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July 4, 2017-Chapter 3 Ethics, Independence and Professional Judgement

Retrospective of a small rural Western North Carolina CPA firm with 42 years attempting to comply with the GAO standards. A firm that is leaving the audit market after this period due to the difficulty of maintaining our independence. Our focus will be to provide only non-attest services to governments and non-profits. Since 2004 we have actually been providing both services for different clients (i.e. no audit services where we provide any non-attest services, no non-attest services where we provide audit services for Yellow Book and Single Audit clients). For future reference when I refer to a "Safeguarder", I am referring to auditors who perform both non-attest and attest services for the same audit client.

Hopefully, our questions and observations will be beneficial to the GAO in updating their standards and how small audit firms, governments and non-profits are affected. Even more importantly, they may lead to a strengthening of the Independence standards. The reader will find that we are in direct opposition to a majority of our profession in regard to the performance of non-attest services. Also the reader should know that the writer understands that integrity at times can appear to be self-righteous. So please have understanding during your reading of our response to the new standards.

Attached are several documents and questions, we have asked personnel at the GAO, AICPA, NC Association of CPAs and the NC State Board regarding independence and non-attest services:

1. GAO Response to new Draft Standards-the document you are currently reading
2. NC Supreme Court Case regarding Fiduciary Responsibility
3. Questions related to the audit process in NC
4. GAO response to various questions
5. NC Senate Bill 304-establishing a specific time period related to prolonged auditor association
6. NC State Board Legal Council's Opinion of the NC Supreme Court Case
7. Sample of audit findings related to SKE

The following are the areas that we believe may require additional changes to the standards:

1. Independence

A. RITP-Reasonably Informed Third Party

- i. Is there a new RITP in town- the NC Supreme Court? Has the NC Supreme Court, along with the Appellate Court case (Estate of Smith v Underwood) which they refer, determined that when a CPA performs two non-attest services they have a fiduciary duty (Estate of Smith) and when performing no non-attest services that no fiduciary duty exists (Commscope Case)? Page 10-12 of the attached court case are of particular importance to the court's opinion and to our understanding of the relationship between having a fiduciary duty regarding non-attest services and having no fiduciary duty when one is only an auditor.
- ii. When it comes to one's revenue stream, it has been our experience that too many auditors lean toward protecting their revenue instead of their independence-revenue puts food on the table and principles don't!

B. Non-attest and Attest Services-They should be separated and no auditor should be allowed to provide both services. At the very least, these services should not be bundled together in a request for proposal, giving the "Safeguard" auditor a distinct advantage in the bidding process as has been done in NC:

- i. The difficulty we have encountered since 2004 to get the auditees to separate the services:
  1. Against the intent of earlier GAO standards, the NC State Treasurer (Local Government Commission-LGC) and the State Association supported the continued combination of non-attest and attest services by the use of a standard request for proposal for all governments in NC. This RFP used by many local governments requires that the non-attest service provider have the same qualifications (both a Peer Review and extended CPE) as the auditor. Under the new AICPA standards, the new Preparation services do not require a "Systems" Peer Review and do not require the 80 hour CPE standard. Under the previous AICPA standards, we have issued non-independent compilations for the non-attest services. In either situation, the non-attest provider is not required to meet the same standards as the auditor. We propose that the separation of these services should be required in any RFP issued by a GAO client.
  2. If the predecessor auditor is a "Safeguarder", it has been virtually impossible to convince the client to separate the services. Often the auditee is not well informed as to the ability to separate these services without the predecessor auditor being willing to give up one of those services.
  3. Skill, knowledge and experience-Is a majority of the profession really just ignoring the issue for the sake of their revenue stream? What happens when there is a conflict between one bidding auditor and another bidding auditor? Why should the "Safeguarder's" opinion always be the winning opinion? What happens when the predecessor auditor and one bidder auditor have concluded that the auditee does not have the SKE but the "Safeguarder" auditor believes they do have the

SKE? Let us assure you that there are differences of opinion regarding the auditee's SKE in the real world.

