

Memorandum

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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. 50

In order to alert you to changes in professional standards, we issue Professional Standards Updates. Thanks to Chris Rodriguez, Gloria Proa, Malissa Livingston, Michelle Philpott, Frank Synowiec, Eric Holbrook, Abe Akresh, and Gail Vallieres, for their contributions to this issue, which contains summaries of:

Auditing Standards and Guidance

GAO

- *Federal Information System Controls Audit Manual*

AICPA

- Clarity Project
- Technical Practice Aides related to implementing the Audit Risk Standards, SASs 104-111
- Revised Standards for Performing and Reporting on Peer Reviews

International Auditing and Assurance Standards Board (IAASB) - redrafted International Standards on Auditing (ISA)

- ISA 250, *Consideration of Laws & Regulations in an Audit of Financial Statements*
- ISA 510, *Initial Audit Engagements - Opening Balances*
- ISA 540, *Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures*
- ISA 550, *Related Parties*
- ISA 560, *Subsequent Events*
- ISA 570, *Going Concern*
- ISA 580, *Written Representations*

IFAC Guide to Using International Standards on Auditing in the Audits of Small- and Medium-sized Entities

Regulatory Guidance

- OMB Circular A-136, *Financial Reporting Requirements*, 2008 Revision

Accounting Standards and Guidance

Federal Accounting Standards Advisory Board

- Technical Release No. 8, *Clarification of Standard Relating to Inter-Entity Costs*
- Technical Release No. 9, *Implementation Guide for FASAB Statement 29: Heritage Assets and Stewardship Land*

Financial Accounting Standards Board

- Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*
- Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*
- Statement No. 163, *Accounting for Financial Guarantee Contracts*

Governmental Accounting Standards Board

- Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*

Auditing Standards and Guidance

Government Accountability Office

Federal Information System Controls Audit Manual

GAO issued an exposure draft (ED) of the Federal Information System Controls Audit Manual (FISCAM) (GAO-08-1029G); the ED is available at <http://www.gao.gov/special.pubs/fiscam.html>. The period for submitting comments closed on September 5, 2008.

In 1999, GAO issued the FISCAM to present a methodology for performing information system (IS) control audits of federal and other governmental entities in accordance with professional standards. This ED reflects the current computing environment and other changes affecting IS audits, including technology used by government entities, audit guidance and control criteria issued by National Institute of Standards and Technology (NIST), and generally accepted government auditing standards (GAGAS).

The FISCAM ED is for financial and performance audits and attestation engagements performed in accordance with *Government Auditing Standards*. The FISCAM ED is consistent with the GAO/PCIE Financial Audit Manual (FAM). Also, FISCAM control activities are consistent with and have been mapped to NIST Special Publication 800-53.

The FISCAM ED is organized to facilitate effective and efficient IS control audits. Specifically, the methodology in the FISCAM incorporates:

- A top-down, risk-based approach that considers materiality and significance in determining effective and efficient audit procedures.
- Evaluation of general controls and their pervasive impact on business process application controls.
- Evaluation of security management at all levels (entity wide, system, and business process application levels).
- A control hierarchy (control categories, critical elements, and control activities) to assist in evaluating the significance of identified IS control weaknesses
- Groupings of control categories consistent with the nature of the risk.
- Experience gained in GAO’s performance and review of IS control audits, including field testing the concepts.

American Institute of CPAs (AICPA)

Clarity Project

The AICPA's Auditing Standards Board (ASB) has begun a 3-year project of redrafting its auditing standards to make them easier to read, understand and apply. This project is designed to respond to concerns over the length and complexity of the standards. Standards that are understandable, clear, and capable of being consistently applied assist auditors in better understanding their responsibilities and more effectively implementing the standards, thereby leading to the performance of higher-quality audits.

The International Auditing and Assurance Standards Board (IAASB) has undertaken a similar project that is expected to be completed at the end of 2008. The ASB believes that the IAASB clarity effort will provide an excellent basis for improving U.S. generally accepted auditing standards (GAAS), which are applicable to audits of non issuers. Accordingly, as the ASB undertakes this Clarity Project, it will also converge its standards with the International Standards on Auditing (ISAs) issued by the IAASB.

