GAO From Yellow to Green

AGA Nashville

April 5, 2013

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2011 Yellow Book
It is Already Effective!

• 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
Primary Yellow Book Changes

• Updated independence
  • Included a conceptual framework

• Focused on converging where practical
  • Incorporated clarified SASs
  • Fewer differences

• Added documentation requirements
  • Additional documentation in independence
  • Focus on non-audit services

• Made minor changes for performance audits
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 requirement
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
Chapter 3 – General Standards: Independence

**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

Assess condition or activity for threats to independence

Threat identified?

No → Proceed

Yes → Is threat related to a nonaudit service?

No → Proceed

Yes → Is the nonaudit service specifically prohibited in GAGAS paragraphs 3.36 or 3.49 through 3.58?

No → Proceed

Yes → Assess threat for significance

Is threat significant?

No → Proceed

Yes → Identify and apply safeguard(s)

Assess safeguard(s) effectiveness

Is threat eliminated or reduced to an acceptable level?

No → Proceed

Yes → Document nature of threat and any safeguards applied

Proceed

Independence impairment; do not proceed
New documentation requirement

- Must document when safeguards have been applied
  - Beyond the threat level
  - Only once safeguards are applied
  - Document how safeguards sufficiently mitigate the threats
Independence
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
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
Routine Audit Services and Nonaudit Services

Services that are considered non-audit services include:

• Financial statement preparation
• Bookkeeping services
• Cash to accrual conversions (a form of bookkeeping)
• Other services not directly related to the audit

Unless specifically prohibited, nonaudit services MAY be permissible but should be documented

• In relation to the conceptual framework
• In relation to the auditor’s assessment of managements’ skill, knowledge or experience
Nonaudit Services

• Certain services may be permitted
• First, determine if there is a specific prohibition
• If not, the auditor should assess the nonaudit service’s impact on independence using the conceptual framework
The framework requires the auditor to assess the significance of threats

- Threats related to non-audit 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 non-audit services performed by the auditors

• Auditors should document their understanding with management regarding the non-audit 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 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 in part based on:

- Ability of the identified client personnel to identify material errors or misstatements in a non audit service work product
- Ability of the client to sufficient background to understand the nature and results of the audit service
- Ability of management to take responsibility and understand the work

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
    • Examples may include:
      • Actions taken by the client to gain an understanding of the non-audit service and detect any errors
      • 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
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 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

Significant change in auditing prohibitions for future periods after a system implementation
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*
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
Assessing Significance for Bookkeeping and Financial Statement Preparation

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 as 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 Timeframes

Impairment exists during

• The period of the audit
• The professional engagement
GAO will retire current Government Auditing Standards: Questions and Answers to Independence Standard Questions guidance
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 deleted

Other potential considerations
  • Independence in appearance for subsequent periods

Possible Safeguard: One audit cycle performed by another audit organization after the nonaudit service completion date provide a safeguard
General Standards: Continuing Professional Education (CPE)

No revision to overall requirements:
• Minimum of 24 hours of CPE every 2 years
  • Government
  • Specific or unique environment
  • Auditing standards and applicable accounting principles
• Additional 56 hours of CPE for auditors involved in
  • Planning, directing, or reporting on GAGAS assignments; or
  • Charge 20 percent or more of time annually to GAGAS assignments
• Minimum of 20 hours of CPE each year
General Standards: Competence

CPE requirements for external specialists:

• External specialists are not required to meet GAGAS CPE requirements, but should be qualified and maintain professional competence.
CPE requirements for internal specialists:

- Internal specialists serving as auditors are subject to all CPE requirements
  - Specialized CPE count towards the required 24 hours
- Internal consulting specialists are not required to meet GAGAS CPE requirements, but should be qualified and maintain professional competence
Overall Changes for Financial Audits
Overall Changes for Financial Audits

- Considered Clarity Project conventions
- Streamlined language to harmonize with AICPA
- Clarified additive requirements

No new requirements were added for financial audits and attestation engagements
Requirements Beyond AICPA

Additional requirements relate to

- Auditor communication
- Previous audits and attestation engagements
- Noncompliance with provisions of contracts or grant agreements, or abuse
- Developing elements of a finding
- Documentation

For attestation engagements, this applies only at the examination level
Additional requirements relate to:

- Reporting auditors’ compliance with GAGAS
- Reporting on internal control, compliance with provisions of laws, regulations, contracts, and grant agreements, and other matters
- Reporting views of responsible officials
- Reporting confidential or sensitive information
- Distributing reports
Special Considerations for Government Engagements

Applying certain AICPA standards

• Materiality
• Early communication of deficiencies (SAS No. 115)
Removed Duplicative Requirements

Financial Audits
• Restatements
• Internal control deficiency definitions
• Communication of significant matters
• Consideration of fraud and illegal acts

Attestation Engagements
• Internal control deficiency definitions
Chapter 5
Attestation Engagements
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
Chapter 5 - Attestation Engagements

Within each section, emphasized

• Citing compliance with GAGAS
• Required elements of AICPA reporting
• Communicating the services to be performed
Chapters 6 & 7
Field Work & Reporting
Standards for Performance Audits
Chapter 7 - Performance Audits: Reporting - Modifications

Updates to fraud requirements

• Emphasized fraud reporting to occurrences significant to the audit objectives

• Fraud that is not significant within the context of the audit objectives but warrants the attention of those charged with governance should still be communicated in writing to officials
Resources

• Yellow Book
  • www.gao.gov/yellowbook
  • yelllowbook@gao.gov
Going Green

For more information, contact Jim Dalkin, Director at DalkinJ@gao.gov tel. 202-512-3133
• To discuss GAO’s plan to update the *Standards for Internal Control in the Federal Government* last issued November 1999 (Green Book)
What’s in Green Book for State – Local Governments?

• Green Book may be an acceptable framework for internal control on the state and local government level.
• Green Book has been written for government
  • Leverages off COSO
  • Removes non-governmental references
• Under OMB A-133 (proposal)
  • This may be an acceptable framework
Do You Want to Avoid Headline Headaches?

More than $154 Million in Questioned and Unsupported Costs in [Grant Recipients]' Proposed Budget

Internal Controls Over [Entity’s] Staff Retreats Could Be Improved

Additional Audit Work Confirmed $88 Million of Unallowable Contingency Costs in Construction Budget

Improper Release of Personally Identifiable Information

More than $6.3 Million of University Costs at the [Green’s Higher Education] Firm
• In fiscal year 2012, 32 auditor-identified material weaknesses were reported.
• This is an approximate 50% decline from the 61 material weaknesses identified at the start of the past decade.
Reasons for Green Book Revision

• Last issued in November 1999.
• Changing landscape has become more global, complex, and technological, creating new risks and challenges.
• Maintain relevancy of the standards.
• Opportunity to take advantage of new technology to make Green Book/Management Tool more user-friendly.
• Existing Green Book utilizes Committee of Sponsoring Organizations (COSO) internal control concepts. Revision will harmonize federal standards with the updated COSO framework.
The Green Book Revision Process

- GAO will harmonize with the concepts presented by COSO in their Internal Control: Integrated Framework Post Exposure Draft
- GAO will adapt the concepts for a government environment where appropriate
- GAO will also adapt the language from COSO’s framework to make it appropriate for a government standard
- Outreach to the user community
  - Program Managers
  - Auditors
Internal Control – COSO Integrated Framework

Published by COSO

Established:
• Common internal control definitions
• Internal control components

COSO’s revision of its original 1992 Internal Control – Integrated Framework is currently underway
Relationship of Objectives and Components are Similar

- A direct relationship exists between objectives (which are what an entity strives to achieve) and the components (which represent what is needed to achieve the objectives). These relationships are identical across the Framework and the Standards.

COSO depicts the relationship in a form of a cube:

- The three objectives are represented by the columns.
- The five components are represented by the rows.
- The entity’s organization structure is represented by the third dimension.
The COSO Framework sets out 17 principles

- The principles are the fundamental concepts associated with the components.

Each principle is supported by related attributes

- The attributes represent characteristics associated with the principles.
The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.

The organization selects and develops general control activities over technology to support the achievement of objectives.

The organization deploys control activities through policies that establish what is expected and procedures that put policies into action.
Control Environment – Principle Two - Exercises Oversight Responsibility

Under COSO
The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.