- ii. While the separation of the services might harm the revenue stream of the larger audit firms, the profession as a whole will not lose revenue. It will just be spread out over more firms. We believe that local CPA firms should be the non-attest service provider and the auditor should come from at least two counties away. This would give the client a more favorable report plus an independent review of the report to control excessive bias. It would also assist in the independence issues regarding familiarity, prolonged association and other threats.
  - iii. Why does PCAOB have a more stringent standard? What makes a private investor more important than the general public or other public entities?
  - iv. Should there be a different "Independent Auditors' Report" heading for Safeguarders (i.e. "Independent Auditors' Report-Using the Safeguard Standards")? Would this be helpful to users of the financial statements to know if the Safeguards were used?
  - v. We have attached a sample of a Safeguarder's findings related to SKE. For a number of years, we have indicated that when these findings are reported the auditor appears to us to have lost their independence. Significant harm could be done to the auditee and the auditor if it is determined at the end of the audit process that the auditor is no longer independent. It appears to us that this finding, which is commonly used, is a way for Safeguarders to protect themselves from this issue. In addition, the notion that separating the services is too costly, is just plain false!! We believe that the costs should go down, since the Safeguard portion of the audit budget would be eliminated. We have been informed by Safeguarders that the safeguard procedures add between 10% and 20% to the audit budget. Seems to be a complete waste of time when the alternative is to separate the services and eliminate those costs. In addition, with the bidding of audits at fixed costs, are resources being diverted to safeguard procedures that are needed to actually complete the audit?
  - vi. Many Safeguarders and the State of NC often refer to the non-attest services as being incidental to the audit. Our years of monitoring the non-attest services and attest services indicate that this is not accurate. Clearly when these services have been separated one would find that the costs are close to 50/50.
2. Peer Reviews
- A. During our last and apparently final Systems Peer Review, we had a disagreement with our Peer Reviewer regarding the definition of "Other contracts" related to the engagement letter. The GAO should clearly identify what is meant by other engagement forms. We, for years, have only used the NC State contract for audit services required for all government audits in NC with no issues being raised by any Peer Reviewer since its inception. We saw no need for the auditee to sign two separate audit engagement contracts. We did however agree to an FFC regarding this issue, whereby we would correct the problem. However at the Peer Review committee level, the RAB insisted that the issue was pervasive and indicated that a fail report should be issued. We, of course, appealed the committee's decision and at the same time defended our Peer Reviewer from the committee. The committee indicated that they could

- not form an independent hearing committee. We were then placed under the review of an AICPA Peer Review committee. Well first of all, it took one year to get the issued resolved, which is in violation of the Peer Review standards. Second the AICPA committee indicated that the original Peer Reviewer was correct and that only an FFC was indicated in this case.
- B. The main reason we have added this to our comments, is that the RAB, had been a previous Peer Reviewer for us. We used them for one Peer Review. We had several issues with them and in the end fired the firm before signing the engagement letter for the next Peer Review. The issues were 1) the exist conference was about 10% related to our Peer Review and about 90% attempting to get us to use their firm for asset management for our clients 2) the firm bid on one of our clients that they had Peer Reviewed 3) the team captain refused to give us the standards he was using to determine that tax returns were part of the process. While we did investigate and found him to be correct, his refusal to give us the citations was more than we could stand. "My way or the highway" kind of crap! All of this said, clearly the RAB should have recused himself from our Peer Review because he was well aware of the issues we had with his firm. So in summary, the use of Firm on Firm Peer Reviews can and will cause an issue related to conflicts of interest, potential retaliation by firms in the same market and numerous differences of opinion. Overall it left us with a bad taste and a lowering of our opinion as to the objectivity of Peer Review.

Finally, goodbye to excessive and mundane CPE, to GAO standards that the profession finds ways to circumvent, to Systems Peer Reviews, to unreasonable Quality Control requirements, to completion of all the ridiculous checklists for the sake of a Peer Reviewer and goodbye to the audit profession.

Respectfully submitted,

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