Over the next two to three years, the ASB will redraft existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU Sections), to apply the clarity drafting conventions and to converge with the ISAs. The ASB expects there to be very few requirements of ISAs that will not also be requirements of U.S. GAAS. However, there may be some additional requirements in U.S. GAAS that are not in ISAs to address issues specific to the U.S. environment or to retain current practices. The redrafting process will include (1) exposing the clarity redrafts for comment, (2) considering comments and making changes, and (3) finalizing the standards.

The clarity drafting conventions include the following changes from the current format used for drafting auditing standards:

- Stating the objective at the beginning of each standard.
- Defining new terminology introduced in each standard.
- Separating auditor requirements, indicated by the words "must" and "should," into a discreet section of each standard that is separate from application and other explanatory material, i.e. guidance.
- Identifying application and other explanatory material (guidance) paragraphs using an *A*-prefix and presenting it in a separate section that follows the requirements section.
- Using formatting techniques, such as bullet lists, to enhance readability.
- Including, where appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the standard.
- Including, where appropriate, special considerations relevant to audits of governmental entities within the text of the standard.

These new clarity drafting conventions will be applied to most standards issued by the ASB after January 2008.

Currently the ASB proposes that all redrafted standards will become effective for audits of financial statements for periods beginning no earlier than December 15, 2010. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards and that the proposed date would be long enough after all redrafted standards have been finalized to allow sufficient time for training and updating of firm methodologies.

Additional information about the project is posted on the ASB website at <http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm> or contact Gail Vallieres.

The Institute of Internal Auditors (IIA) has redrafted its Standards for the Professional Practice of Internal Auditing using a clarity framework, separating requirements from guidance and consistently using the words must and should to indicate requirements. The redrafted IIA standards will be available in early 2009. For copies of IIA standards, contact Abe Akresh.

Technical Practice Aids

The AICPA has issued the following new Technical Practice Aids (TPA) to assist auditors in implementing the audit risk standards, SAS 104 – 111, and to address other practice issues:

- **TIS 8200.05 Testing the Operating Effectiveness of Internal Control:** Per AU section 314, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatements*, the auditor should obtain an understanding of the internal controls, even if he or she intends to design a substantive approach and not rely on controls. The TPA further explains why it is important to perform this step.
- **TIS 8200.06 The Meaning of Expectations of the Operating Effectiveness of Controls:** This TPA discusses the meaning of “expectation of the operating effectiveness of controls,” which appears in paragraph .23 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

- **TIS 8200.07 Considering a Substantive Audit Strategy:** An all substantive audit approach may be followed even if the auditor, after gaining an understanding of internal control, believes that controls are designed effectively. The TPA discusses several instances where this approach may be appropriate.
- **TIS 8200.08 Obtaining an Understanding of the Control Environment:** This TPA clarifies that, based on AU section 314, the auditor is required to obtain an understanding of the control environment of the audited entity, regardless of the entity's size or complexity. Also, the TPA provides guidance on the timing of the auditor's control environment valuation.
- **TIS 8200.09 Assessing Inherent Risk:** Based on AU section 312, *Audit Risk and Materiality in conducting an Audit*, the auditor should assess both inherent risk and control risk, even if he or she assesses inherent risk as "low." Because an auditor is required to assess the combined risk of material misstatement, an auditor cannot ignore control risk regardless of his or her assessment of inherent risk. The TPA provides additional guidance on this issue.
- **TIS 8200.10 Defaulting to Maximum Control Risk:** Under AU section 314, defaulting to the maximum control risk level is not permitted. The TPA provides further discussion about this issue.
- **TIS 8200.11 Ineffective Controls:** The auditor cannot skip the evaluation and documentation of the controls over financial reporting, even if he or she believes, in advance of performing risk assessment procedures, that these controls are nonexistent or ineffective. The TPA bases this statement on the requirements set forth in AU section 314.
- **TIS 8200.12 Use of Walkthroughs:** This TPA explains how often the auditor should perform walkthroughs, as required by AU section 314, to obtain an understanding of the entity's internal control.
- **TIS 8200.13 Documenting Internal Control:** This TPA provides guidance for addressing situations when the entity has not documented important controls.
- **TIS 8200.14 Suggesting Improvements in Internal Control:** This TPA clarifies that when performing a walkthrough of controls, an auditor may suggest improvements in internal control to the client.
- **TIS 8200.15 Identifying Significant Deficiencies:** This TPA explains that an auditor's decision to not test controls does not imply the existence of a control deficiency that must be evaluated under AU section 325, *Communicating Internal Control Related Matters Identified in an Audit*.

