are appropriate and sufficient and will enhance the focus of the auditor on disclosures.

- 13. Are there any specific areas where, in your view, additional enhancements to either the requirements or application material would be necessary for purposes of effective auditing of disclosures as part of a financial statement audit?**

We believe the proposed changes provide the requirements and guidance necessary for effective auditing of disclosures as part of a financial statement audit.

- 14. Will the proposed changes to the assertions in AU-C section 315 help appropriately integrate the auditor's audit approach to the risk of material misstatement in the disclosures with the audit work on the underlying amounts, thereby promoting a more effective audit of disclosures?**

We believe the proposed changes will help to emphasize the need to integrate work on auditing disclosures earlier and throughout the draft.