Memorandum

Date: January 2007
To: GAO's Financial Management and Assurance Team
PCIE/IG Financial Audit Community

From: Jeanette M. Franzel, Director - FMA
Steven J. Sebastian, Director - FMA

Subject: Professional Standards Update No. 47

In order to alert you to changes in professional standards, we issue Professional Standards Updates. Thanks to Gail Vallieres, Frank Synowiec, Heather Keister, and Michael Hrapsky for their contributions to this issue, which contains summaries of:

<u>Auditing Standards</u>

GAO
• *Government Auditng Standards, 2007 Revision*

AICPA Auditing Standards Board (ASB)
• SAS No. 113, *Omnibus 2006*
• SAS No. 114, *The Auditor's Communication With Those Charged With Governance*
• SSAE No. 14, *SSAE Hierarchy*
• *Journal of Accountancy* articles on AICPA Audit Risk Standards, SAS No. 104 through No. 111
• Audit Guide*: Assessing and Responding to Audit Risk in a Financial Statement Audit*
• "*Alternative Investments – Audit Considerations*," a Practice Aid

Public Company Accounting Oversight Board (PCAOB)
• *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud*

Institute of Internal Auditors (IIA)
• *The Role of Auditing in Public Sector Governance*
• Revision to International Standard for the Professional Practice of Internal Auditing No.1312, *External Assessments*

Accounting Standards

FASAB
• SFFAS No. 32, *Consolidated Financial Report of the US Government Requirements: Implementing Statement of Federal Financial Accounting Concepts No. 4 "Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government"*
• SFFAS No. 31, *Accounting for Fiduciary Activities*
• Technical Bulletin 2006-01, *Recognition and Measurement of Asbestos-Related Cleanup Costs*

FASB
• FAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*
• FAS No. 157, *Fair Value Measurements*

GASB
• Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*
• Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*

Regulatory Guidance

Office of Management and Budget
• OMB Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*

Securities and Exchange Commission
• SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*

Auditing Standards

GAO

The Comptroller General of the United States has issued the **2007 revision of *Government Auditing Standards***, which supersedes the 2003 revision. The January 2007 version contains the final 2007 revisions to the standards, except for the quality control and peer review sections in chapter 3. Concurrent with the electronic issuance of the January 2007 revision of *Government Auditing Standards*, GAO is exposing for comment redrafted sections on quality control and peer review in response to the wide range of comments we received on those sections. The complete 2007 revision of *Government Auditing Standards* will be available after the quality assurance and peer review sections are finalized and incorporated into the standards. Electronic versions of the documents can be accessed on the Web at http://www.gao.gov/govaud/ybk01.htm.

The 2007 revision contains the following fundamental changes that reinforce the principles of transparency and accountability, and provide the framework for high quality government audits that add value:

- heightened emphasis on ethical principles as the foundation, discipline, and structure behind the implementation of the standards, including a description of five key ethical principles that should guide the work of those who audit government programs and operations;

- clarified and streamlined discussion of professional services other than audit services (i.e., nonaudit services) and their impact on auditor independence;

- updated financial auditing standards based on recent developments in financial auditing and internal control, increased transparency surrounding restatements and significant concerns, uncertainties, or other unusual events that could have a significant impact on the financial condition or operations of a government entity or program;

- enhanced performance auditing standards that elaborate on the overall framework for high-quality performance auditing, including the concepts of reasonable assurance and its relationship to audit risk and the levels of evidence used to support audit findings and conclusions;

- standardized language to define the auditor's level of responsibility and distinguish between auditor requirements and additional guidance; and

- reinforced role of auditing in maintaining accountability and providing information for making improvements in government operations.

This revision of the standards went through an extensive deliberative process, including public comments and input from the Comptroller General's Advisory Council on Government Auditing Standards. The Advisory Council includes 27 experts in financial and performance auditing and reporting drawn from federal, state, and local government; the private sector; and academia. The views of all parties were thoroughly considered in finalizing the standards.