- **TIS 8200.16 Examining Journal Entries:** This TPA explains what the phrase “adjustments made during the course of preparing the financial statements” found in paragraph .52 of AU section 318 refers to.
- **TIS section 9120 Part of an Audit Performed in Accordance with International Standards on Auditing:** The TPA explains the implications on the principal auditor’s audit report when the work performed by other independent auditors is conducted in accordance with International Standards on Auditing, or another country’s auditing standards, rather than U.S. GAAS.

These TPAs can be found at:

<http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/Recently+Issued+Technical+Practice+Aids.htm>

Revised Peer Review Standards

The AICPA’s Peer Review Board issued revised standards for performing and reporting on peer reviews to promote quality in CPA firms’ accounting and auditing practices. These standards are effective for peer reviews beginning on or after January 1, 2009.

Under the revised standards, letters of comment have been eliminated and the three-tier system of “unmodified,” “modified” and “adverse” grades given to firms by reviewers is replaced with a simplified “pass,” “pass with deficiencies,” or “fail” grading system.

The AICPA has developed a white paper that serves as a bridge between the current and revised standards and interpretations and incorporates exhibits summarizing the changes. The revised standards and the white paper are available on the AICPA Peer Review Program Web site at <http://www.aicpa.org/members/div/practmon/index.htm>.

International Auditing and Assurance Standards Board (IAASB)

The IAASB approved the following 7 new financial audit standards that will apply to audits beginning on or after December 15, 2009:

- *ISA 250 (Redrafted) Consideration Of Laws & Regulations In An Audit Of Financial Statements.* The objective of an auditor conducting an audit in

accordance with this ISA is to: (1) obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements; (2) to perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and (3) to respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

- ISA 510 (redrafted): *Initial Audit Engagements – Opening Balances* This standard provides requirements and guidance for auditing opening balances on initial audit engagements or first audit assignments. The auditor is required to conduct audit procedures in order to gain sufficient appropriate audit evidence that opening balances have not been materially misstated.
- ISA 540: *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, And Related Disclosures* (Revised & Redrafted) The objective of an auditor conducting an audit in accordance with this standard is to gather sufficient appropriate audit evidence on the reasonableness of accounting estimates, including fair value accounting estimates.
- ISA 550: *Related Parties (Revised And Redrafted)* The standard requires auditors to obtain an understanding of related party relationships and transactions regardless of whether or not the applicable financial reporting framework requires disclosure of such matters and, where appropriate, to audit for appropriate identification, accounting, and disclosure of related party transactions.
- ISA 560: *Subsequent Events (Redrafted)* The standard establishes requirements and guidance on events/facts occurring in the following periods:
 1. between the date of the Financial Statements and the Date of the Auditor's Report:
 2. after the date of the auditor's report and before the date of issue of the Financial Statements, and
 3. after issuance of the Financial Statements.
- ISA 570: *Going Concern (Redrafted)* The objective of this standard is for the auditor to acquire sufficient and appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to consider the implications for the audit report when matters or conditions affecting going concern arise. audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether

- ISA 580 (Revised & Redrafted): *Written Representations* The objectives of an auditor working in accordance with this standard are:
 1. for the auditor to obtain written representations from management on the latter's fundamental responsibilities related to the audit;
 2. to obtain written representations, where appropriate, in support of other audit evidence; and
 3. to address situations when management fails to provide written representations.

These standards are posted at:

<http://www.ifac.org/Store/Category.tpl?Category=Auditing%2C%20Assurance%20%26%20Related%20Services&Cart=121942859662865>

IFAC Guide to Using International Standards on Auditing in the Audits of Small- and Medium-sized Entities

The International Federation of Accountants (IFAC) published this implementation guide in December 2007 to assist practitioners on the audit of small- and medium-sized entities (SMEs) and to promote consistent application of the International Standards on Auditing (ISAs). The guide is a 399-page document and is available free in PDF format at the following URL:
<http://www.ifac.org/Store/Details.tpl?SID=1197644225547443&Cart=121932302625827>

The Guide provides non-authoritative guidance on applying ISAs. The new Guide is divided into four major sections:

- Basic Audit Concepts, including discussions of risk-based auditing, internal control, and financial statement assertions;
- Risk Assessment, including risk assessment procedures, development of an overall audit strategy, and materiality;
- Risk Response, including controls testing, substantive procedures, and management representations; and
- Reporting, including evaluating audit evidence, communicating with those charged with governance, and audit reports and modifications.

