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Agenda and Learning Objectives

- Understand and apply significant changes made to Generally Accepted Government Auditing Standards (GAGAS) that impact audits performed in accordance with the Government Accountability Office (GOA), 2011 Revision of *Government Auditing Standards* (GAS or Yellow Book)



QUESTION

- Have you read the 2011 Revision of Government Auditing Standards?
 - a. Yes
 - b. No
 - c. No, but I plan to soon

Effective Dates

- For financial audits and attestation engagements, changes are effective for periods ending after December 15, 2012
 - Online version posted in August, updated
 - Effective date the same as clarity
- Print version issued December 2011
- For performance audits, changes became effective for audits beginning 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

Overall Changes for Financial Audits

- Considered clarity project/standards
- Streamlined language to harmonize with AICPA
- Clarified additive requirements
- No new requirements were added for financial audits and attestation engagements



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Requirements Beyond AICPA

Additional GAS 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



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Requirements Beyond AICPA, continued

Additional GAS 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



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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

Deleted Requirements

- Covered by the Quality Control system
 - Develop policies to address requests by outside parties to obtain access to audit documentation
- Covered by AICPA Standards
 - Document terminated engagements
 - Retained requirement for performance audits

Attestation Engagements

- Separated attest requirements
 - Examination
 - Review
 - Agreed-Upon Procedures
- Update considerations
 - Identified practice issue
 - Clarified distinctions between engagement types
 - Emphasized AICPA reporting requirements

QUESTION

- Have you ever performed an attestation engagement in accordance with GAS?
 - a. Yes, many
 - b. Yes, but not many
 - c. No

Supplementary Materials

- From GAO Web site
 - Summary of Major Changes
 - Listing of Technical Changes
- <http://www.gao.gov/yellowbook>

2011 Revision GAS

INDEPENDENCE

Chapter 3 – General Standards: Independence

- Defines independence of mind and in appearance
- Emphasizes the importance of considering individual threats to independence both individually and in aggregate

Chapter 3 – General Standards: Independence

Conceptual Framework

- Allows the auditor to assess unique circumstances
- Adaptable
- Consistent with AICPA and IFAC frameworks

Significant differences from AICPA Int. 101-3

- Entry point for use of the framework
- Emphasis on services "in aggregate"
- Documentation requirement

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
 - Paragraphs 3.45 through 3.58
- Beyond a prohibition
 - Apply the conceptual framework
 - Will be used more often than AICPA

Chapter 3 – General Standards: Independence

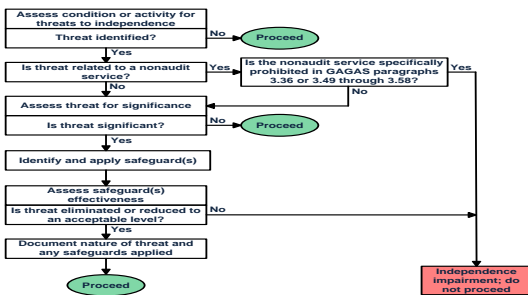
Threats could impair independence
 - Do **not** necessarily result in an independence impairment

But...

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



GAGAS Conceptual Framework for Independence



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



Assessing Significance in the Conceptual Framework for Non-audit services

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



Documentation Requirement Conceptual Requirement

New documentation requirement

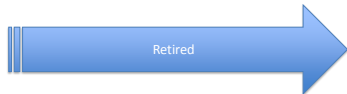
- Must document when safeguards have been applied
 - Beyond the threat level
 - Only once safeguards are applied
 - Document how safeguards sufficiently mitigate the threats



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Independence Q&A Guide

Government Auditing Standards: Questions and Answers to Independence Standard Questions guidance



Preconditions to Performing Nonaudit Services

- Management should take responsibility for nonaudit services performed by the auditors
- Auditors should document their understanding with management regarding the nonaudit service
- Auditors should assess (AICPA) and document (GAGAS) whether management possesses suitable skill, knowledge, or experience
- (SKE) 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 re-perform the service



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QUESTION

- How would you currently determine management's SKE, when you perform nonaudit services in connection with a GAAS audit?
 - A. I don't
 - B. Typically through preparation of the arrangement and representation letters
 - C. Through inquiry of management and/or those charged with governance
 - D. Through the preparation of a formal detailed memo that documents our identification, substantiation, and assessment of relevant SKE



