Introduction: Yellow Book = “GAGAS”

GAGAS—Generally Accepted Government Auditing Standards

- Broad statements of auditors’ responsibilities
- An overall framework for ensuring that auditors have the competence, integrity, objectivity, and independence in planning, conducting, and reporting on their work
- For financial audits and attestation engagements, incorporates and builds on the AICPA standards (SASs and SSAEs)
Session Objectives

• Highlight areas revised in the 2011 Yellow Book, especially focusing on independence
  ➢ Use of conceptual framework
  ➢ New documentation requirements

• Walk through a common case study on independence

• Highlight revisions made for financial audits and attestation engagements

2011 Yellow Book Effective Dates

• Effective for financial audit periods ending on or after December 15, 2012
• Effective for attestation periods ending on or after December 15, 2012
• Effective for performance audits starting on or after December 15, 2011
• Independence may be impacted before the beginning of an engagement
The 2011 Yellow Book
Applicability

• Chapters 1, 2, and 3 apply to all GAGAS engagements
 ➢ Chapter 1: Government Auditing: Foundation and Ethical Principles
 ➢ Chapter 2: Standards for Use and Application of GAGAS
 ➢ Chapter 3: General Standards
• Chapter 4: Standards for Financial Audits – applies only to financial audits
• Chapter 5: Standards for Attestation Engagements - applies only to attestation engagements

The 2011 Yellow Book
Applicability (Continued)

• Chapters 6 and 7 apply only to performance audits
 ➢ Chapter 6: Field Work Standards for Performance Audits
 ➢ Chapter 7: Reporting Standards for Performance Audits
• Appendix: Provides additional guidance (not requirements) for all GAGAS engagements
• Interpretations: Available on the Yellow Book web page. Provide additional guidance (not requirements) for areas of particular interest or sensitivity.
Primary Yellow Book Changes

- Updated independence
  - Included a conceptual framework
- Added documentation requirements
  - Additional documentation in independence
  - Focus on non-audit services
- Focused on converging where practical
  - Incorporated clarified SASs
  - Fewer differences
- Made several revisions to details of the performance audit chapters

Chapter 1: Government Auditing: Foundation and Ethical Principles

- Provide a framework for conducting high quality audits with competence, integrity, objectivity, and independence
- For use by auditors of government entities and entities that receive government awards
Chapter 2: Types of GAGAS Engagements

• All audits begin with objectives, and those objectives determine the type of audit to be performed and the applicable standards to be followed.

• The types of audits that are covered by GAGAS, as defined by their objectives, are classified in the Yellow Book as
  ➢ Financial audits,
  ➢ Attestation engagements, and
  ➢ Performance audits.

Chapter 2: Financial Audits

Financial audits performed under GAGAS include
• Financial statement audits
• Other types of financial audits
Chapter 2: Attestation Engagements

• In addition to financial audits
• Attestation engagements can cover a broad range of financial or non-financial objectives and may provide different levels of assurance about the subject matter or assertion depending on the users’ needs.
• The three types of attestation engagements are:
  ➢ Examination
  ➢ Review
  ➢ Agreed-Upon Procedures

Chapter 2: Performance Audits

• Performance audits are defined as audits that provide findings or conclusions based on an evaluation of sufficient, appropriate evidence against criteria
• Performance audits provide objective analysis to assist management and those charged with governance and oversight in using the information to
  ➢ Improve program performance and operations
  ➢ Reduce costs
  ➢ Facilitate decision making, and
  ➢ Contribute to public accountability
Chapter 2: Use of Terminology

Standardized language to define the auditor requirements

- Consistent with SAS No. 102:
  - **Must** indicates an unconditional requirement
  - **Should** indicates a presumptively mandatory requirement
  - Text not using the above conventions is considered explanatory material

- Interpretive publications are recommendations on the application of GAGAS specific circumstances

Chapter 2: Stating Compliance with GAGAS in the Auditors’ Report

Auditors should cite compliance with GAGAS with either an unmodified or a modified compliance statement.

- **Unmodified**: the auditors have
  - Followed unconditional and applicable presumptively mandatory GAGAS requirements, or
  - Followed unconditional requirements and documented justification for departures from presumptively mandatory requirements and have achieved the objectives of those requirements
Chapter 2: Stating Compliance with GAGAS in the Auditors’ Report

Auditors should cite compliance with GAGAS with either an unmodified or a modified compliance statement.

