

Yellow Book Update: 2010 Exposure Draft

2010 Annual NSAA
Conference

James R. Dalkin
Marcia B. Buchanan
Carefree, AZ
June 16, 2010

1

Session Objectives

- Review why *Government Auditing Standards* (the Yellow Book) is being revised
- Highlight areas that GAO expects to be revised in the next Yellow Book
- Discuss the anticipated timeline for the Yellow Book revision

2

Disclaimer Required to Receive a Preview

The revisions discussed are preliminary and subject to change based on feedback from the Comptroller General's Advisory Council on Government Auditing Standards and comments received on the Exposure Draft

3

Why the Yellow Book is being revised

- Promote the modernization of auditing standards
- Streamline with standard setters
- Address issues GAO has observed

4

2011 Yellow Book Projected Dates

June 2010:

- Issue Exposure Draft of 2011 Revision of GAGAS

September 2010:

- Comments due on Exposure Draft

February – March 2011:

- Issue 2011 Revision of GAGAS
- Effective date to be determined

5

Chapters 1 and 2

6

Reorganization of Chapters 1 and 2

Realigned Chapters 1 and 2

- Chapter 1 - concepts and ethics that serve as the foundation for the requirements and guidance for GAGAS
 - Purpose and applicability of GAGAS
 - Ethical principles
- Chapter 2 - requirements for the use and application of GAGAS
 - Use of terminology to define professional requirements
 - Relationship between GAGAS and other professional standards
 - Stating compliance with GAGAS in the auditors' report
 - Types of GAGAS audits and attestation engagements

7

Chapter 1 – Government Auditing: Foundation and Ethical Principles

- Clarified or added definitions of
 - Auditor
 - Audit organization
 - Audit team
 - Audit period

8

Chapter 2 – Standards for the Use and Application of GAGAS

Overall discussion of audit documentation

- Not necessary to document every matter considered or professional judgment made
- Not necessary to document separately compliance that is demonstrated within audit documentation

Clarified citing compliance with GAGAS

- Determination of appropriate GAGAS compliance statement is a matter of professional judgment
- Departures from presumptively mandatory requirements
- Using GAGAS with other standards

9

Chapter 2 – Standards for the Use and Application of GAGAS

Recognized the long-standing objective of a GAGAS financial audit includes reporting on

- Internal control
- Compliance with laws and regulations, and provisions of contracts and grant agreements

10

Chapter 3 General Standards

Independence
Professional Judgment
Competence
Quality Control and Assurance

11

Conceptual Framework Approach for Independence

- Current rules-based approach to independence does not provide needed flexibility
- AICPA and IFAC both have frameworks
- GAGAS framework includes independence of mind and independence of appearance
- GAGAS framework will:
 - Provide consistent results when compared with AICPA / IFAC
 - Address unique governmental structural issues

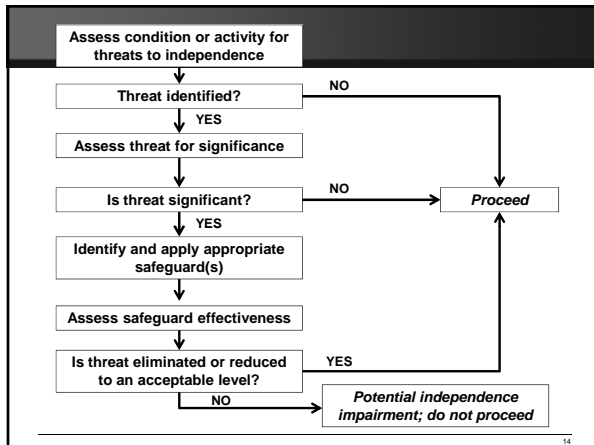
12

Conceptual Framework Approach for Independence

Under the proposed GAGAS Conceptual Framework, auditors

- identify threats to independence;
 - evaluate the significance of the threats identified; and
 - apply safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level.
- GAO will retire current *Questions and Answers to Independence Standard Questions* guidance

13



14

Broad Categories of Threats

Seven categories of threats:

- Self-interest threat
- Self-review threat
- Bias threat
- Familiarity threat
- Undue influence threat
- Management participation threat
- Structural threat

15

Safeguards

Controls that eliminate or reduce to an acceptable level a threat's potential to impair independence

16

Safeguards (Continued)

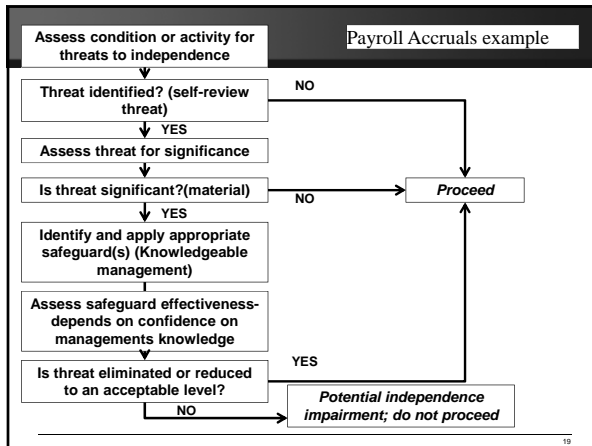
- Safeguards created by the profession, legislation, or regulation
 - Professional or regulatory monitoring and disciplinary procedures
 - External review by a third party of the reports, communications or other information produced by the auditor
- Safeguards in the work environment
 - Using different management and engagement teams with separate reporting lines for the provision of nonaudit services to and audited entity
 - Having additional review of the nonaudit service or the audit by staff who was not involved in providing the service/working on the engagement
 - The audited entity provides appropriate oversight and communication regarding the nonaudit service and the audit engagement

