



The New 2011 Yellow Book:

... What You Need to Know Now




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Objectives of Session

- To cover the following topics
 - A high level summary of changes in the 2011 Yellow Book;
 - A more detailed exploration of the new independence standards;
 - The Yellow Book's independence conceptual framework and related additional documentation requirements;
 - How the 2011 Yellow Book's independence rules compare to the AICPA's rules;
 - Discussion of a few practical real-life situations and how the independence standards would apply;
 - A new toolkit being developed by the AICPA to help auditors
- Answer your questions!

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Today's Speakers

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The New 2011 Yellow Book



Why the Yellow Book is being revised

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

Effective Dates

- For financial audits and attestation engagements, changes are effective for periods ending after December 15, 2012
 - Online version posted
 - Effective date the same as clarity
- Print version pending ASB's clarity project
 - Restricted use open
- For performance audits, changes 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 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



Requirements Beyond AICPA

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

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

Supplementary Materials

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

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

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

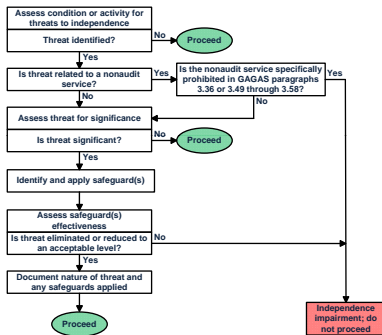
Threats could impair independence

- Do **not** necessarily result in an independence impairment

Safeguards could mitigate threats

- Eliminate or reduce to an acceptable level

GAGAS Conceptual Framework for Independence



Independence Categories of Threats

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



Independence Q&A Guide

GAO will retire current *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 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

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



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



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

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



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 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

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 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



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's Accountability & Standards Team

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We also get lots of help from:

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

Contact us at yellowbook@gao.gov



GAO Independence Standards Versus AICPA Standards

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**

Real-Life Scenario Case Studies

Case Study – Background

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 – 1

ABC meets with Brandon, the Executive Director 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

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 – 2

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

Case Study – 3

During the audit ABC 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

Case Study – 4

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 experience in local governments and is knowledgeable of governmental GAAP*
- He utilizes various reporting and disclosure practice aids to review the financial statements*
- He has attended continuing education in the last year on current GAAP 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

Case Study – 5

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

Case Study – 6

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*

Looking Forward

GAO Actions

- Finalize 2011 Yellow Book
- Changes expected?
- Timing?

AICPA Yellow Book Toolkit – Coming Soon

- Toolkit to assist auditors in complying with independence considerations for nonaudit services
- Includes a practice aid to incorporate in workpapers that will evaluate and document
 - Significant threats to independence
 - Application of safeguards
 - Evaluation of the skills, knowledge or experience
 - Management responsibilities

AICPA Yellow Book Toolkit – Coming Soon

- 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
- Will be made available through the AICPA Governmental Audit Quality Center (GAQC) and free to AICPA members

Summary & Questions



Thank You For Participating!



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