

June 9, 2017

Mr. Gene L. Dodaro
Comptroller General of the United States

Re: Exposure draft, 2017 revision of *Government Auditing Standards* (GAO-17-313SP)

By e-mail to YellowBookComments@gao.gov

Dear Mr. Dodaro:

Thank you for this opportunity to provide comments on the exposure draft (ED), 2017 revision of *Government Auditing Standards*, commonly known as the Yellow Book (YB), issued April 2017. For your information, we are a regional audit firm with extensive experience and current practice in the state and local government auditing field.

Except where otherwise indicated by the context, our comments apply primarily to audits of financial statements conducted under generally accepted government auditing standards (GAGAS). These comments are divided into three sections: Part 1 contains our responses to selected questions for commenters characterized in the ED as “Discussion Items” in the section of the ED designated as “Enclosure II;” Part 2 contains our comments regarding areas of most concern to us, as auditors, fraud, abuse and waste, and Part 3 contains our other, less significant comments organized by reference to the numbered paragraphs in the proposed new Yellow Book contained in the ED.

Part 1, “Discussion Items” identified in the ED

Our responses to the numbered items we have selected to comment upon (and italicized, below) follow. We have no comments with regard to item nos. 8 and 9, which are, therefore, omitted.

1. Generally accepted government auditing standards (GAGAS) is presented in a revised format. This is intended to allow auditors to quickly identify requirements and application guidance related to those requirements. In addition, certain topics are regrouped within the chapters.

Please comment on how the revised format of GAGAS affects the organization and readability of the standards.

The format used (distinguishing between the requirements and application guidance that relates directly to the requirements, modeled after the so-called “clarity” format adopted in recent years by the AICPA) is helpful in most respects. However, we believe cautionary language should be included in the new YB to prevent application guidance from being misinterpreted by some auditors and regulators as supplementing, amplifying or qualifying (rather than only more fully explaining) the related requirements and, therefore, also being deemed to be requirements with the same weight as those in the body of the standard. Wherever such an interpretation is, in fact, intended, the language in the application guidance should be elevated clearly to that of a presumptively or unconditionally mandatory requirement and relocated from application guidance to the main body of GAGAS.

2. In chapter 3 (“Ethics, Independence, and Professional Judgment”), additional requirements and guidance are provided concerning the provision of nonaudit services to audited entities, including further explanation of the responsibility to ensure that management of the audited entity possesses the appropriate skills, knowledge, and experience to oversee the nonaudit service and expanding discussion of nonaudit services that should be considered threats or impairments to an external auditor’s independence. (various paras. 3.67 through 3.101)

Paragraph 3.69 sets forth that management responsibilities performed by the auditor would invariably be impairments of independence and that no safeguards could be applied to reduce the resulting threats to an acceptable level. Paragraph 3.73 provides a list of what would appear (based on the language in paragraph 3.74) likely to be management responsibilities, depending on facts and circumstances. However, we believe more guidance is needed as to what facts and circumstances would give rise to different conclusions, and it should be more clearly and directly emphasized that independent auditors are strictly prohibited from performing any services that represent management responsibilities.

Please comment on whether the revisions related to nonaudit services sufficiently and clearly explain what is required and prohibited under GAGAS.

Paragraphs 3.69 and 3.76 discuss and provide examples of “routine activities” that universally would not be considered “nonaudit services” under GAGAS. The most troublesome part of this is example (a) of paragraph 3.76, *i.e.*, “providing advice to the audited entity on an accounting matter as an ancillary part of the overall financial audit.” An auditor’s ability, without impairing independence, to inform a client in advance as to what accounting conclusion(s) would be acceptable upon audit has been and should continue to be consistently and forcefully preserved. In 2005, the staff of the U.S. Securities and Exchange Commission (SEC) issued a statement containing its view in this regard that an “auditor’s discussing and exchanging views with management does not in itself violate the independence principles ... [and that] as long as management, and not the auditor, makes the final determination as to the accounting used, including determination of estimates and assumptions, and the auditor does not design or implement accounting policies, such auditor involvement is appropriate.”