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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:
 1. Actions taken by the client to gain an understanding of the non-audit service and detect any errors
 2. Actions taken by the auditor to preserve independence such as an extra level of review or secondary review

Routine Audit Services and Non audit 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 Non audit 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
 - Preparation of tax filings
- 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

Bookkeeping Services

- May be performed provided the auditor does not
- Determine or change journal entries, account codes 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 Int. 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

Installation of packaged system not specifically prohibited

Significant change in auditing prohibitions for future periods after a system implementation



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Prohibitions Related to Internal Control Monitoring

Management is responsible for designing, implementing and maintaining internal control

External auditors

- May not provide ongoing monitoring services or procedures
- May not design the system of internal controls and then assess its effectiveness

May evaluate the effectiveness of controls



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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



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Financial Statement Preparation

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 experience

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 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

Where to Find the Yellow Book

- The Yellow Book is available on GAO's website at:

www.gao.gov/yellowbook

- For technical assistance, contact the GAO at:

yellowbook@gao.gov

GAO Independence Standards Versus AICPA Standards

What are the major differences?

Yellow Book vs. AICPA - Similarities

- Specific threats & safeguards
 - Except GAO "structural threat" is unique to governments
- Prohibitions on nonaudit services
- AICPA Int. 101-3 general requirements
 - Audited entity must:
 - a. assume all management responsibilities;
 - b. designate an individual to oversee the services who has suitable skill, knowledge, or experience;
 - c. evaluate adequacy and results of services performed;
 - d. accept responsibility for the results of the services.
- Documentation of –
 - Understanding with the audited entity
 - Significant threats to independence that require the application of safeguards

Yellow Book vs. AICPA - Differences

- Conceptual framework approach
 - Yellow Book requires all circumstances/relationships that may result in threats to undergo threats/safeguards analysis
 - AICPA only requires threats/safeguards analysis if circumstance/relationship not specifically addressed in Code
- Permitted Nonaudit services
 - Yellow Book requires all permitted nonaudit services to undergo threats/safeguards analysis which may result in need for safeguards
 - If nonaudit service is permitted under AICPA Int. 101-3, additional safeguards are generally not required
- Documentation of management's skills, knowledge or experience

Case Study

■ Background

The case studies revolve around the fictional CPA firm ABC Company (ABC) and the fictional local government "Small Town" (ST), USA. 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.

Note - 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:

- Brandon – Town Manager*
- Dave – Finance Director*
- Shelley – Accounting Clerk*

A Ten Member Elected Governing Board – Meets Monthly



QUESTION

- *ABC meets with Brandon, the Town Manager of ST at the beginning of the audit engagement. Brandon indicates that he and Dave have closed the trial balance but will not prepare the year-end financial statements of ST. Can ABC prepare the year end financial statements and remain independent under AICPA and YB standards?*

- A. Yes
- B. No
- C. Maybe



Financial Statement Preparation

May be permissible provided

- Management possesses suitable
 - Skill,
 - Knowledge, or
 - Experience
 To evaluate the adequacy and results of the services performed

Consistent with AICPA Int. 101-3

Otherwise no safeguard could reduce the threat to an acceptable level



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Suitable skill, knowledge, and/or experience

- Individual designated to oversee the nonattest service has the ability to understand the nature, objective, and scope of the nonattest service.
- Does not require the designated individual to supervise the member in the day-to-day rendering of the services.
 - make all significant judgments;
 - evaluate the adequacy and results of the service;
 - accept responsibility for the service results; and
 - ensure that the resulting work product meets the agreed-upon specifications.



Case Study

What documentation must ABC have in order to comply with the proposed Yellow Book independence requirements given that ABC has prepared the year end financial statements?



AICPA 101-3 Documentation requirements

- *In connection with nonaudit services, an auditor should establish and document in writing their understanding with the audited entity's management or those charged with governance, as appropriate, regarding the following:*
 - objectives of the nonaudit service engagement;
 - services to be performed;
 - audited entity's acceptance of its responsibilities;
 - the auditor's responsibilities; and
 - any limitations of the nonaudit service engagement



Additional Yellow Book Documentation Requirements

- New audit documentation requirements include:
 - Documentation of the conceptual framework for issues requiring application of safeguards.
 - Under AICPA, documentation required but only applicable when circumstances not addressed in Code
 - For any non-audit service there is an additional documentation requirement
 - Assessing management's skill, knowledge or experience
 - Note: The assessment is required by the AICPA, GAGAS requires documentation of that assessment.