- **Modified:** the auditors
  - Have performed the audit in accordance with GAGAS, except for specific applicable requirements, or
  - Because of the significance of departures the auditor was unable to perform the audit in accordance with GAGAS

Chapter 3: General Standards

- Independence
  - Conceptual framework
  - Provision of nonaudit services to auditees
- Professional judgment
- Competence
  - Technical knowledge
  - Continuing Professional Education
- Quality Assurance
  - System of quality assurance
  - Peer review
Chapter 3: Independence

• In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be independent.

• Independence comprises:
  ➢ Independence of Mind
  ➢ Independence in Appearance

Independence

• Conceptual Framework
  ➢ Allows the auditor to assess unique circumstances
  ➢ Adaptable
  ➢ Consistent with AICPA and IFAC frameworks

• Significant differences from ET-101-3
  ➢ Entry point for use of the framework
  ➢ Emphasis on services “in aggregate”
  ➢ Documentation requirements
Independence Timeframes

- Impairment exists during
  - The period of the audit – usually the fiscal year
  - The professional engagement
    - usually starts with earlier of start of planning or engagement agreement.
    - usually ends on the last report date.

- Depending on the circumstances, independence may be impacted beyond this timeframe.
- Recurring engagement may mean that some activities or circumstances will always impair.
Applying the Framework

- New approach combines a conceptual framework with certain rules (prohibitions)
  - Balances principle and rules based standards
  - Serves as a hybrid framework

- Certain prohibitions remain
  - Generally consistent with Rule 101 AICPA

- Beyond a prohibition
  - Apply the conceptual framework
  - Will be used more often than AICPA

---

<table>
<thead>
<tr>
<th>Conceptual Framework:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Identify threats to independence</td>
</tr>
<tr>
<td>2. Evaluate the significance of the threats identified, both individually and in the aggregate</td>
</tr>
<tr>
<td>3. Apply safeguards as necessary to eliminate the threats or reduce them to an acceptable level</td>
</tr>
<tr>
<td>4. Evaluate whether the safeguard is effective</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Documentation Requirement:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Para 3.24: When threats are not at an acceptable level and require application of safeguards, auditors should document the safeguards applied.</td>
</tr>
</tbody>
</table>
Applying the Framework

**Threats could** impair independence
- Do **not** necessarily result in an independence impairment

**Safeguards could** mitigate threats
- Eliminate or reduce to an acceptable level

---

**GAGAS Conceptual Framework for Independence**

1. Assess condition or activity for threats to independence
   - Threat identified?
     - Yes
     - No: Proceed
2. Is threat related to a nonaudit service?
   - Yes: Proceed
   - No
3. Assess threat for significance
   - Is threat significant?
     - Yes
     - No: Proceed
4. Identify and apply safeguard(s)
5. Assess safeguard(s) effectiveness
   - Is threat eliminated or reduced to an acceptable level?
     - Yes
     - No:
6. Document nature of threat and any safeguards applied
   - Proceed
7. Is the nonaudit service specifically prohibited in GAGAS paragraphs 3.36 or 3.49 through 3.58?
   - Yes
   - No:
8. Independence impairment; do not proceed

---
Applying the Framework: Categories of Threats

1. Management participation threat
2. Self-review threat
3. Bias threat
4. Familiarity threat
5. Undue influence threat
6. Self interest threat
7. Structural threat

Applying the Framework: Examples of Safeguards

- Reassign individual staff members who may have a threat to independence.
- Have separate staff perform the non-audit and audit services.
- Have professional staff from outside of the team review the work.
- Use or consult with an independent third party.
- Involve another audit organization.
- Decline to do the requested scope of the non-audit service.
Routine Audit Services and Nonaudit Services

Routine audit services pertain directly to the audit and include:
• Providing advice related to an accounting matter
• Researching and responding to an audited entity’s technical questions
• Providing advice on routine business matters
• Educating the audited entity on technical matters

Other services not directly related to the audit are considered nonaudit services.

Services that are specifically identified as nonaudit services include:
• Financial statement preparation
• Bookkeeping services
• Cash to accrual conversions (a form of bookkeeping)
• Other services not directly related to the audit
Nonaudit Services

1. Determine if there is a specific prohibition. Unless specifically prohibited, nonaudit services MAY be permitted but should be documented.

2. If not prohibited, assess the nonaudit service’s impact on independence using the conceptual framework.

3. If the auditor assesses any identified threat to independence as higher than insignificant, assess the sufficiency of audited entity management’s skill, knowledge, and experience to oversee the nonaudit service.

