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Memorandum # 2013-12

To: **Local Government Financial Officials and their Independent Auditors**

From: **Sharon Edmundson, Director, Fiscal Management Section**

Subject: **2011 Revision - *Government Auditing Standards* (GAGAS)**

Date: **April 16, 2013**

The U.S. Governmental Accountability Office (GAO) has issued the 2011 revision of the *Governmental Auditing Standards* (GAGAS), commonly referred to as the Yellow Book. The 2011 revisions are effective for audits and attestation engagements for periods ending on or after December 15, 2012, which is June 30, 2013 for most units of governments and public authorities in North Carolina. Auditors that are providing non-audit services for the periods covered by the revised 2011 standards need to consider the new independence provisions when they determine whether they can perform the non-audit services and not impair their independence for the year end audit.

One of the more significant changes from the 2007 version of the Yellow Book is in the area of independence, especially as it applies to non-audited services. A conceptual framework for auditor independence has been introduced, which replaces the overarching independence principles. In addition, specific references to personal, external, and organizational impairments have been removed. Though the underlying concepts related to these categories have been retained, the current version is a more principles-based approach to analyzing independence which allows auditors to assess the unique facts and circumstances that arise during their work.

The revised 2011 Yellow Book standards have removed certain Statement on Auditing Standards and Statement on Standards for Attestation that were duplicated in the 2007 version of the Yellow Book, and uses footnotes to directly reference other standards. For example, the 2011 version of the Yellow Book has removed the definition of material weaknesses and significant deficiencies, and references the AICPA's definition in new Clarified Auditing Standard AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*. The effective date for the revised 2011 Yellow Book standards coincides with the effective date of the AICPA's Clarified Auditing Standards, commonly referred to as the Clarity Standards. (Refer to LGC memorandum No. 2013-13 for a discussion on the Clarity Standards.) The 2011 Yellow Book revisions represent a modernized version of the standards, taking into account recent changes in other auditing standards, including the international standards.

This memorandum's discussion is limited to the applicable sections of the Yellow Book as they relate to financial audits of local governments and public authorities in North Carolina and their independent auditors.

Auditor's Independence

The 2011 Yellow Book revision simply defines independence as two components:

- Independent in mind – being free from influences that can compromise professional judgment
- Independent in appearance – the absence of circumstances that would cause a reasonable and informed third party to conclude that the integrity, objectivity, and professional skepticism of an audit organization or team member has been compromised

In order to assist the auditor in maintaining independence of mind and appearance, a conceptual framework approach to independence has been established, and the auditor must employ it in all matters of audit work. Independence is required from the time there is an agreement to perform an audit until the termination of the professional relationship or issuance of the report, whichever is later. Auditors should use professional judgment in determining whether facts and circumstances warrant the use of the conceptual framework.

There are three steps to the conceptual framework approach:
1. Identify threats to independence
2. Evaluate the significance of the threats identified, both individually and in the aggregate
3. Apply safeguards as necessary to eliminate the threats or reduce them to an acceptable level

Threats to independence include:
- Self-interest threat – the auditor will be influenced due to a financial or other interest in the audit results.
- Self-review – an auditor that performs non-audit services will be reviewing his or her own work.
- Bias – based on political, social, ideological or other convictions, the auditor will not be objective.
- Familiarity – due to relationships with personnel of the entity, the auditor will not be objective.
- Undue influence – pressures may influence the auditor's judgment.
- Management participation – auditor will be taking on the role of management.

After identifying and evaluating the significance of a potential threat, the auditor must apply safeguards to eliminate those threats or reduce them to an acceptable level. Examples of safeguards include:
- Consulting a knowledgeable third party,
- Involving another firm to perform part of the audit,
- Having another staff member, not on the audit team, review the work, or
- Removing the individual who poses a threat to independence from the audit team.

Non-audit Services

If a non-audit service is not expressly prohibited, the auditor should apply the conceptual framework to conclude whether a potential impairment to independence exists. If there is a potential impairment, safeguards may mitigate threats to an acceptable level.

A critical component of this determination is consideration of management's ability to effectively oversee the non-audit service to be performed. The auditor should determine if an individual has the suitable skills, knowledge, and experience (SKE) and that the person understands the services to be performed sufficiently to oversee them. The person is not required to possess the expertise to perform or re-perform the services. The auditor should document consideration of management's ability to effectively oversee all non-audit services to be performed.

The revised Yellow Book standards specifically prohibit certain non-audit services since they would directly support the entity's operations and impair the auditor's independence. The list below represents the most prevalent of the prohibited non-audit services but it is not all inclusive.

Internal audit assistance services involving assisting an entity in performance of its internal audit activities by:

- Setting internal audit policies or strategic direction of internal audit activities,
- Performing procedures that form part of the internal control process, such as reviewing and approving changes to employee data access privileges,
- Determining the scope of the internal audit function and resulting work.

Internal Control Monitoring such as:

- Providing ongoing monitoring procedures.

Information Technology Systems Service such as:

- Designing or developing an IT system that would be subject to an audit by the same auditor,
- Modifying source code unless insignificant.
- Operating or supervising the operation of an IT system.