Assessing Management's Skill, Knowledge or Experience

- Considerations to include in documentation
 - Understanding of the nature of the service
 - Knowledge of the business
 - Knowledge of the industry
 - General business knowledge
 - Education
 - Position at the client
- Some factors may be given more weight
GAGAS does not require re-performance



Sample Documentation

ABC has determined that there exists a threat of both self review and management participation through its preparation of the financial statements of ST. ABC believes that the threat is of such significance that documentation of the evaluation is necessary and that application of safeguards is necessary to reduce the threat to acceptable levels.

ST has assigned Dave to oversee the engagement. ABC has determined that Dave has suitable skills, knowledge and experience to oversee the engagement as demonstrated by the following:

- Dave has 20 years of accounting experience, the first 5 of which were with a large public accounting firm, and he is knowledgeable of the GASB accounting and reporting requirements for state and local government entities
- He utilizes various industry reporting and disclosure practice aids to review the financial statements
- He has attended continuing education in the last year on current GASB standards



Sample Documentation – cont.

ABC has determined that the following safeguards are necessary:

- Documentation through the engagement letter that management assumes all responsibility for the financial statements and that management will a)oversee the services by designating an individual, who possesses suitable skill, knowledge, and/or experience; b)evaluate the adequacy of the service performed and c) accept responsibility for the service
- Documentation of our evaluation of the sufficiency of Dave's SKE as well as his responsibilities with ST



Sample Documentation – cont.

ABC has determined that the following safeguards are necessary:

- Have the statements prepared by an individual within the firm who is not responsible for planning and supervising the engagement and
- Have the statements reviewed by an individual within the firm not on the audit team

Conclusion – ABC has determined that Dave has suitable SKE to oversee the engagement and that independence is not impaired by virtue of preparing the financial statements



QUESTION

ABC failed to document its evaluation of threats and safeguards regarding its preparation of the financial statements for ST. Is ABC independent under the proposed yellow book ?

- a. Yes
- b. No
- c. As long as it doesn't get caught
- d. Should immediately retract the audit report and notify the client



Failure to document independence considerations

- Insufficient documentation does not automatically impair independence
- Appropriate documentation required by GAGAS and AICPA 101-3.
- Lack of documentation would be noncompliance with both standards

ALERT – Internal and Peer reviewer's and regulatory reviewer's will be explicitly looking for this documentation. Lack of documentation would result in findings.



Case Study – What If....

ABC prepares the depreciation schedule for ST.

- What safeguards could be implemented to reduce the self review threat?



Safeguard Examples

- Safeguards in the work environment
 - Select non-impaired auditor
 - Separate engagement teams
 - Secondary reviews

- Nonaudit services
 - Management responsibility
 - **Sufficient skills, knowledge, or experience**

- Safeguards created by the profession, legislation, or regulation
 - External review by a third party
 - Monitoring and disciplinary procedures



Safeguard examples

- *Preparation by personnel not involved in the audit team*
- *Emphasis of the risks of self review to the engagement team*
- *Detailed discussion of the schedule with client personnel*

Don't forget documentation of above, as well as, SKE and understanding/arrangements for nonaudit service



QUESTION

What if...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. Yes
- b. No
- c. Maybe



QUESTION

What if ...During the audit ABC also identifies the following issues:

- ST'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 trial balance

ABC has been asked by ST to do whatever necessary to get the books in order to complete the audit. Would ABC's independence be impaired if it agrees to do so?

- a. Yes
- b. No



Looking Forward



AICPA Practice Aid

- AICPA, 2011 Yellow Book Independence – Nonaudit Services Documentation Practice Aid
 - Significant threats to independence
 - Application of safeguards
 - Evaluation of the skills, knowledge or experience
 - Management responsibilities



AICPA Practice Aid

- Appendices provide detailed guidance and examples, including
 - Evaluation of significance of threats
 - Determination of applicable and appropriate safeguards
 - Evaluation of skills, knowledge or experience
 - Completed example practice aid
- Available free through the AICPA Governmental Audit Quality Center (GAQC) to AICPA members.
Unlocked version available for purchase



Questions ?????