The complete 2007 revision of *Government Auditing Standards* will be available after the quality assurance and peer review sections are finalized and incorporated into the standards and will be effective for financial audits and attestation engagements for periods beginning on or after January 1, 2008, and for performance audits beginning on or after January 1, 2008. Early implementation is permissible and encouraged.

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AICPA Auditing Standards Board (ASB)

Statement on Auditing Standards (SAS) No. 113, *Omnibus 2006* amends and makes the following conforming changes to various standards:

- Revises the terminology used in the ten standards in SAS No. 95 to reflect the terminology used in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards.*

- Adds footnotes to SAS No. 99, *Considerations of Fraud in a Financial Statement Audit,* to provide a clear link between the auditor's consideration of fraud, assessment of risk, and procedures in response to those assessed risks.

- Replaces the term "completion of fieldwork" with the term "the date of the auditor's report" throughout the SASs.

- Requires dating the representation letter as of the date of the auditor's report.

The first two provisions above are effective for audits of financial statements for periods beginning on or after December 15, 2006, while the latter two provisions are effective for audits of financial statements for periods ending on or after December 15, 2006. For all provisions, early application is permitted.

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SAS No. 114, *The Auditor's Communication With Those Charged With Governance,* replaces SAS No. 61 and requires auditors to communicate certain significant matters related to the audit to those charged with governance. SAS No. 114 also establishes standards and provides guidance on matters for auditors to communicate, with whom to communicate, and the form and timing of the communication.

The term "those charged with governance" refers to officials with responsibility for overseeing the entity's strategic direction and accountability and includes overseeing the entity's financial reporting process. Auditors should identify the appropriate entity officials with whom to communicate certain matters. The SAS provides guidance for determining with whom auditors should communicate, since those officials may vary depending on the nature of the matter to be communicated.

SAS 114 is effective for audits of financial statements for periods beginning on or after December 15, 2006. Janet Krell of GAO served on the AICPA task force that developed SAS 114.

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Statements on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy*, amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements*. This SSAE is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.

Summaries of new SASs and SSAEs are available on the AICPA website at http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Authoritative+Standards+and+Related+Guidance+for+Non-Issuers/default.htm

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Two recent ***Journal of Accountancy*** articles provide an overview of the new AICPA audit risk standards, SAS No. 104 through SAS No. 111. The first article, on page 43 of the July 2006 issue, discusses the process of assessing the risks and controls leading to the concept of the risk of material misstatement. The second article, which discusses how the auditor responds to the risk of material misstatement in designing and performing audit procedures, is on page 59 of the January 2007 issue. The *Journal of Accountancy* can be accessed at *http://www.aicpa.org/pubs/jofa/joahome.htm.*

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The AICPA's new **Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit***, was written to assist practitioners in applying the auditing standards related to the assessment of risk in an audit of financial statements. The guide provides both guidance on applying the audit risk standards and addresses, among other things:

- Key concepts underlying the auditor's risk assessment process,
- Planning and performing risk assessment procedures,
- Understanding the client, its environments and its internal control,
- Linking risk assessment and the design of further audit procedures,
- Performing further audit procedures, and
- Evaluating audit findings, audit evidence and internal control deficiencies.

The existing Audit Guide titled *Consideration of Internal Control in a Financial Statement Audit* has been incorporated into this new guide.

GAO's Abe Akresh served on the Risk Assessment Guide Task Force. The Guide is available for purchase from the AICPA at https://www.cpa2biz.com/CS2000/Products/CPA2BIZ/Publications/Assessing+and+Responding+to+Audit+Risk+in+a+Financial+Statement+Audit+AICPA+Audit+Guide+Subscription.htm?cs_catalog=CPA2Biz&pagetype=product&cs_category=accounting%5Fauditing.