Even if language similar to the foregoing view of the SEC staff were to be added to paragraph 3.76 (which we firmly recommend) it appears, based on the criteria implied by paragraph 3.75, that an auditor who provides extensive substantive advice of some other kind that is not insignificant may, as a result, be at risk of having his objectivity impaired or challenged due to a perceived natural, albeit inadvertent, bias against subsequently contradicting such advice in the event facts and circumstances indicate a need to do so. An acceptable approach might be for the new YB to retain the proposed language together with a caution to the auditor against the unintended introduction of potential bias and a suggestion that an auditor offer advice if possible only in the form of alternatives for the client management’s consideration.

Paragraph 3.80 mentions three-party or two-party professional service arrangements for which GAGAS does not provide sufficient guidance regarding possible independence impairment implications. One of the examples presented, “estimating the fiscal impact of proposed legislation,” might, under certain circumstances, result in an independence impairment because quantitative estimation of fiscal impact would necessarily be based on assumptions selected by the estimator from among available alternatives as to revenue recognition methods, expense accruals or capitalization policies. Such estimates, when based on assumptions selected by the auditor, might easily be perceived as biasing the auditor’s judgments and expectations when assessing the results of any future activities relative to the subject legislation. In our view, more detailed, extensive and, therefore, useful guidance in this area appears to be warranted.

3. *In chapter 4 (“Competence and Continuing Professional Education”), GAGAS discusses the levels of proficiency required for the roles on an engagement as well as a description of the tasks generally expected to be performed by auditors in these roles. (paras. 4.09 through 4.10)*

Do these roles and descriptions clarify the competence required of auditors conducting engagements in accordance with GAGAS? Is the level of proficiency expected for each of these roles clear?

In our opinion, the undefined terms “basic,” “intermediate” and “advanced” do not, by themselves, provide sufficient clarity to afford reasonable assurance of competent performance in the designated roles. We believe more comprehensive definitions of these three terms is necessary.

4. *Chapter 4 (“Competence and Continuing Professional Education”) includes a requirement for auditors to complete at least 4 hours of continuing professional education (CPE) in GAGAS topics (“GAGAS Qualification”). This 4-hour requirement is a subset of the 24-hour CPE requirement and needs to be completed each time a GAGAS revision is issued. Application guidance provides examples of the types of topics that would qualify as GAGAS topics. (paras. 4.15 and 4.23)*

Please comment on any additional topics that could be included in the 4-hour GAGAS CPE requirement or other requirements that would enhance auditor proficiency in GAGAS.

Experience tells us that many auditing firms often receive satisfactory peer review results without actually having the competency or sufficiently effective quality controls to afford reasonable assurance of the performance of quality audits. Nevertheless, we believe the degree of competence to be acquired or maintained and that would likely be assured through quantitatively arbitrary CPE requirements is difficult to control or measure. While efforts should be made to improve the likely positive effects of CPE on auditor proficiency, we believe emphasis should be placed on the quality and content of CPE, rather than its quantity, and the observable results of internally conducted quality control inspections, peer reviews and/or similar practice monitoring activities, and the timeliness and effectiveness of remedial actions taken in response to observed results.

5. *The content from the GAGAS guidance document on CPE (GAO-05-568G) is largely incorporated into chapter 4. We plan to retire the guidance document when the new GAGAS is issued. (paras. 4.26 through 4.50)*

Is there any additional application guidance that should be included in the GAGAS revision to enable auditors and audit organizations to effectively implement the CPE requirements given the planned retirement of the CPE guidance document?

See our response to item no. 4, above.

6. *In chapter 5 (“Quality Control and Peer Review”), the sections on quality control and external peer review are expanded to harmonize with other standards and promote consistency in practice across the range of GAGAS auditors.*

Are the changes to the quality control and external peer review sections appropriate and reasonable?

Except for the content of paragraphs 5.63 through 5.113 (see item 7, below), we see nothing in chapter 5 that is particularly germane to GAGAS engagements so as to warrant its inclusion in the new YB instead of merely a reference requiring auditors to comply with the AICPA standards for quality control, supplemented by paragraphs. 5.63-113. (See also our response to item no. 4, above.)

7. *In chapter 5 (“Quality Control and Peer Review”), peer review requirements are categorized by requirements for (1) audit organizations affiliated with recognized organizations and (2) other audit organizations. (paras. 5.63 through 5.113).*

Are the peer review requirements for each category of audit organization clear?

We believe the proposed peer review requirements set forth in paragraphs. 5.63-113 are clear. (See also our response to item no. 6, above.)

