

June 10, 2017

Mr. James Dalkin, Director, Financial Management and Assurance
U.S. Government Accountability Office
441 G Street N.W.
Washington, DC 20548

Submitted via email to YellowBookComments@gao.gov

Dear Mr. Dalkin:

Thank you for the opportunity to provide these comments regarding the proposed changes to the *Government Auditing Standards* (GAGAS, the Standards). The Government Accountability Office (GAO) and the Advisory Council on Government Auditing Standards are to be commended for recognizing the need to update the December 2011 revision of the Standards.

I appreciate this opportunity to respond and my comments reflect my views as a former auditor and government finance officer and a current academician responsible for teaching undergraduate and graduate level courses in governmental accounting and auditing. In addition, I have been a contract Continuing Professional Education (CPE) discussion leader for the Association of International Certified Professional Accountants (AICPA) for the past 12 years. As such, I interact with hundreds of government auditors every year. My response is prefaced with a few general comments followed by responses to the specific questions raised in the Exposure Draft.

Overall Comments

I am providing the following demographic information to assist in understanding the potential impact some of the proposed changes may have on audit organizations which are audit firms rather than federal, state, or municipal audit organizations. While I agree providing certain nonaudit services either impairs independence or represents a significant threat to independence, my anecdotal evidence indicates many audit firms do not agree. Consequently, they either ignore certain aspects of the Standards relating to nonaudit services or do not adequately document their conclusion with respect to their independence.

The following information is taken from the 2012 Census of Governments conducted by the U.S. Census Bureau and available at www.census.gov/govs/cog/.

- Of the 90,056 local governments surveyed, 43% and 57% represent general purpose governments (38,910 counties, municipalities, and townships) and special purpose governments (33,031 single function and 5,235 multiple function), respectively.
- 12,249 independent school districts (kindergarten/elementary through secondary) represent 24% of the special purpose governments and 14% of all local governments.
- Based on population, 95% of the local governments (37,132) surveyed have a population of less than 50,000 and 91% of the local governments (35,490) have a population of less than 25,000. 83% of local governments have populations of less than 10,000.

- 93% of the independent and dependent school districts have enrollments of less than 10,000 students. 85% of these school districts have enrollments of less than 5,000 students.
- Using the midpoint of the enrollment categories and the 2014 national average for per pupil spending of \$11,009 (Annual Survey of School System Finances, U.S. Census Bureau), this equates to school districts with budgets of approximately \$1,100,000 to \$82,600,000 for 93% of the independent and dependent school districts. Using the districts in the 85% level, budgets range from approximately \$1,100,000 to \$41,300,000.
- Most independent and dependent school districts (42%) are in the 1,000 to 2,499 (24%) and 500 to 999 (18%) enrollment categories.
- According to the National Center for Charitable Statistics, there are 1,527,525 not-for-profit entities in the US and 1,056,912 (69%) of those represent entities organized under Internal Revenue Code (IRC) section 501 (c)(3). Of the 1,527,525 entities, 101,892 (7%) are private foundations with the remaining 368,721 (24%) representing other not-for-profit entities mostly those organized under IRC sections 501 (c)(4), 501 (c)(6), and 501 (c)(9).
- In 2014, the *Nonprofit Sector in Brief* reported that 35% of the not-for-profit entities registered with the Internal Revenue Service (IRS) filed either Federal Form 990, 990 EZ, or 990 PF for 2012. Of the returns filed, 66% of the entities (190,249) reported less than \$500,000 in gross receipts. From an expense perspective, almost 87% of the entities reported expenses of \$1,000,000 or less and only 5% of the entities filing a return reported expenses in excess of \$10,000,000.

This demographic information leads me to conclude the vast majority of local governments, school districts, and not-for-profit entities are not large and many are in fact very small. Typically, smaller governmental and not-for-profit entities have limited personnel with the expertise in the accounting and finance functions necessary to prepare financial statements in accordance with Generally Accepted Accounting Principles (GAAP). As such, the auditor of these entities frequently provides nonaudit services to these entities and often such nonaudit services are extensive. Exacerbating this situation is the ever increasing complexity of new accounting standards applicable to governmental and not-for-profit entities.

I realize the GAO establishes GAGAS rather than accounting standards for governmental and not-for-profit entities. Additionally, I understand the GAO establishes GAGAS for a diverse group of government auditors and government audit organizations. However, the increasing complexity of accounting standards makes it necessary for many small and medium-sized governmental and not-for-profit entities to rely more and more on their auditor to ensure their financial statements are prepared in accordance with GAAP.

