

Modernizing Auditing Standards: The 2006 Revision to the Yellow Book

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Presentation Framework

Developing High Quality Government Auditing Standards

Government Auditing Standards 2006 Revision Exposure Draft

Questions and Comments

Developing High Quality Government Auditing Standards

Our Overarching Goals

Develop high quality Government Auditing Standards that are well understood, highly regarded, widely used, and serve as a model for other environments such as the private sector and other governments around the world.

Provide leadership in modernizing and transforming the accountability profession in the public and private sectors, both domestically and internationally.

Build a solid foundation for an accountability profession that is

- **effective,**
- **ethical, and**
- **prepared for the challenges of the 21st century.**

Collaboration With Other Standard Setters

- AICPA
 - Use of Terms to define professional requirements in auditing standards
 - Those Charged with Governance
 - Group Audits
 - Audit Risk
 - Audit Documentation
 - Auditor's Report
 - Internal Control Communications and Attestation on Internal Control
 - International Auditing Standards Subcommittee
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Collaboration With Other Standard Setters

- IAASB/INTOSAI
 - Audit Documentation
 - Auditor Report Modifications and Matters of Emphasis
 - Communications with Those Charged with Governance
 - IFAC/INTOSAI
 - Ethics Committee Task Force on Independence of Government Accountants
 - COSO
 - Internal control framework for small businesses
 - SOX implementation issues
 - IIA
 - Yellow book standards
 - Role of government auditing in governance
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Collaboration With Other Standard Setters

- PCAOB
 - Standing Advisory Group

Comment Letters on Critical Auditing Issues

- January 20, 2006, COSO: Draft COSO Internal Control Integrated Framework – Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting.
 - October 31, 2005, IAASB: Independent Auditor's Reports on Other Historical Financial Information and Summary Audited Financial Statements
 - October 31, 2005, AICPA's ASB: Communication of Internal Control Matters
 - August 26, 2005, AICPA's ASB: Audit Risk
 - August 10, 2005, IAASB: Modification to the Opinion in the Auditor's Report and Emphasis of Matter Paragraphs and Other Matters
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Comment Letters on Critical Auditing Issues

- August 8, 2005, IAASB: Auditor's Communication with Those Charged with Governance
 - August 2, 2005, IAASB: Audit of Group Financial Statements
 - June 27, 2005, AICPA's ASB: Meaning of Present Fairly in Conformity with GAAP for Nongovernmental Entities
 - June 27, 2005, FASB: Hierarchy of GAAP
 - June 24, 2005, AICPA's Professional Ethics Division: Proposed New Interpretation 101-15 under Rule 101: Financial Relationships
 - May 9, 2005, AICPA's ASB: Defining Professional Requirements in Statements on Auditing Standards and a Related Proposed Statement on Standards for Attestation Engagements
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Comment Letters on Critical Auditing Issues

- May 9, 2005, PCAOB: Rulemaking Docket Matter No. 018: Proposed Auditing Standard—Reporting on the Elimination of a Material Weakness
- May 2, 2005, AICPA's ASB: Audit Documentation
- May 2, 2005, IAASB: Auditing Accounting Estimates and Related Disclosures
- May 2, 2005, IAASB: Materiality in the Identification and Evaluation of Misstatements
- February 11, 2005, IAASB: Audit Documentation

Technical Assistance, Outreach, and Training

- Technical questions
 - 2,000 phone inquiries
 - 2,000 e-mail inquiries
- Outreach and Training
 - Intergovernmental audit forums
 - Professional associations
 - State societies
 - Government organizations—federal, state, local

Creation of the U.S. Auditing Standards Coordinating Forum

- U.S. Auditing Standards Coordination Forum—PCAOB, GAO, ASB
 - Several meetings each year, with ongoing staff coordination
 - Maximize complementary standards-setting agendas
 - Minimize duplicative or competing efforts where possible
 - Work toward consistency where appropriate
 - Identify any significant gaps not being addressed
 - Develop strategies for modernizing the auditing profession in the U.S. and coordinating globally

Comptroller General's Advisory Council on Government Auditing Standards

- Experts drawn from all levels of government, private enterprise, public accounting, academia, and the user community