Part 2, fraud, abuse and waste

Fraud has been a focus of financial auditing, more or less, since its inception in the early twentieth century. In modern U.S. generally accepted auditing standards (GAAS), it has been the subject of the AICPA's Statement on Auditing Standards (SAS) 82 issued in 1997 and the expansion thereof five years later in SAS 99. The guidance from SAS 99 now resides in the clarified codification of GAAS in AU-C Section 240, "Consideration of Fraud in a Financial Statement Audit."

Although with respect to financial statement audits, the YB has always been known to be built upon, supplemental to and consistent with GAAS, and although there are other references in the proposed new YB to specific sections thereof, there are no references specifically to AU-C Section 240, from which much of its language regarding fraud appears to be derived. AU-C 240.03 clearly states (1) that fraud is a broad legal term, (2) that an auditor may positively identify (rather than merely suspect) the occurrence of fraud only in rare cases, and (3) that "the auditor does not make legal determinations of whether fraud has actually occurred." AU-C 240.A4 states further that fraud is particularly difficult to identify in matters involving accounting estimates and the application of accounting principles because of the inherent difficulty in establishing intent, a critical element of fraud.

With regard to the inherent uncertainty in identifying instances (and effects) of fraud associated with the foregoing characteristics identified in AU-C 240 that are not stated in the proposed YB, we observe that there are only a few references to fraud in the ED that are appropriately qualified with terms, such as "suspected" or "likely," that express some degree of uncertainty but that most references are not so qualified. Accordingly, we believe the inherent uncertainty associated with identifying instances (and effects) of fraud is not sufficiently emphasized in the proposed new YB, and that as a result, there are unintended implications in the ED that effectively overstate an auditor's ability to identify fraud with any certainty.

Abuse has been defined and discussed in the YB dating back to its earliest editions, but in our opinion, its historical and currently proposed definitions are too general and vague to be useful. Waste, on the other hand, is discussed historically for the first time in the ED and with a similarly vague and imprecise definition. Neither abuse nor waste is mentioned in GAAS, therefore, auditors generally have little knowledge of these concepts from sources other than the YB. Accordingly, we recommend that more precise definitions of both waste and abuse, supplemented by several examples, be provided to achieve greater clarity and consistency of auditing and reporting.

Most significantly regarding both abuse and waste, paragraphs 6.16 and 7.18 of the proposed new YB would add onerous new responsibilities for auditors that would, for the first time, push them well beyond the appropriate scope of a financial statement audit. Although these new responsibilities rightfully fall short of requiring auditors to search actively for abuse or waste, they would require auditors who become aware of such matters "that could be quantitatively or qualitatively material to the financial statements or other financial data significant to the audit objectives," to perform additional procedures that they believe to be sufficient to enable them to evaluate such effects but without any objective criteria. We believe the new YB should caution that such evaluations are ordinarily beyond the competency of financial auditors to make unless, perhaps, if assisted by specialists. Moreover, such expanded efforts would likely add substantial time and costs to GAGAS audits, often without measurable benefits when caused by mere suspicions that ultimately prove to be unfounded.

Unless expressly engaged to do so, such as in a performance audit, and unless specific measurement criteria are established or agreed-upon, we believe the auditor's only responsibility after becoming aware of possible waste or abuse should be to report the existence and general circumstances of such waste or abuse unless clearly trivial. An auditor should consider the need to adjust the audit scope only in the rare instance when a significant risk of material misstatement in the financial statements is perceived.

Barring any potential for booking previously unrecorded assets judged to be recoverable, such as from insurance, the monetary effects of waste or abuse ordinarily have no effect on the financial statements and, therefore, are irrelevant to the sole objective of a financial statement audit (see the final paragraph in Part 2). Any perceived deficiency in internal control over financial reporting or compliance that may have contributed to a suspected loss from waste or abuse, unless clearly trivial (and subject to the caution set forth in the penultimate paragraph in Part 2), should be reported without regard to the potential materiality of the dollar amount of any such loss actually observed or any other qualitative considerations along with, and in the same manner as, other reported control deficiencies relative to financial reporting or compliance. Accordingly, we believe any discussion of auditor responsibilities regarding abuse or waste should be limited in the final version of the new YB to the context of internal control and compliance reporting, for example, as is set forth in paragraph 6.44, and performance auditing.