Due to the increasing complexity of accounting standards, and the proposed expansion of management's ability to effectively oversee nonaudit services (para. 3.67), the auditor may conclude management does not have the requisite knowledge, skills, and experience (SKE). There are numerous rural areas across the United States where there may be only one audit firm or only one audit firm qualified to conduct audits under GAGAS. If these firms conclude they are not independent, entities required to have an audit conducted under GAGAS would be forced to attempt to engage audit firms from urban areas. These audit firms might also conclude

independence would be impaired and refuse to accept the engagement. Therefore, entities may then resort to engaging audit firms not having the requisite expertise (or do not realize they do not have the requisite expertise) to conduct audits under GAGAS. In these circumstances, the incumbent auditor, in an effort to service the audit needs of the entity, may ignore the SKE requirement in whole or part or may simply conclude management has the SKE to effectively oversee the nonaudit services.

Discussion Items for Respondents

Question 1

The revised format of GAGAS clearly delineates what is required and what is application material. I personally find the box format for requirements extremely helpful in visually identifying requirements. The additional chapters resulting from separating information in chapters in the 2011 GAGAS are helpful in quickly identifying topic areas.

Question 2

As I traveled the country the past 12 years as a CPE discussion leader, I observed government auditors working in an audit firm do not always understand the language used in GAGAS. Some auditors do not recognize they may have situations outlined in paragraph 3.47 (b) and (c) of the Exposure Draft and paragraph A3.04 (b) and (c) of the 2011 GAGAS because of the language used. For example, some auditors do not understand the phrase "...original data used to generate records that are the subject matter of the engagement" and how auditor-prepared depreciation schedules and reconciliations may be original data. Likewise, auditors do not realize providing a service directly affecting "the subject matter information of the engagement" likely encompasses accounting and recordkeeping services they may provide to small and medium sized clients. My recommendation would be to consider using very plain language and specific examples in paragraph 3.47.

Recently released information relating to compliance audit reporting packages filed with the Federal Audit Clearinghouse indicates it is difficult to determine if the Summary Schedule of Prior Audit Findings was prepared by the grantee as required by the Uniform Guidance. In compliance audits of small and medium sized entities, this schedule may be prepared by the auditor rather than the grantee. Therefore, paragraph 3.51 (d) could be expanded to include the auditor preparing this schedule as I believe a management participation threat likely exists in this situation.

With respect to nonaudit services, I agree with the additional requirement in paragraph 3.67 of the Exposure Draft for the designated individual to be capable of detecting a material error, omission, or misstatement. Additionally, I appreciate the GAO adding such clarification relating to the SKE requirement.

The requirement for the identified individual to "detect" material errors, omissions, or misstatements represents a relatively high level of SKE. As stated in my Overall Comments, the expanded requirement may prove problematic in financial audits of small and medium sized

entities when such entities are required to comply with complex accounting standards. As such, the expanded requirement may result in fewer individuals being identified as able to effectively oversee nonaudit services provided by the auditor. Per paragraph 3.68 in the Exposure Draft, the auditor should conclude independence is impaired when the entity does not have an individual with the suitable SKE to oversee the auditor-provided nonaudit services.

If the requirement in paragraph 3.67 was for the individual to possess the SKE to “be familiar with what might cause a material error, omission, or misstatement”, situations discussed in my Overall Comments might be avoided in whole or part. For example, many small and medium sized governments have individuals capable of “detecting” a material error, omission, or misstatement in the fund-level financial statements because such information represents the government’s day-to-day decision making information. As such, the individual is likely to “detect” material errors, omissions, or misstatements in the fund-level financial statements. Small and medium sized entities do not typically have an individual capable of “detecting” a material error, omission, or misstatement in the governmental activities information in the government-wide statements. However, these entities are likely to have an individual who is familiar with the major differences in what is reported in the governmental fund fund-level statements and in the governmental activities in the government-wide statements.

Likewise, small and medium sized governmental and not-for-profit entities are likely to have individuals familiar with the purpose of the financial statement notes and what items are generally discussed in the notes. These entities are not likely to have an individual capable of “detecting” a material error, omission, or misstatement in the notes to the financial statements, however.