Valuation services such as:

- Providing valuation services that would have a material effect, separately or in the aggregate, on the financial statements or other information on which the auditor is reporting, and the valuation involves a significant degree of subjectivity.

Other non-audit services included in the Yellow Book that are prohibited are in the area of nontax disbursements, benefit plan administration, investment, and human resource services. The emphasis in these areas is on whether the auditor assumes the role of management or has custody of assets in these areas, then there is an impairment of independence.

Financial Statement Preparation and Bookkeeping

Activities such as financial statement preparation, conversions from the cash basis to the accrual basis of accounting for reporting purposes, and reconciliations are not prohibited. However, each service would have to be evaluated using the conceptual framework. The auditor must assess management's skills, knowledge, and experience to oversee the non-audit service being provided. Certain services related to these activities are prohibited in the revised 2011 standards:

- Determining or changing journal entries, account codes or classifications for transactions or other accounting records for the entity without obtaining management's approval
- Authorizing or approving the entity's transactions
- Preparing or making changes to source documents without management's approval.

Documentation

The revised 2011 Yellow Book increases documentation requirements. These documentation requirements include:

- Threats to independence that require the application of safeguards along with the safeguards applied
- Management's ability to effectively oversee a non-audit service to be provided by the auditor, including whether or not management possesses the suitable SKE
- The agreement between the auditor and the audited entity as it relates to the non-audit service being performed.

Auditors should establish and document their engagement agreement with the entity regarding:

- Objectives of the non-audit services
- Services to be performed
- Audited entity's acceptance of its responsibilities
- The auditor's responsibilities
- Any limitations of the non-audit service

Under the more principle-based framework, auditors will need to address the threats and safeguards within the conceptual framework. Therefore, the Q&A *Guide Answers to Independent Standards Questions* issued by GAO in July 2002 will be retired once the 2011 revised standards go into effect and will no longer be applicable.

Continuing Education Requirements: Though there were no changes to the overall basic requirements from the 2007 version, internal specialists, such as actuaries, who apply their specialized skills to the audit should complete 24 hours of CPE in their area of specialty.

Financial Audit Chapters: The 2011 revised standards did not add any new fieldwork or reporting requirements. The term *fieldwork* is now replaced with the clarity standard term "performance." The performance and reporting standards are now included in one chapter of the Yellow Book standards. Requirements already included in the AICPA audit standards have been eliminated from the revised Yellow Book standards as follows:

- Restatements
- Definitions of internal control deficiencies
- Communications of significant matters
- Considerations of fraud and illegal acts.

AICPA Standards v. Yellow Book

Independence and providing non-audit services: AICPA Standards and Yellow Book standards are similar in that a conceptual framework is to be used by auditors to identify, evaluate, and apply safeguards to address threats to independence. Yellow Book standards should be applied to non-audit services unless the non-audit service is specifically prohibited. Under AICPA requirements, if the non-audit service is not addressed under Interpretation 101-3, *Performance of Non-attest Services* of the AICPA Code [ET 101.05], then the AICPA's conceptual framework should be applied. If a non-audit service is allowed under AICPA Interpretation 101-3, then the conceptual framework does not need to be applied. If an auditor provides more than one non-audit service, the Yellow Book standards require the auditor to consider the aggregate effect of these services on threats to independence. Therefore it is understandable that the Yellow Book conceptual framework will be used more often than the AICPA's.

AICPA Interpretation 101-3 and the Yellow Book have similar requirements in that the audited entity must:

- Assume all management's responsibilities
- Oversee the services by designating an individual who has suitable SKE
- Evaluate adequacy and results of services performed
- Accept responsibility for the results of the service.

Documentation requirements are similar except that under the Yellow Book standards the auditor must document the SKE of the individual in the audited entity who is overseeing the non-audit service being performed by the auditor.

Additional requirements for Yellow Book audits beyond those required by the AICPA standards: As mentioned, the Yellow Book has incorporated AICPA standards by footnote references; however, there are additional requirements for performing financial audits in the following areas (for the specific requirements please refer to the Yellow Book paragraph referenced in each requirement):

- auditor communication (¶4.03)
- previous audits and attestation engagements (¶4.05)
- developing elements of findings (¶4.10 – ¶4.14)
- audit documentation (¶4.15 – ¶4.16)
- fraud, noncompliance with provisions of laws, regulations, contracts, and grant agreements, and abuse (¶4.06)

Additional Yellow Book reporting requirements for reporting on financial audits are as follows:

- Reporting auditors' compliance with GAGAS (¶4.18)
- Reporting on internal control, compliance with provisions of laws, regulations, contracts, and grant agreements, and other matters (¶4.19 - ¶4.22)
- Reporting views of responsible officials (¶4.33 - ¶4.39)
- Reporting confidential or sensitive information (¶4.40 - ¶4.44)
- Distributing reports (¶4.45)

The 2011 Revision of the Yellow Book is available on the GAO's website at www.gao.gov/yellowbook. Examples of financial reports that have been updated for the 2011 edition of *Government Auditing Standards*, as well as for the new clarity auditing standards, can be found at www.nctreasurer.com; select *Division*, *Local Fiscal Management*, and *Single Audit Resources.*

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