Although as stated above, in rare circumstances, a quantifiable effect of fraud on the financial statements might be determinable and result in an audit adjustment, or a mere, unquantifiable, suspicion of fraud could lead to an opinion qualification or a disclaimer due to a circumstantial scope limitation, the effect of abuse or waste ordinarily cannot be quantified unless usable, objective measurement criteria were to be established. Even if quantifiable criteria were to be established, it would be impractical to apply them within the normal scope boundaries of a financial statement audit conducted in accordance with GAGAS. Moreover, except in the rare case of a recoverable loss, even a conclusion regarding waste or abuse that is objectively quantifiable nevertheless would never lead to a conclusion of a material financial statement misstatement. (If it could, what would be the journal entry?)

Auditors are required to conduct their audits and meet their reporting responsibilities with professional objectivity. But identifying abuse and waste, particularly in the absence of objective measurement criteria, entails considerable subjective judgment. Therefore, auditors should be cautioned in the new YB that unless the presence of waste or abuse is clearly supported by solid evidence such that it is relatively indisputable (like the now famous \$700 toilet seat), such judgments are highly susceptible to disagreements between auditors and management that have substantial potential to damage working relationships and thus, severely impair the auditor's ability to audit effectively and efficiently. This is not in the public interest.

Lastly, there are several vague references throughout the proposed new YB in the ED to an auditor's obligation to assess the significance or materiality (in some instances, characterized as "quantitatively or qualitatively material") of known or suspected fraud, abuse or waste, among other matters, in relation to unstated "audit objectives." We believe it should be clearly stated in the final version of the new YB that, despite an auditor's obligations to report other findings, such as internal control deficiencies, illegal acts and possible waste or abuse, the *only* objective of a financial statement audit (described imprecisely, in our opinion, in paragraph 1.17 (a) as its "primary purpose"), as opposed to a performance audit, the objectives of which can vary significantly, as discussed in paragraph 1.21, is to obtain reasonable assurance as to the absence of material misstatement in the financial statements (whether from fraud or error).

Part 3, other comments

Following are other, less significant comments organized by reference to the numbered paragraphs in the proposed new YB contained in the ED:

3.58 (a) and (b) We disagree with the assertion that that the head of an internal audit department may be considered structurally independent when reporting to the head or deputy head of the government entity (which is, in fact, top management). We believe structural independence should always require that internal auditors be accountable only to those charged with governance or a committee thereof (usually an audit committee or equivalent).

3.69 As set forth in paragraph 2.02 (b), the use of the word “should” in the first sentence denotes a presumptively mandatory requirement from which an auditor may depart only in the “rare” circumstances described on paragraphs 2.03, 2.04, and 2.08. Its use seems to be contradicted by the following sentence, which states that management responsibilities assumed by an auditor would invariably create threats that “would be so significant that no safeguards could reduce them to an acceptable level.” Accordingly, we see no reason the status of this prohibition should not be elevated to an unconditional requirement, as described in paragraph 2.02 (b), by substituting “must” for “should” in the first sentence.

4.34 It is not clear if the term “actual classroom time” used here is intended to be calculated using the traditional 50-minute rule of paragraph 4.33 used in educational contexts, or is to be the actual time spent in class. This should be clarified in the final version.

6.35 (b) and (c) Because of the heightened sensitivity to possible adverse public reaction in the government auditing arena, and the risk that whatever actual or suspected fraud, abuse or waste was observed may likely represent only the “tip of the iceberg,” unless clearly trivial and subject to the qualifying conditions set forth in Part 2, above, we believe observations of suspected fraud, waste or abuse should be reported to management and the governing body as findings without regard to their quantitative or perceived qualitative materiality.

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Our thanks, once again, to the GAO for providing this opportunity to comment on the proposed changes to the YB. Your thoughtful consideration of our comments would be greatly appreciated. Any questions about the views expressed in this letter should be addressed to our Governmental Practice Director, Richard H. Bowler [REDACTED], or the undersigned [REDACTED].

Very truly yours,

PIERCY BOWLER TAYLOR & KERN
Certified Public Accountants and Business Advisors



Howard B. Levy, CPA, Principal
and Director, Technical Services

cc: James Dalkin, Director, Financial Management and Assurance