Similar to my previous comments in this section relating to the language in paragraph 3.04 (a) and (b), auditors, in my experience, do not understand what activities are referred to in paragraph 3.36 (h) of the 2011 GAGAS (paragraph 3.73 (h) of the Exposure Draft). In financial audits of small or medium sized governmental or not-for-profit entities the auditor may provide a number of nonaudit services to bring the entity’s financial information in line with GAAP. Often, the auditor uses the information provided by the nonaudit services to prepare the entity’s financial statements. The Management Representation Letter includes a representation management is responsible for the financial statements which may be based in large part on information provided from nonaudit services.

Based on my years of being a CPE discussion leader, auditors may not have management accept the results of any nonaudit services prior to the auditor posting such information to an auditor-prepared trial balance. In addition, auditors may not have management review the adjusted trial balance before using such information to prepare the entity’s financial statements. Management may not review the draft financial statements before signing the Management Representation Letter and/or before the auditor produces the final bound financial statements for the entity. If paragraph 3.73 (h) were reworded to better (or specifically) address these situations, auditors might then realize the full impact of providing this type of nonaudit services during the audit continuance/acceptance process. Additional application material could be added to address these types of situations as well.

To also address the situations described in the preceding two paragraphs, I would suggest paragraph 3.81 include a requirement for the auditor to determine whether or not management actually performed the functions in (a) through (d). Additionally, I would suggest the auditor make this determination and document such no later than completion of the nonaudit services or issuance of the auditor's report on the financial statements whichever occurs first.

I would also suggest adding a similar documentation requirement to paragraph 3.82. The auditor needs to establish and document his/her understanding with the audited entity (1) prior to accepting the engagement to perform the nonaudit services and (2) prior to accepting the financial statement audit engagement. Such a requirement aligns with the requirement in paragraph 3.67 of the Exposure Draft relating to evaluating the effect of nonaudit services on independence prior to accepting the nonaudit service engagement. The suggested documentation requirement also aligns with the requirements in paragraph 3.67 relating to required SKE. My rationale for this suggested documentation is discussed in the following paragraph.

Based on my experience as a CPE discussion leader, many auditors use one engagement letter for nonaudit and audit services. This single engagement letter is typically where the information in paragraph 3.39 of the 2011 GAGAS (paragraph 3.82 of the Exposure Draft) is documented. In some cases, this single engagement letter may be the only evidence documenting management's understanding of the nonaudit services provided by the auditor. Obtaining the information in paragraph 3.82 prior to accepting the nonaudit service engagement aligns with the requirement in paragraph 3.67 to evaluate nonaudit services before agreeing to provide them.

I agree with the proposed changes to the independence requirements in paragraph 3.89 of the Exposure Draft. However, I believe the wording in (b) needs to address "draft" financial statements and the "entity's" trial balance. Such changes would, respectively, emphasize the final financial statements are not the responsibility of the auditor and would also avoid confusion with the "auditor's" trial balance.

Based on my previous comments in this section, paragraph 3.89 (b) might also be expanded to allow the auditor to prepare draft financial statements based on management's approval of the auditor's trial balance. In my actual and discussion leader experience, small and medium sized entities do not typically prepare a trial balance. Additionally, the auditor may not ask the entity to prepare or produce a trial balance because they plan to use their own trial balance.

Valuation services are not listed in paragraph 3.89 as services which create significant threats to independence. In my opinion, certain valuation services may create a significant threat to independence and many auditors may not realize this. Some auditors may not be aware certain "proposed adjustments" actually result from valuation services. For example, auditors may calculate the fair value of long-term pledges receivable and the related discount and temporarily restricted contribution revenues. Auditors may provide nonaudit services with respect to determining pension and pension-related amounts and disclosures. While much pension information is provided by actuaries, it requires a high level of expertise to evaluate the actuary-provided information and then determine its effect on the financial statements. In my mind, these calculations represent valuation services as defined in paragraph 3.99 of the Exposure Draft. Because these amounts are typically material to the financial statements, I believe they

represent significant threats to independence. As such, I believe it is appropriate to require the auditor to consider valuation services as a significant threat to independence.

Other than the previously noted issues, the revisions relating to nonaudit services sufficiently and clearly explain what is required and prohibited under GAGAS.

Question 3

The roles and descriptions clarify the competence required of auditors conducting engagements in accordance with GAGAS. Additionally, the level of proficiency expected for these roles is clear.