And…

Nonaudit Services (Continued)

4. If the auditor concludes that performance of the nonaudit service will not impair independence, document assessments in relation to both:
   • safeguards applied in accordance with the conceptual framework and
   • the auditor’s assessment of sufficiency of audited entity managements’ skill, knowledge or experience to oversee the nonaudit service (paragraph 3.34).
Assessing Significance in the Conceptual Framework for Nonaudit services

The framework requires the auditor to assess the significance of threats

• Threats related to nonaudit services often include
  ➢ Management participation threat
  ➢ Self review threat

• Indicators of a significant threat include:
  ➢ Level of services provided (aggregation assessment)
  ➢ Significance to the audit objective
  ➢ Basic understanding of the service enough to recognize material errors
  ➢ Facts and circumstances that increase the perception that the auditor is working as part of management

Preconditions to Performing Nonaudit Services

• Management should take responsibility for nonaudit services performed by the auditors

• Auditors should document (GAGAS and AICPA) their understanding with management regarding the nonaudit service

• Auditors should assess (AICPA) and document (GAGAS) whether management possesses suitable skill, knowledge, or experience to oversee the nonaudit service
Assessing Management’s Skill, Knowledge, or Experience

• Factors to document include management’s:
  ➢ Understanding of the nature of the nonaudit service
  ➢ Knowledge of the audited entity’s mission and operations
  ➢ General business knowledge
  ➢ Education
  ➢ Position at the audited entity

• Some factors may be given more weight than others

• GAGAS does not require that management have the ability to perform or reperform the service

Sufficiency of Skills, Knowledge and Experience

• Sufficient skills, knowledge and experience may be judged based in part on:
  ➢ Ability of the responsible audited entity personnel to understand the nature and results of the nonaudit service
  ➢ Ability of the responsible person to identify material errors or misstatements in a nonaudit service work product
  ➢ Ability and willingness and of the responsible person to take meaningful action in the event of identification of a problem with the nonaudit service

• Client prepared material in poor condition may indicate the client is not capable of taking responsibility for the service. Significant audit findings and adjustments may also be indicative of this issue.
Safeguards – Non audit services

Auditors should document safeguards when significant threats are identified.

• Auditor has responsibility to perform the assessment, this cannot be a management assertion
• Assessment should be in writing and indicate actions the auditor has taken to mitigate the threat
• Assessment should include a conclusion
• Auditor should document actions taken to mitigate the threat (safeguards)
• An example of safeguards for nonaudit services may include actions taken by the auditor to preserve independence such as an extra level of review or secondary review

Bookkeeping Services

May be performed provided the auditor does not
• Determine or change journal entries, account codings or classifications for transactions, or other accounting records without obtaining client approval
• Authorize or approve transactions
• Prepare source documents
• Make changes to source documents without client approval

Consistent with AICPA ET 101-3
Auditors may prepare financial statements
• Considered by GAGAS a non-audit service
• Must apply the conceptual framework
• Two additional documentation requirements:
  ➢ Document application of safeguards
  ➢ Document assessment of management’s skill, knowledge or expertise

Relative significance is a continuum
• Indicators of significant threats for bookkeeping and financial statement preparation may include:
  ➢ Financial statement preparation with other non-audit services such bookkeeping or cash to accrual conversions
  ➢ Condition of client prepared books and records
  ➢ Level of anticipated “correction” or adjustments to client prepared schedules and documents
  ➢ Condition of the general ledger/trial balance
• Less significant may be:
  ➢ Purely mechanical calculations
Prohibited Nonaudit Services

Management responsibilities (not a comprehensive list):
• Setting policies and strategic direction for the audited entity
• Directing and accepting responsibility for the actions of the audited entity’s employees in the performance of their routine, recurring activities
• Having custody of an audited entity’s assets
• Reporting to those charged with governance on behalf of management
• Deciding which of the auditor’s or outside third party’s recommendations to implement

Prohibited Nonaudit Services

More examples of management responsibilities:
• Accepting responsibility for the management of an audited entity’s project
• Accepting responsibility for designing, implementing, or maintaining internal control
• Providing services that are intended to be used as management’s primary basis for making decisions that are significant to the subject matter of the audit
• Developing an audited entity’s performance measurement system when that system is material or significant to the subject matter of the audit
• Serving as a voting member of an audited entity’s management committee or board of directors
Prohibitions within Internal Audit

Services provided by external auditors
• Setting internal audit policies or the strategic direction

• Deciding which recommendations resulting from internal audit activities to implement

• Taking responsibility for designing, implementing and maintaining internal control

Prohibitions within Valuation Services

External auditors may not provide valuation services that
• Would have a material effect,
• Involve a significant degree of subjectivity, and
• Are the subject of an audit
Prohibitions Related to Internal Control Monitoring

External auditors
- May not provide ongoing monitoring services
- May not design the system of internal controls and then assess its effectiveness
- May evaluate the effectiveness of controls

Management is responsible for designing, implementing and maintaining internal control