Under Green Book
Those charged with governance must oversee the development and performance of internal control.
**Principles & Attributes (Concept draft)**

<table>
<thead>
<tr>
<th>Component</th>
<th>COSO</th>
<th>GAO</th>
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</thead>
<tbody>
<tr>
<td>Control Environment</td>
<td>5 Principles</td>
<td>5 Principles</td>
</tr>
<tr>
<td></td>
<td>20 Points of Focus</td>
<td>13 Attributes</td>
</tr>
<tr>
<td>Risk Assessment</td>
<td>4 Principles</td>
<td>4 Principles</td>
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<tr>
<td></td>
<td>27 Points of Focus</td>
<td>10 Attributes</td>
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<tr>
<td>Control Activities</td>
<td>3 Principles</td>
<td>3 Principles</td>
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<td></td>
<td>16 Points of Focus</td>
<td>11 Attributes</td>
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<tr>
<td>Information &amp; Communication</td>
<td>3 Principles</td>
<td>3 Principles</td>
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<tr>
<td></td>
<td>14 Points of Focus</td>
<td>7 Attributes</td>
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<tr>
<td>Monitoring</td>
<td>2 Principles</td>
<td>2 Principles</td>
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<tr>
<td></td>
<td>10 Points of Focus</td>
<td>6 Attributes</td>
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</tbody>
</table>

GAO combined COSO’s Points of Focus into Attributes; it did not delete them.
<table>
<thead>
<tr>
<th>COSO Exposure Draft</th>
<th>Green Book Draft</th>
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<tbody>
<tr>
<td><strong>327</strong> Although the process by which an entity manages change is similar to, if not a part of, its regular risk assessment process, it is discussed separately. This is because it is critically important to effective internal control and because it can too easily be overlooked or given insufficient attention in the course of dealing with everyday issues.</td>
<td><strong>3.42</strong> As part of risk assessment or through a similar process, management identifies changes that could significantly impact the entity’s internal control system. Identifying, analyzing, and responding to change is similar to, if not part of, the entity’s regular risk assessment process. However, change is discussed separately because it is critical to an effective internal control system and can often be overlooked or inadequately addressed in the normal course of operations.</td>
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</tbody>
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Linkage Between Findings and Control Activities

- Findings are composed of
  - Condition (What is)
  - Criteria (What should be)
  - Cause (Cause)
  - Effect (Result)
  - And sometimes a Recommendation

Generally the criteria are embedded within a well worded control activity e.g., expense reports are to be reviewed for compliance with entity expense policies by travel office supervisors and approved/disapproved within 10 business days of receipt in the business office.
Linkage Between Findings and Control Activities

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  - Condition (What is)
  - Criteria (What should be)
  - Cause (Cause)
  - Effect (Result)
  - And sometimes a Recommendation

When there is a finding the cause is usually related to an internal control deficiency
Outreach with the User Community

• Green Book Comptroller General Advisory Council with cross-cutting representation will be established (similar to the Yellow Book advisory council)

• GAO will seek input from user groups with expertise in internal control from various entities
  • Federal agency management
  • IG and audit community
  • State and local government management and audit
  • OMB
  • Academia
  • COSO
  • Other users
Green Book Revision Timeline

- Outreach with the user community – Ongoing
- Green Book Advisory Council Meeting
  - May 20, 2013
- Public Exposure Period 2013 (Summer Release)
  - 90 Day Comment Period
- Finalize early 2014
Yellow Book Case Studies

(Time permitting)
The case studies revolve around the fictional CPA firm ABC Company (ABC) and the fictional local government “Small Town, USA” (ST). ABC audits ST.

The cases involve evaluating independence (or lack thereof) and compliance requirements under the new Yellow Book and under existing AICPA standards in the Code of Conduct.

Changes are being discussed at AICPA that could significantly impact some of the possible answers.
Case Study – Background

ST has the following employees involved in the audit:

A Ten Member Town Council – Meets Monthly

Brandon – Town Manager
Dave – Finance Director
Shelley – Accounting Clerk
Case Study

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

- 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

- **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:
  a. Yes
  b. No
Case Study

During the audit ABC becomes aware that the accounting system for ST is not as originally anticipated. Many workpapers that were intended to be prepared by ST, such as depreciation, have not been prepared by the client. Can ABC prepare these workpapers without impairing independence?

A. No
B. Yes
C. Maybe
The Yellow Book is available on GAO’s website at:

www.gao.gov/yellowbook

For technical assistance, contact us at

yellowbook@gao.gov