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"*Alternative Investments – Audit Considerations*," a practice aid for auditors has been developed and issued by the Audit Issues Task Force that was established by the Auditing Standards Board. This practice aid is considered an *Other Auditing Publication* as defined in AU section 150*, Generally Accepted Auditing Standards* and is intended to provide guidance to auditors. *Other Auditing Publications* have no authoritative status; however, they may help auditors understand and apply the SASs.

The practice aid is intended to assist in auditing alternative investments and includes guidance on:

- general considerations pertaining to auditing alternative investments,
- addressing management's financial statement assertion about existence,
- addressing management's financial statement assertion about valuation,
- management representations,
- disclosure of certain significant risks and uncertainties, and
- reporting.

The practice aid also includes appendices that provide illustrative confirmation requests for alternative investments and examples of due diligence, ongoing

monitoring, and financial reporting controls. The document can be downloaded from the following Web site:
http://www.aicpa.org/members/div/auditstd/alternative_investments.htm

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Public Company Accounting Oversight Board (PCAOB)

Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud provides guidance relevant to auditors' consideration of fraud. Based on observations from PCAOB inspections of audits performed by registered public accounting firms, it does not change existing auditing standards or provide a new interpretation of any aspect of existing standards. The paper is organized around the following topics:

- auditor's overall approach to the detection of financial fraud,
- brainstorming sessions and fraud-related inquiries,
- auditor's response to fraud risk factors,
- financial statement misstatements,
- risk of management override of controls, and
- other areas to improve fraud detection.

The document can be downloaded from the following Web site:
http://www.pcaobus.org/News_and_Events/News/2007/01-22.aspxBoard Issues Report on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud

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The Institute of Internal Auditors

The Institute of Internal Auditors has published professional guidance on ***The Role of Auditing in Public Sector Governance***. The guidance discusses internal and external auditing in a government context, public sector governance, the role of government auditing, and key elements of an effective government audit activity and has an appendix which discusses audit committees in the public sector. The publication is available at
http://www.theiia.org/download.cfm?file=3512.

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The revision to section 1312 of ***The International Standards for the Professional Practice of Internal Auditing*** *(Standards)* pertaining to External Assessments became effective January 2007. The Standards are available under the Professional Practices Framework at http://www.theiia.org/guidance/standards-and-practices/.

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Accounting Standards

FASAB

Statement of Federal Financial Accounting Standards (SFFAS) No. 32, *Consolidated Financial Report of the US Government Requirements: Implementing Statement of Federal Financial Accounting Concepts No. 4 "Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government,"* amends several standards issued prior to January 2003 to specify disclosure requirements appropriate for the Consolidated Financial Report of the US Government (CFR) based on the guidance contained in Statement of Federal Financial Accounting Concepts (SFFAC) No. 4. It does not change reporting for agency level financial statements. Some disclosure requirements contained in previously issued standards have been modified for CFR purposes to allow aggregation and reduce detail for government-wide reporting while other disclosure requirements have been eliminated at the CFR level because of excessive detailed information required that is inappropriate for a government-wide report consistent with the guidance contained in SFFAC No. 4.

Issued in September 2006, this standard is effective for reporting periods beginning after September 30, 2005.

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SFFAS No. 31, *Accounting for Fiduciary Activities* requires agencies to distinguish information relating to fiduciary activities from all other activities of a federal entity. Fiduciary assets will not be recognized on the balance sheet of any federal entity. Instead, note disclosure would include the following information about the federal entity's fiduciary activities:

- an explanation of the nature of the fiduciary relationship,
- a schedule of fiduciary net assets, and
- a schedule of fiduciary activity.

The CFR will include a note disclosure describing the nature of the fiduciary activities of the federal government and a list of component entities responsible for fiduciary activities and the total amount of fiduciary net assets of each responsible component entity. The CFR note disclosure will refer the reader to the component entity financial statements for additional information about each component's fiduciary activity.