- An extensive deliberative process

2006 Yellow Book Revisions

- Audit quality assurance, monitoring, inspection, peer review
- Ethics/professional judgment
- Expanding and clarifying the categories of nonaudit services
- Reporting deficiencies in internal control for financial audits
- Auditor's responsibility for evaluating and disclosing financial statement restatements
- Evidence in performance audits
- Audit documentation
- Use of GAGAS with other standards (PCAOB, AICPA, IIA, IAASB)
- Clarification and "clean up"

Government Auditing Standards
2006 Revision
Exposure Draft

2006 Yellow Book Exposure Draft

- Overall emphasis:
 - Critical role of government audits in achieving credibility and accountability in government
 - Audit Quality
 - Ethics
 - Modernizing GAGAS and updating for major developments in the accountability and audit environment
 - Clarifying and streamlining GAGAS

Chapter 1

Use and Applicability of GAGAS

- Emphasis of the key role of government auditing
- Use of terminology to define professional requirements
- Relationship between GAGAS and other professional standards
- Types of government audits and attestation engagements

Chapter 1

Use and Applicability of GAGAS

- **Use of terminology to define professional requirements**
 - **Must** and **is required** indicate an unconditional requirement
 - **Should** indicates a presumptively mandatory requirement
 - **Should consider** indicates that the consideration is presumptively required; carrying out the procedure or action is a matter of auditor professional judgment based on existing facts and circumstances
 - Text not using the above conventions is considered explanatory material

Chapter 1

Use and Applicability of GAGAS

- AICPA field work and reporting standards are incorporated by reference for financial statement audits
- PCAOB and IAASB standards can be used in conjunction with GAGAS for financial statement audits
- IIA standards can be used in conjunction with GAGAS for performance audits

Chapter 2

Auditor's Ethical Responsibilities

Overarching auditor ethical responsibilities to uphold and protect the public trust.

“While audit organizations have overall responsibility for creating the environment to promote conducting audit work in accordance with ethical principles, ethics is also a matter of personal responsibility. Auditors should observe overriding ethical concepts in the performance of their professional responsibilities, including exercising reasonable care and diligence in maintaining high ethical standards. Ethical conduct includes auditors preserving their independence and performing competent work, as well as following applicable standards.”

Except from paragraph 2.02

Chapter 2

Auditor's Ethical Responsibilities

Ethical concepts to provide the framework for auditors work:

- The Public interest
- Professional behavior
- Integrity
- Objectivity
- Proper use of government information, Resources and position

Chapter 3

General Standards

- Independence
- Professional judgment
- Competence
- Quality control and assurance
- Peer review

Chapter 3

General Standards

Independence

- Moved non-audit services from “personal impairments” to “organizational impairments”
- Created three distinct categories of non-audit services, and consolidated and streamlined the examples of that had been interspersed throughout the independence section:
 - Non-audit services that do not impair auditor independence and therefore do not require compliance with the supplemental safeguards.
 - Non-audit services that would not impair independence if supplemental safeguards are implemented.
 - Non-audit services that impair independence

Chapter 3

General Standards

Independence

- Included additional guidance in the appendix dealing with non-audit services provided that do not involve a current or potential audit/attest entity.
 - These types of services are often performed by government audit organizations, in contrast to the consulting types of engagements performed by independent public accounting firms.
 - We did not re-open or change the overall independence standard, but made the changes above to clarify and facilitate implementation of the standard.
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Chapter 3

Audit Quality Control and Assurance

- Discussion expanded to describe a system of quality control, which consists of policies and procedures addressing each of the following elements:
 - Ethical requirements
 - Initiation and continuance of audit and attestation engagements
 - Human capital management
 - Engagement performance and reporting
 - Monitoring of quality
- Audit organizations are strongly encouraged to implement rigorous monitoring processes

Chapter 3

Audit Quality/ Peer Review

- Audit organizations should make the results of external peer reviews public
- New peer review timeframes, based on risk and underlying quality assurance system

Chapter 3

Audit Quality/ Peer Review

Peer Review Timeframes

- As soon as practical given the timeframes needed to implement corrective action (but no later than three years), if the most recent peer review opinion is adverse or modified.
 - Every three years if the audit organization has an unmodified peer review opinion and does not meet the enhanced quality assurance criteria for a five year cycle, or does not chose a five-year cycle
 - Every five years if the audit organization has an unmodified peer review opinion and meets the enhanced quality assurance criteria
 - Every five years if the audit organization is an internal audit organization that follows the IIA standards.
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Chapter 3