17

Independence Framework Example Payroll Accruals

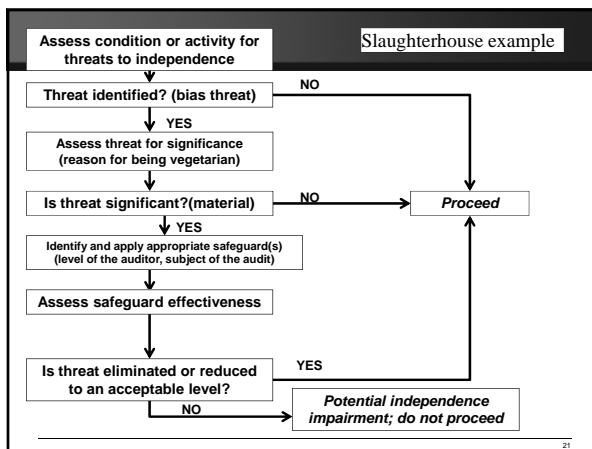
- Client requests auditor to assist with payroll accruals for financial statements prepared using GASB accounting standards
 - Threat—self-review threat
 - Safeguard—Knowledgeable staff at client that is able to review and check reasonableness of numbers based on analytical calculation
 - Safeguard—Staff assigned are not connected to the audit team

18



Independence Framework Example Slaughterhouse

- Auditor, who is a vegetarian, is asked to work on an audit of a slaughterhouse
 - Threat – bias threat
- Significance of the threat
 - Why is the auditor a vegetarian? (Health or personal views)
- Safeguards
 - Role and responsibilities of the auditor on the engagement
 - Activity being audited (Payroll or slaughter operations)



Activities so Significant that No Safeguard Could Reduce Threat to an Acceptable Level

- Certain activities in preparing accounting records and financial statements
 - Audit entity managers charged with overseeing the nonaudit service must possess suitable skill, knowledge and experience to evaluate the adequacy and results of the services performed
 - Otherwise no safeguard could reduce the threat to an acceptable level

22

Activities so Significant that No Safeguard Could Reduce Threat to an Acceptable Level

- Certain internal audit services provided by external auditors
 - Setting internal audit policies or the strategic direction of internal audit activities
 - Deciding which recommendations resulting from internal audit activities to implement
 - Taking responsibility for designing, implementing and maintaining internal control

23

Activities so Significant that No Safeguard Could Reduce Threat to an Acceptable Level

- Internal control assessments
 - Assisting management in documenting or performing the internal control assessment
- Certain recruiting services
 - Recommending a single individual for a specific position that is key to the audited entity or program,
 - Ranking or influencing management's selection of the candidate, or
 - Conducting an executive search or a recruiting program for the audited entity

24

Activities so Significant that No Safeguard Could Reduce Threat to an Acceptable Level

- Certain IT services
 - Design or development of a financial or other IT system that would be subject to or part of an audit
 - Services that entail making other than insignificant modifications to the source code underlying such a system
 - Operating or supervising the operation of such a system
- IT Services – “no audit period”
 - The “no audit period” extends for one year or one audit cycle past the project completion date for IT services such as system implementations

25

Activities so Significant that No Safeguard Could Reduce Threat to an Acceptable Level

- Certain valuation services
 - If the valuation services would have a material effect, separately, or in the aggregate, on the financial statements or other information that is the subject of an audit, and the valuation involves a significant degree of subjectivity

26

Professional Judgment

Emphasized that auditors use professional judgment in applying the conceptual framework for independence

27

Continuing Professional Education (CPE)

- 2007 Revision of GAGAS incorporated the revised CPE requirements that were issued in April 2005 (GAO-05-568G)
- No revision to overall requirements
 - 24 hours of CPE every 2 years directly related to GAGAS engagements
 - Additional 56 hours of CPE, involved in planning, directing, or reporting on GAGAS assignments or charge 20 percent or more of time annually to GAGAS assignments
 - 20 hours of CPE each year

28

Competence

Clarified CPE requirements for specialists

- External specialists and internal specialists consulting on a GAGAS engagement should be qualified and maintain professional competence
- Internal specialists involved in planning, directing, performing audit procedures, or reporting should comply with GAGAS CPE requirements
 - Would be subject to both the 24 hour and the 56 hour requirement
 - Training in the area of specialization qualifies for the 24 hour requirement

29

Quality Control and Assurance

Proposed changes:

- Permit the use of AICPA Quality Control Standards as meeting GAGAS requirements
- Expand discussion for elements of the GAGAS system of quality control for more consistency with AICPA Quality Control Standards