Question 4

The topics listed in paragraph 4.23 for inclusion in the 4-hour GAGAS CPE requirement appear adequate and appropriate. However, I would suggest adding language to clarify whether all of the topics listed are required to be included in the 4-hour course. If it is the intent of the GAO for all topics listed to be included in the 4-hour course, I would suggest topics (e), (f), (g) and (h) be reconsidered. I do not believe it is necessary for a government auditor only involved in financial audits performed under GAGAS to be familiar with GAGAS requirements relating to examination, review, agree-upon procedures engagements, or performance audits. Similarly, I do not believe it is necessary for a government auditor only involved in performance audits to be familiar with GAGAS requirements relating to financial audits or attestation engagements.

Question 5

Mandatory requirements relating to auditor competence in paragraphs 4.02 and 4.03 of the Exposure Draft appear to replace the respective mandatory and presumptively mandatory requirements in paragraphs 3.69 and 3.70 of the 2011 GAGAS. I support the proposed mandatory requirements in paragraphs 4.02 and 4.03 and the proposed presumptively mandatory requirements in paragraph 4.04. However, I would suggest the requirements of paragraphs 4.02, 4.03 and 4.04 respectively refer to the "... GAGAS engagement...", "... assign auditors to the GAGAS engagement who at the time...", and "...necessary to conduct the GAGAS engagement." to add clarity and to avoid confusion.

While I agree with the mandatory requirement in paragraph 4.03, I believe the presumptively mandatory requirements relating to when auditors are to obtain GAGAS Qualification CPE contradict the mandatory requirement in paragraph 4.03. In my opinion, all auditors working in a GAGAS engagement need to have the GAGAS Qualification CPE before being assigned to the GAGAS engagement. For example, if the requirements in paragraph 4.03 are incorporated into the final GAGAS, management and leadership of the audit organization would need to be aware of this mandatory requirement when assigning staff to the GAGAS engagement. If they were unaware of the mandatory requirement, they might assign staff to the GAGAS engagement who might not possess the competence to perform in their assigned roles.

At a minimum, I believe supervisors and partners/directors need to complete the GAGAS Qualification CPE before assigning staff to a GAGAS engagement. Because GAGAS differ in many respects from Generally Accepted Audit Standards (GAAS), all auditors assigned to a GAGAS engagement need to be at least familiar with GAGAS before being assigned to such engagements. In theory, this would ensure the GAGAS engagement was conducted in accordance with GAGAS from client acceptance to final reporting.

Paragraph 4.16 states "... the CPE provider should include in the course content the relevant GAGAS topics listed in paragraph 4.23 and include in the course description wording that indicates that its purpose is to fulfill the GAGAS Qualification CPE requirement." Use of the word "should" in this context places a presumptively mandatory requirement on the CPE provider. The scope of GAGAS extends to government auditors and audit organizations only; therefore, GAGAS cannot place presumptively mandatory requirements on CPE providers. To achieve what I believe is the intent of the requirement in paragraph 4.16, I would suggest the GAO consider the following language:

For CPE to fulfill the GAGAS Qualification CPE requirement, the audit organization should ensure the CPE provider has included in the course content the relevant GAGAS topics listed in paragraph 4.23. In addition, the audit organization should ensure the CPE provider has included wording in the course description indicating the purpose of the CPE is to fulfill the GAGAS Qualification CPE requirement.

Examples of topics for the 24-hour requirement in paragraph 4.24 (b) need to clarify the accounting principles need to be relevant to the GAGAS engagements to which each auditor is assigned. From conducting CPE sessions over the past 12 years, I have concluded many government auditors from audit firms, take courses in not-for-profit accounting when they do not work on, nor does the audit firm have, not-for-profit clients. Likewise, government auditors take courses in governmental accounting when they are not involved in audits of governmental entities. I realize the stem of the paragraph references the engagement objectives. However, I believe reiterating something to this effect in 4.24 (b) would reinforce CPE relates to the type of entity audited and the role the auditor plays in the engagement.

In the 2011 GAGAS (para. 3.76), the 56-hour requirement relates to enhancing "... the auditor's proficiency to perform audits." This is less proscriptive than the proposed requirements in paragraph 4.18 which refer to the 56-hour requirement as "Subject matter or topics that directly enhance the auditor's professional expertise to conduct GAGAS engagements". Paragraph 4.25 does not include the reference to GAGAS included in paragraph 4.18. I believe this may lead to confusion among government auditors working for auditing firms because they are familiar with the 2011 GAGAS definition. As such, when reading paragraph 4.25 they might assume there have been no changes in the 56-hour requirement. Language proposed in paragraph 4.25 appears to be more in line with the language in the 2011 GAGAS (para. 3.76) rather than the language proposed in paragraph 4.18. To avoid potential confusion and misapplication of the requirements of paragraph 4.18, I would recommend the GAO consider including "GAGAS" with respect to "engagements" in paragraph 4.25 of the Exposure Draft.

