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United States Government Accountability Office
Washington, DC 20548

May 29, 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) January 2009 Exposure Draft for a proposed Statement on Auditing Standards (SAS) entitled *Consideration of Fraud in a Financial Statement Audit (Redrafted)*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the ASB's proposed SAS on the auditor's consideration of fraud in a financial statement audit. Generally, we support the proposed statement and agree that the principles-based approach used in this standard will permit the flexibility needed in this critical area. Our responses to the questions raised in the related Explanatory Memorandum are noted below. In addition, we are providing comments on retaining a separate fraud risk standard and the need for additional guidance related to third party fraud.

Responses to Questions on Application of the Clarity Conventions and Converging with International Standard on Auditing (ISA) No. 240

- (1) We believe that the objectives stated in the proposed SAS to be achieved by the auditor are appropriate.
- (2) We agree with the revisions made to the existing standard to converge with the ISA.
- (3) We agree with the differences between the proposed SAS and ISA 240.
- (4) We agree with the governmental considerations included in the proposed standard, and we recommend including additional special considerations for audits of governmental entities to provide further guidance on fraud risks that relate to government entities. In the attachment to this letter we propose wording for these additional considerations.

Comments on Retaining a Separate Fraud Risk Standard

The Board has requested comments on its approach of retaining a separate fraud risk standard rather than adopting the PCAOB's integrated approach. We believe that maintaining a discrete fraud standard rather than incorporating fraud considerations throughout other standards heightens the auditor's focus on this important topic. Accordingly, we support retaining a separate fraud standard.

Guidance on the Extent of Auditor Responsibility Related to Third Party Fraud

Consistent with ISA 240, the definition of fraud in paragraph 11 of the proposed standard incorporates the concept of fraud perpetrated against the entity by someone outside the entity (third party fraud). However, the proposed standard does not provide adequate discussion or guidance on critical considerations such as (1) ways that third party fraud may be accomplished, (2) characteristics of third party fraud and corresponding fraud risk factors, and (3) audit procedures to address the assessed risk of material misstatement due to third party fraud.

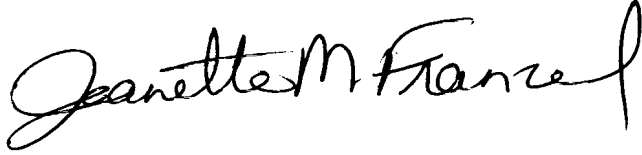
Third party fraud is particularly relevant in government but also is a concern for private sector entities such as insurance companies and financial institutions. For example, in government there may be a risk of material misstatement due to fraudulent claims for social security benefits or other benefits established in law. In the private sector, fraudulent insurance claims and fraudulent investment valuations from third party appraisers or investment advisers may be a risk.

The Exposure Draft does not address the limits or boundaries of the auditors' responsibility with respect to third party fraud. For instance, we are not sure if the proposed definition of fraud is intended to include third party fraud by service organization personnel.

Without further clarification, the extent of auditor responsibility related to the risk of material misstatement due to third party fraud may be interpreted too narrowly or too broadly by auditors and lead to inconsistent and inappropriate application of the standard. It also could widen the gap between user expectations and actual auditor procedures performed in relation to third party fraud. We encourage the Board to develop guidance on third party fraud to include in the proposed standard before adoption.

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, looping initial "J".

Jeanette Franzel
Managing Director
Financial Management and Assurance

Attachment

cc: Mr. Harold Monk, Chair
Auditing Standards Board

The Honorable Mark W. Olson, Chairman
Public Company Accounting Oversight Board

Recommended Additions to Proposed Fraud Standard - Proposed Considerations Specific to Governmental Entities

Characteristics of Fraud (Ref. paragraph 3)

Proposed New Paragraph to follow current paragraph A7: In a government environment additional fraud characteristics may exist, including:

- Incentive/pressure:
 - Employees may be under pressure to deliver high volume and quality services with inadequate resources.
 - There may be incentives to spend available budget resources within legislated deadlines or budget periods.
- Opportunity:
 - Long standing internal control weaknesses or financial systems weaknesses could provide the opportunity for fraud.
- Rationalization/attitude:
 - Belief that 'no one is hurt' if an individual steals from the government.

Identification and Assessment of the Risks of Material Misstatement Due to Fraud (Ref. paragraph 26)

Proposed New Paragraph to follow current paragraphs A21 and A31: Certain government entities with significant revenue collection responsibilities may have a greater risk of material misstatement due to fraud in the area of revenue recognition. Examples of entities that may have significant revenue collection responsibilities include tax authorities or other agencies that collect revenues, such as state universities and colleges, hospitals or regulatory agencies that charges fees for services rendered or receive donor funding. Also, in certain governmental entities, procurement expenditures and grant payments may have an increased risk of material misstatement due to third party fraud.

**Recommended Additions to Proposed Fraud Standard -
Proposed Considerations Specific to Governmental Entities**

Appendix A, pg 44-47: Risk factors relating to misstatements arising from fraudulent financial reporting specific to governmental entities

In government entities, additional risk factors may relate to internal and budgetary reporting as well as to financial reporting.

Incentives/Pressures

- Pressures or requirements to implement or expand programs without sufficient allocated resources and funding.
- Pressure for management to meet the expectations of legislative or oversight bodies and/or to achieve political outcomes.
- A need to achieve financial targets required in bond covenants.

Opportunities

- The existence of long-standing weaknesses in IT security and systems.
- Weak entity controls over:
 - budget preparation and development,
 - compliance with laws and regulations, and/or
 - procurement of goods and services, especially in certain industries such as defense and homeland security that may involve large dollar contracts and receive less oversight due to security considerations.
- Weak monitoring of entity controls.

Attitudes/Rationalizations

- Belief that 'no one is hurt' if an individual steals from the government.

Appendix A, pg 48 – 50: Risk factors arising from material misstatements developing from misappropriation of assets specific to governmental entities.

Incentives/Pressures

- Compensation structures that may be perceived as inconsistent with performance results and reward seniority instead of performance.

Opportunities

- Focus on cash and budgetary accounting may cause less emphasis on accountability over assets.

Attitudes/Rationalizations

- The belief by certain governmental officials that their level of authority justifies a certain level of compensation and personal benefits or privileges.

Recommended Additions to Proposed Fraud Standard - Proposed Considerations Specific to Governmental Entities

Appendix C: Pg 55-56: The following are examples of circumstances in governmental entities that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

- Significant transfers or transactions between funds and/or programs.

- Abnormal budget conditions, such as
 - significant budget adjustments,
 - requests for additional funding,
 - budget adjustments made without approval,
 - large amounts of over-or-under spending, and
 - programs with an emphasis on spending money quickly.

- Procurement conditions, such as
 - lack of procurement legislation,
 - recent changes to procurement legislation,
 - complex or unclear legislation,
 - involvement of significant monetary amounts (such as in the defense area),
 - inspection by regulatory authorities,
 - complaints received from potential suppliers about unfair practices related to awarding of contracts, and
 - former governmental officials functioning as executives of companies to which contracts have been awarded.

- Program conditions, such as
 - newly implemented programs without existing management and accountability structures,
 - programs established for political purposes,
 - programs established to deal with an immediate emergency or crisis, and
 - programs experiencing unusual growth due to conditions beyond the control of management.

- Grant and donor funding conditions, such as
 - non-compliance with grant requirements,
 - unclear grant requirements,
 - grants not reaching the intended recipient,
 - complaints from intended recipients or interest groups, and
 - lack of monitoring of grantee compliance with applicable laws and regulations.