30

Quality Control and Assurance

Additional requirements to

- Communicate deficiencies noted during the monitoring process
- Make recommendations for appropriate remedial action

31

Chapter 4 Financial Audits

32

Financial Audits

Clearly identified the additional GAGAS requirements beyond the AICPA

- Referenced the AICPA standards when applicable

No new requirements were added for financial audits

33

Financial Audits

Removed duplication between GAGAS and AICPA standards

- Restatements
- Definitions of internal control deficiencies
- Communication of significant matters
- Consideration of fraud and illegal acts

34

“New” vs. “Old” Internal Control Definitions for a Material Weakness

- New Definition- SAS No. 115:
A deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis
- 2007 GAGAS-SAS No. 112:
A significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material misstatement of the financial statements will not be prevented or detected

35

“New” vs. “Old” Internal Control Definitions for Significant Deficiency

Significant Deficiency

- New Definition- SAS No. 115:
A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance
- 2007 GAGAS-SAS No. 112:
A deficiency in internal control or combination of deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with GAAP such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected

36

Financial Audits

Highlighted considerations for applying certain AICPA standards in a GAGAS financial audit

- Materiality
 - Auditors may find it appropriate to use a lower materiality level in a governmental environment
- Ongoing investigations or legal proceedings
 - Avoid interfering since important to pursuing fraud, illegal acts, etc.
 - May evaluate the impact on the current audit
 - May work with investigators and/or legal authorities, or withdraw or defer further work

37

Financial Audits

Highlighted considerations for applying certain AICPA standards in a GAGAS financial audit

- Early communication of deficiencies
 - For some matters, early communication important because of relative significance and urgency for corrective follow-up action
 - May communicate orally to management, and when appropriate to those charged with governance to assist them in taking timely remedial action to minimize risks of material misstatement

38

Financial Audits

Deleted GAGAS requirements that were adequately covered by AICPA or elsewhere in GAGAS:

- Document terminated engagements
- Develop policies to address requests by outside parties to obtain access to audit documentation

39

Chapter 5
Attestation Engagements

40

Attestation Engagements

Clearly identified the additional GAGAS requirements beyond the AICPA

- Referenced the AICPA standards when applicable

No new requirements were added for attestation engagements

41

Attestation Engagements

Adding separate sections on

- Agreed-Upon procedures engagements
- Review-level attestation engagements
 - Additional GAGAS requirement on citing compliance with GAGAS
 - Emphasize the required elements of AICPA reporting under each level of attestation engagements

42

Attestation Engagements

Removed duplication between GAGAS and AICPA standards

- Definitions of internal control deficiencies

43

Attestation Engagements

Highlighted considerations for applying certain AICPA standards in a GAGAS attestation engagement (consistent with Financial Audits)

- Materiality
- Ongoing investigations or legal proceedings
- Early communication of deficiencies

44

Attestation Engagements

Deleted GAGAS requirements that were adequately covered by AICPA or elsewhere in GAGAS:

- Document terminated engagements
- Develop policies to address requests by outside parties to obtain access to audit documentation

45

Chapters 6 and 7
Performance Audits

Performance Audits

Added the following:

- Definition of waste
 - Waste is the intentional or unintentional careless expenditure, inappropriate consumption, mismanagement, inappropriate use, or squandering of government resources. Waste also includes incurring unnecessary costs as a result of inefficient or ineffective practices, systems, or controls.
- Requirements regarding the auditor's responsibilities concerning waste

Performance Audits

Reporting requirements

- Modified the requirement for reporting all fraud
- Added reporting requirement for waste that is consistent with abuse

Performance Audits

Deleted the following:

- Requirement for the audit organization to develop policies to deal with requests by outside parties to obtain access to audit documentation
- Requirement for the audit organization to develop policies to address requests by outside parties to obtain access to audit documentation since covered by Quality Control requirements of GAGAS

48

Performance Audits

Retained the documentation requirement pertaining to termination of an audit

- Proposed deletion for financial audits and attestation engagements

Added consideration for early communication of internal control deficiencies

50

GAO's Accountability & Standards Team

Yellow Book Team:

- Jim Dalkin (202) 512-3133
- Marcia Buchanan (202) 512-9321
- Cheryl Clark (202) 512-9377
- Kristen Kociolek (202) 512-2989
- Gail Vallieres (202) 512-9370
- Michael Hrapsky (202) 512-9535
- Heather Keister (202) 512-2943
- Theresa Phipps (202) 512-2574
- Tom Hackney (303) 572-7304
- Eric Holbrook (202) 512-5232
- Mark Kaufman (202) 512-9341
- Andrew Seehusen (202) 512-4896

We also get lots of help from:

- Bob Dacey, GAO Chief Accountant
- Jennifer Allison, Advisory Council Administrator

Contact us at yellowbook@gao.gov

51

Questions?

Where to Find the Yellow Book

- The Yellow Book is available on GAO's website at:
www.gao.gov/govaud/ybk01.htm
- For technical assistance, contact us at
yellowbook@gao.gov