I appreciate the inclusion of some of the guidance in GAO-05-568G, *Guidance on GAGAS Requirements for Continuing Professional Education*, in the application material. However, I believe it might be helpful to expand the list of suggested topics for the 56-hour requirement to include topics more recognizable to government auditors working in audit firms. For example, government auditors working in audit firms are familiar with cost accounting, forensic auditing, data analysis, and enterprise risk management. Any government auditor who is a licensed Certified Public Accountant (CPA) might steer clear of some of the topics listed in paragraph 4.25 of the Exposure Draft. Because many state boards of accountancy limit the number of hours each licensing period in what is perceived as “soft skills” auditors often do not use their CPE budget for these types of courses. Without additional examples to guide these auditors, they might substitute courses similar to what they counted as meeting the 56-hour requirement under the 2011 GAGAS.

As someone who speaks at conferences, acts as a discussion leader, and writes course materials, I find the limit of 40 and 20 hours in any 2-year period in paragraph 4.36 and 4.37, respectively, to be a bit troublesome. I realize this is an area where abuse can occur but I believe such abuse is isolated rather than systemic. Authors of annual accounting and auditing update courses often spend far more than 40 hours writing such courses. CPE discussion leaders may spend 20 hours or more preparing to teach an 8-hour course for the first time in a given year. In addition, the limit of 40 hours in a reporting period penalizes authors and discussion leaders writing and teaching multiple courses.

The 40 and 20 hour limits seem a bit inequitable when you consider attendees often leave a CPE session for extended periods of time or leave early. In addition, auditors often multi-task during face-to-face or self-study CPE courses. I have personal anecdotal evidence these situations are systemic rather than isolated. These auditors would be able to count multiple hours toward the CPE requirements when they were not truly “present” or “engaged” in learning. Perhaps the GAO could reconsider the limits in light of these types of situations and if the auditor kept detailed time records of the time spent preparing for presentations et al or writing courses.

Other than the previously noted issues, the requirements and application guidance in the GAGAS revision appear to enable auditors and audit organizations to effectively implement the CPE requirements.

Question 6

Changes to the quality control and external peer review sections are appropriate and reasonable.

Question 7

The peer review requirements for each category of audit organization are clear.

Question 8

The expanded requirements and application guidance to incorporate the AICPA’s Statements on Standards for Attestation Engagements (SSAE) No. 18, *Attestation Standards: Clarification and*

Recodification, and Statements on Standards for Accounting and Review Services (SSARS) No. 21 section 90, *Review of Financial Statements*, are appropriate in the performance of attestation and review engagements, respectively. However, I believe the specific references to the actual statement numbers (i.e. SSAE No. 18 and SSARS No. 21 in para. 7.01) are too proscriptive and short sighted. Additionally, with respect to the AICPA's attestation standards, the appropriate form of reference is the codified section number (i.e. AT-C section xx) rather than the actual statement number.

If the AICPA were to amend either SSAE No. 18 or SSARS No. 21 after the issuance of the next revision of GAGAS, GAGAS would then conflict with AICPA SSAEs and SSARSs for review engagements. Differences in GAGAS the AICPA's SSAEs and SSARSs relating to review engagements could lead to confusion among audit organizations. Therefore, I would recommend the GAO consider referring to the AICPA's SSAEs and SSARSs for review engagements generically. Language such as in paragraph 2.20 (a) of the 2011 GAGAS would be more appropriate and flexible than referring to specific standard/statement numbers. Alternatively, if specific references to SSAE No. 18 and SSARS No. 21 are deemed essential for GAGAS, perhaps a phrase similar to "as may be amended from time to time" could be added to each of the specific references.

Question 9

Paragraphs 8.37 through 8.65 clearly describe ways auditors should assess internal control when conducting performance audits.

Thank you again for the opportunity to respond to this exposure document. Should you have any questions regarding the above, please contact me at [REDACTED] or [REDACTED]

Sincerely,

Lynda M. Dennis, CPA, CGFO, PhD
Lecturer, University of Central Florida