Prohibitions within IT Services

External auditors may not
- Design or develop an IT system that would be subject to or part of an audit
- Make significant modifications to an IT system’s source code
- Operate or supervise an IT system
Revisions to Timeframes Related to IT and Other Services

- Q&A guidance prohibited installing or designing a system and subsequently performing an audit
  - This prohibition has been eliminated along with the Q&A

- Independence in appearance may be a concern in subsequent periods
  - Possible safeguard: one audit cycle performed by another audit organization after the nonaudit service completion date provide a safeguard

Independence: Documentation Requirements

Para 3.59 summarizes documentation requirements for independence:

- Threats that require the application of safeguards along with the safeguards applied (3.24)
- Safeguards in place if an audit organization is structurally located within a government entity (3.30)
- Consideration of sufficiency of audited entity management’s skill, knowledge, and experience to take responsibility for and effectively oversee the nonaudit services (3.34)
- The auditor’s understanding with an audited entity regarding nonaudit services to be provided (3.39)
Case Study #1

- Can ABC Audit Firm prepare the financial statements of We Help People (WHP), a not-for-profit organization, and remain independent under the AICPA and Yellow Book Standards?

  a. Yes
  b. No
  c. Maybe

Case Study #1 (Continued)

- ABC has proposed in excess of 50 adjusting entries to correct WHP financial statements. Is ABC independent with respect to WHP?

  a. Yes
  b. No
  c. Maybe
Case Study #1 (Continued)

- ABC has also identified the following issues:
  - WHP’s trial balance is not in balance
  - The balance sheet has account balances that appear to be materially wrong—assets with credit balances and liabilities with debit balances
  - Bank reconciliations are materially different from the amounts in the trial balance

- ABC has been asked by WHP to do whatever necessary to get the books in order to complete the audit. ABC can take on this role and remain independent:
  a. Yes
  b. No

Chapter 3: Changes Related to CPE

Clearer distinction between internal/external specialists
- External specialists
  - Should be qualified and competent in their area of specialization, but not required to meet GAGAS CPE requirements.
- Internal specialists
  - Consulting on a GAGAS engagements (the same requirements as for external specialists apply).
  - If performing work under GAGAS, the CPE requirements apply. Training in the area of specialization qualify under the 24 hours of CPE that directly relate to government auditing, the government environment, or specific environment.

Par 3.79-3.81
Chapter 3: Changes to Quality Control Monitoring Procedures

Audit organizations should analyze and summarize, in writing, the results of monitoring procedures at least annually:

• Include identification of any systemic issues needing improvement
• Include recommendations for corrective action
• Communicate deficiencies noted to appropriate personnel and make recommendations for remedial action

Chapter 3: Changes Related to Peer Reviews

The peer review team uses professional judgment in deciding the type of peer review report. The following are the types of peer review reports:

• Peer review rating of pass
• Peer review rating of pass with deficiencies
• Peer review rating of fail
Chapter 4: Financial Audits- Overall Changes

- Considered Clarity Project conventions
- Streamlined language to harmonize with AICPA
- Clarified additive requirements
- Combined 2007 GAGAS chapters 4 and 5 into one chapter (2011 GAGAS chapter 4)

No new requirements were added for financial audits and attestation engagements

Financial Audits: Additional Considerations

- Materiality
- Early communication of deficiencies
Financial Audits: SAS 125 Alert That Restricts the Use of the Auditor’s Written Communication

SAS 125 makes a special provision for the GAGAS report on internal control over financial reporting and compliance.

• Don’t use the communication required for other audits. Instead, the alert should:
  ➢ Describe the purpose of the communication, and
  ➢ State that the communication is not suitable for any other purpose.

SAS 125: Sample Language for GAGAS Report on ICFR and Compliance

“The purpose of this report is solely to describe the scope of our testing of internal control over financial reporting and compliance, and the results of that testing, and not to provide an opinion on the effectiveness of the entity’s internal control over financial reporting or on compliance. This report is an integral part of an audit performed in accordance with Government Auditing Standards in considering the entity’s internal control over financial reporting and compliance. Accordingly, this report is not suitable for any other purpose.”
Chapter 5 - Attestation Engagements

Separated attest requirements
- Examination
- Review
- Agreed-Upon Procedures

Update considerations
- Identified practice issue
- Clarified distinctions between engagement types
- Emphasized AICPA reporting requirements

The 2011 Yellow Book: What You Need to Know

Questions?
Where to Find the Yellow Book

• The Yellow Book is available on GAO’s website at:
  www.gao.gov/yellowbook

• For technical assistance, contact us at:
  yellowbook@gao.gov
  or call (202) 512-9535