Issued in October 2006, this statement is effective for reporting periods beginning after September 30, 2008. Early adoption is <u>not</u> permitted. In the year this statement becomes effective, entities should <u>not</u> restate the prior period amounts presented in the basic financial statements and notes.

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Technical Bulletin 2006-01, *Recognition and Measurement of Asbestos-Related Cleanup Costs* clarifies the required reporting of liabilities and related expenses arising from friable and nonfriable asbestos-related cleanup costs. Most federal entities recognize liabilities for the removal of asbestos that pose an immediate health threat (i.e. friable asbestos), but many federal entities have not prepared an estimate of cleanup costs for the future removal of asbestos that does not pose an immediate health threat (i.e., nonfriable asbestos). Effective with this bulletin, entities will (1) estimate both friable and nonfriable asbestos-related cleanup costs and (2) recognize a liability and related expense for those costs that are both probable and reasonably estimable, consistent with the current guidance in Statement of Federal Financial Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government*; SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, Chapter 4: Cleanup Costs; and Technical Release (TR) No. 2, *Determining Probable and Reasonably Estimable for Environmental Liabilities in the Federal Government*. Also, federal entities will disclose information related to friable and nonfriable asbestos-related cleanup costs that are probable but not reasonably estimable in a note to the financial statements, which is consistent with SFFAS No. 5 and 6, and TR No. 2.

Issued in September 2006, this technical bulletin is effective for reporting periods beginning after September 30, 2009. Earlier adoption is encouraged.

Electronic versions of FASAB standards and guidance can be accessed on the Web at http://www.fasab.gov/codifica.html

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FASB

Statement of Financial Accounting Standards (FAS) No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans- an amendment of FASB Statements No. 87,88,106, and 132(R)* requires public companies to recognize on their balance sheets the funded status of pension and other postretirement benefit plans. Employers will recognize actuarial gains and losses, prior service cost, and any remaining transition amounts from the initial application of Statements No. 87 and 106 when recognizing a plan's funded status, with the offset to accumulated other comprehensive income. Many employers that sponsor defined benefit plans could therefore report significantly increased liabilities, with corresponding reductions in equity.

Issued in September 2006, public companies are required to recognize on the balance sheet the funded status of their defined-benefit postretirement plans in fiscal years ending after 12/15/06; all other employers are required to adopt these provisions in fiscal years ending after June 15, 2007.

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FAS No. 157, *Fair Value Measurements* defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements. The FASB has previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

To increase consistency and comparability in fair value measurements and related disclosures, a fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and the lowest priority to unobservable inputs (Level 3).

Issued September 2006, the standard is effective for fiscal years beginning after Nov. 15, 2007; earlier application is encouraged.

Electronic versions of FASB standards and guidance can be accessed on the Web at http://fasb.org/st/

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GASB

Statement No. 49, ***Accounting and Financial Reporting for Pollution Remediation Obligations,*** requires governmental entities to report a liability related to pollution remediation. It requires a government to estimate its expected outlays for pollution remediation if it knows a site is polluted and any of the following recognition triggers occur:

- Pollution poses an imminent danger to the public or environment and a government has little or no discretion to avoid fixing the problem
- A government has violated a pollution prevention-related permit or license
- A regulator has identified (or evidence indicates it will identify) a government as responsible (or potentially responsible) for cleaning up pollution, or for paying all or some of the cost of the clean up
- A government is named (or evidence indicates that it will be named) in a lawsuit to compel it to address the pollution
- A government begins or legally obligates itself to begin cleanup or post-cleanup activities (limited to amounts the government is legally required to complete).

Liabilities would be estimated using an "expected cash flows" measurement technique, which is used by environmental professionals but will be employed for the first time by governments. Statement 49 also will require governments to disclose information about their pollution obligations associated with clean up efforts in the notes to the financial statements.