Audit Quality/ Peer Review

Enhanced Quality Assurance Criteria

- Description of overall quality assurance system is made public
- The audit organization has a functioning annual internal quality inspection process that meets the stated criteria
- The audit organization provides its oversight organization with an assertion about the effectiveness of its quality assurance program annually

Chapter 3

Audit Quality/ Peer Review

Enhanced quality assurance/ annual internal inspection criteria

- Review of audit documentation for a representative sample of audits
- Review of selected administrative and personnel records related to independence and human capital management
- Discussions/interviews with audit organization's personnel
- Summarizations of findings into a formal report to top management
- Discussion in the report of the systemic causes of any findings that indicate that improvements are needed
- Communication of findings to appropriate management officials and personnel in the audit organization
- Consideration of the findings by appropriate management personnel who are in a position to take corrective actions
- Retention of inspection documentation until completion of the next peer review

Chapters 4 and 5

Financial Audit Standards

- Definitions of internal control deficiencies
- Fraud and illegal acts
- Abuse
- Documentation
- Restatements

Chapters 4 and 5

Financial Audit Standards

Internal Control Deficiencies:

Significant deficiency – 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 generally accepted accounting principles 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.

Chapters 4 and 5

Financial Audit Standards

Internal Control Deficiencies:

- **Material weakness** – a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

Financial Audits- Internal Control Deficiencies

Old Definitions

New Definitions

<p>Material weakness (<i>GAGAS</i> paragraph 5.14 and AU 325.15)</p>	<p>Material weakness (proposed revised SAS 60, paragraph 5)</p>
<p>Reportable condition (<i>GAGAS</i> paragraph 5.13 and AU 325.02)</p>	<p>Significant deficiency (proposed revised SAS 60, Paragraph 5)</p>
<p>Management letter comment (<i>GAGAS</i> paragraph 5.16)</p>	<p>Other matters related to internal control (proposed revised SAS 60, Paragraph 19)</p>

Chapters 4 and 5

Financial Audit Standards

Internal Control Deficiencies:

GAGAS has the following reporting requirements:

- For all financial audits, auditors should report deficiencies in internal control considered to be significant deficiencies, including material weaknesses.
- Auditors should include all material weaknesses and other significant deficiencies in the auditor's report on internal control.
- Auditors should communicate deficiencies that are not significant deficiencies or material weaknesses separately in a management letter, unless clearly inconsequential.

Chapters 4 and 5

Financial Audit Standards

Fraud and Illegal Acts

- Under both the AICPA standards and GAGAS, auditors have the following responsibilities:
 - to plan and perform the audit to obtain reasonable assurance about whether the financials statements are free of material misstatement, whether caused by error or potential fraud.
 - to plan and perform the audit to provide reasonable assurance of detecting material misstatements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts.

Chapters 4 and 5

Financial Audit Standards

Violations of Contract Provisions or Grant Agreements

- Auditors should design the audit to provide reasonable assurance of detecting misstatements resulting from violations of provisions of contracts of grant agreements that have a material effect on the determination of financial statement amounts or other financial data significant to the audit objectives.

Chapters 4 and 5

Financial Audit Standards

Abuse

- If auditors encounter potential abuse, they should consider whether such situations are indicative of abuse that is material, either qualitatively or quantitatively.
- When information comes to the auditors' attention that material abuse may have occurred, auditors should perform audit procedures as necessary to
 - (1) determine whether the abuse occurred, and if so,
 - (2) determine its effect on the financial statement amounts or other financial data.

Chapters 4 and 5

Financial Audit Standards

Reporting

When auditors conclude that any of the following has occurred or is likely to have occurred, they should include in the audit report the relevant information about:

- Potential fraud and illegal acts that are greater than inconsequential
- Material violations of contracts or grant agreements
- Material abuse

Chapters 4 and 5

Financial Audit Standards

Audit Documentation:

- Updated the standard to achieve consistency with SAS 103:
- Audit documentation is an essential element of audit quality.
- The auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit to understand:
 - Nature, timing and extent of procedures performed
 - The results of procedures performed and evidence obtained
 - How the audit evidence relates to the audit conclusions
 - The conclusions reached on significant matters

Chapters 4 and 5

Financial Audit Standards

Audit Documentation

- Oral explanations on their own do not represent sufficient support for work the auditor performed or conclusions reached
 - May be used to clarify or explain audit documentation
 - Document audit evidence that is contradictory or inconsistent with final conclusions and how the auditor addressed the contradiction or inconsistency
 - Dating of the auditor's report:
 - Not earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the opinion.
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Chapters 4 and 5

Financial Audit Standards

Audit Documentation

- Assemble the final audit engagement file within 60 days following the report release date.
 - After 60 days – no deletion or discarding of existing audit documentation
 - After 60 days – appropriately document subsequent additions
- File retention period -- five years from the report release date.

Chapters 4 and 5

Financial Audit Standards

Restatements:

Auditors have professional responsibilities when they become aware of known or potential misstatements that might have affected their report on previously issued financial statements.

- Determine if previously issued financial statements were materially misstated.
 - Determine whether the misstatements affect the auditor's report and whether persons are currently relying or likely to rely on the financial statements
 - Determine whether management has appropriately disclosed the misstatements
 - If the audited entity refuses to disclose the misstatements, then the auditors should notify those charged with governance, oversight bodies, and funding organizations.
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Chapters 4 and 5

Financial Audit Standards

Restatements

When management restates previously-issued financial statements auditors should perform audit procedures sufficient to reissue or update the auditors report on the reissued financial statements, and include the following in the auditors report:

- A statement that the previously issued financial statements have been restated
- A statement that the previously-issued financial statements were materially misstated and that the previously-issued auditors report is withdrawn and replaced by the current report
- A reference to the notes to the restated financial statements that discussed the nature, cause, and amount of the restatement

Chapter 6

Attestation Engagements

Conforming changes will be made for the following items:

- Definitions of internal control deficiencies
- Description of abuse
- Audit documentation
- Use of terminology to define professional requirements

Chapters 7 & 8

Performance Audits

- Definition of performance audit
- Level of assurance in performance audits
- Sufficient, appropriate evidence
- Relationship between the nature, type, and amount of evidence needed and the audit objectives and conclusions
- Provided clarifications to the auditor's responsibility for fraud and abuse
- GAGAS statement in auditor's report

Chapters 7 & 8

Performance Audits

Definition of performance audit

- Performance audits provide assurance or conclusions relating to audit objectives that provide an evaluation against objective criteria, such as specific requirements or measures, or good business practices.
- Performance audits provide objective analysis so that management and those charged with governance and oversight may improve program performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability.

Chapters 7 & 8

Performance Audits

Level of assurance in performance audits

- Performance audits provide reasonable assurance that the auditor has sufficient, appropriate evidence concerning the achievement of the audit objectives and the conclusions reached.

Chapters 7 & 8

Performance Audits

Sufficient, appropriate evidence

- **Appropriate** evidence is defined as a measure of quality, which encompasses relevance, reliability, and validity in providing support for audit objectives
- **Sufficiency** is defined as a measure of quantity and quality and is evaluated based on the collective audit evidence supporting the findings, conclusions, or recommendations related to the audit objectives

Chapters 7 & 8

Performance Audits

GAGAS statement in auditor's report

- If auditors comply with GAGAS in all respects, they should include the following language in the report:

“This performance audit was conducted in accordance with GAGAS. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides a reasonable basis for our findings and conclusions based on our audit objectives.”

Proposed Issuance Dates

- Issuance of the exposure draft- June 2006
- Comment period - 60 days
- Issuance of Final 2006 Revision of Government Auditing Standards - Fall 2006

2006 Yellow Book

Proposed Implementation Dates

Financial Statement Audits and Attestation

Fieldwork and Reporting (Chapters 4, 5, and 6 only)

- AICPA changes become effective as of their effective dates.

Performance Audits and other Chapters

(Chapters 1, 2, 3, 7, and 8)

- Proposed to be effective for audits beginning on or after July 1, 2007.
- Earlier application permitted.

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Questions or Comments?