Statement No. 49 is effective for financial statements for periods beginning after December 15, 2007, but liabilities should be measured at the beginning of that period so that beginning net assets can be restated.

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Statement No. 48, ***Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues.*** Governments sometimes exchange an interest in their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments—

generally, a single lump sum. The financial reporting question addressed by this Statement is whether those transactions should be regarded as a sale or as a collateralized borrowing resulting in a liability. Historically, guidance for reporting the effects of those transactions in governmental financial statements either has been provided in several standards or, in certain cases, was not specifically addressed in authoritative literature. In addition, little or no information about pledged revenues was being disclosed in the notes to the financial statements. As a result, there has been considerable diversity in the manner in which those transactions and information about them have been reported.

This Statement establishes criteria that governments will use to ascertain whether the proceeds received should be reported as revenue or as a liability. The criteria should be used to determine the extent to which a transferor government either retains or relinquishes control over the receivables or future revenues through its continuing involvement with those receivables or future revenues. This Statement establishes that a transaction will be reported as a collateralized borrowing unless the criteria indicating that a sale has taken place are met. If it is determined that a transaction involving *receivables* should be reported as a sale, the difference between the carrying value of the receivables and the proceeds should be recognized in the period of the sale in the change statements. If it is determined that a transaction involving future revenues should be reported as a sale, the revenue should be deferred and amortized, except when specific criteria are met.

This Statement also provides additional guidance for sales of receivables and future revenues within the same financial reporting entity. It includes a provision that stipulates that governments should not revalue assets that are transferred between financial reporting entity components. Therefore, any assets (or future revenues) sold or donated within the same financial reporting entity should continue to be reported at their current carrying value when those assets or future revenues are transferred.

The requirements of this Statement are effective for financial statements for periods beginning after December 15, 2006.

GASB pronouncements are available for purchase from GASB at http://www.gasb.org/pub/index.html

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Regulatory Guidance

Office of Management and Budget

OMB Bulletin No. 06-03, Audit Requirements for Federal Financial Statements was issued August 23, 2006. The provisions of the bulletin supersede the provisions in OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, and related technical amendments included in OMB Memorandum M-04-22, *Amendments to OMB Bulletin No. 01-02, Audit Requirements for Federal Financial Statements*. The provisions of this bulletin are effective immediately for audits of financial statements, unless stipulated otherwise.

Significant provisions of the bulletin include:

- a narrative on restatements of previously-issued financial statements,
- a narrative on reissuance of audited financial statements,
- a discussion of management's assessment of the internal control over financial reporting and agency compliance with the provisions of OMB Circular No. A-123, Appendix A ,
- requiring a management representation on the consistency of budgetary data used to produce the Statement of Budgetary Resources and the Standard Form (SF) 133,
- a discussion of the agencies subject to the Accountability of Tax Dollars Act and the Government Corporation Control Act,
- revised definitions of material weakness, reportable condition, and significant deficiency to be consistent with SAS 112, *Government Auditing Standards*, and OMB Circular A-123,
- a discussion of communication of material misstatements affecting previously issued financial statements,
- reference to the Statement of Social Insurance,
- a discussion of service organizations and use of SAS 70 audit reports,
- a discussion of compliance with FMFIA and OMB Circular A-123, Appendix A, and

- a discussion of subsequent discovery of fact that existed at the date of the auditors' report.

OMB bulletins are available under Agency Information on OMB's Web site at http://www.whitehouse.gov

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Securities and Exchange Commission

Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, issued in September 2006, addresses the diversity in practice in quantifying financial statement misstatements and the potential under current practice for the build up of improper amounts on the balance sheet. Although SABs represent interpretations and practices followed by SEC in administering disclosure requirements of federal securities laws, they provide best practices and often indicate future direction on emerging issues within the profession.

The SAB states that SEC staff believes that registrants must quantify on current year financial statements the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements.

SAB No. 108 is available on the SEC website at http://www.sec.gov/interps/account.shtml

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