The Guide includes frequent references to specific ISAs. A case study is presented early in the guide and is used throughout as an example for recommended practices.

Regulatory Guidance

Office of Management and Budget, *Circular No. A-136, Financial Reporting Requirements*

OMB issued the 2008 revision of OMB Circular No. A-136 in conjunction with the Chief Financial Officers Council in June 2008. The revised Circular includes the following:

- Advance Performance and Accountability Report (PAR) guidance for fiscal year (FY) 2009 and beyond (Section II);
- Guidelines for the continuation of the FY 2007 PAR Pilot that established an alternative to the consolidated PAR (Section II);
- Clarifications and minor reporting changes relating to the FY 2008 PAR (Section II);
- Guidance on new reporting submission of the Budget, Performance, and Financial Snapshot (Section III);
- Guidelines for the FY 2009 pilot establishing an alternative reporting deadline for interim statements (Section IV); and
- Agency due dates to support Treasury in preparing the 2008 Financial Report of the U.S. Government (Section V).

GAO and the President's Council on Integrity and Efficiency determined that such changes are not significant enough to necessitate updating the FAM Volume 3 (GAO-07-1173G) for FY 2008 audits. For FY 2008 audits, auditors can continue to use FAM Volume 3 containing FAM 2010 and FAM 2020 checklists. However, auditors should note changes to the Circular, such as the following:

- **OMB Circular No. A-136, p. 26, section II.3.4 (This change affects FAM Volume 3, page 2020-12, Item 1 for FY 2008 audits):** Agencies are now required to report (1) a description of their plans to address high risk designations from GAO, and (2) certain information regarding performance for agencies/programs participating in the Program Assessment Rating Tool program;
- **OMB Circular No. A-136, pp. 125-128, section II.4.10.40 (This change does not impact FAM Volume 3 for FY 2008 audits):** Effective for reporting periods beginning in FY 2009, Note 40, which is currently titled "Dedicated Collections," will be re-titled "Fiduciary Activities;" the disclosure requirements for this note will be consistent with those requirements found in SFFAS 31; and

- **OMB Circular No. A-136, pp. 110-111, section II.4.10.16 (This change does not impact FAM Volume 3 for FY 2008 audits):** Effective for reporting periods beginning in FY 2010, FASAB Technical Bulletin 2006-1 indicates disclosures for asbestos-related cleanup costs that are probable but not reasonably estimable.

OMB also provided additional clarification and guidance throughout the Circular. As a result, page numbers in Circular A-136 have changed, which impacted the cross references in FAM Volume 3.

This Circular is effective beginning the third quarter of FY 2008, unless otherwise specified in the Circular. OMB circulars are available on OMB's Web site at <http://www.whitehouse.gov/omb/circulars>.

Accounting Standards and Guidance

Federal Accounting Standards Advisory Board

Technical Release No. 8, *Clarification of Standard Relating to Inter-Entity Costs*, (Issued February 2008) provides guidance to federal entities on three aspects of full costing specified in SFFAS 4: (1) guidance on costs that should be considered broad and general for all entities, (2) guidance on *Directness of Relationship to the entity's operations* as used in determining if a transaction should be considered material to the receiving entity, and (3) guidance on *Identifiability* as used in determining if a transaction should be considered material to the receiving entity.

Technical Release No. 9, *Implementation Guide for FASAB Statement 29: Heritage Assets and Stewardship Land* (Issued February 2008) provides guidance to assist federal entities in reporting information on heritage assets (HA) and stewardship land (SL) in accordance with SFFAS 29 *Heritage Assets and Stewardship Land*.

The technical release covers the following four areas:

- *Materiality Considerations* describes an approach for considering materiality that is common to entities as they apply the materiality concept to HA/SL. It includes qualitative factors to consider in making materiality judgments about HA/SL.
- *Identification, Categorization, and Quantification* discusses issues related to identifying HA/SL and describes how the standard allows entities "flexibility" in determining the format and level of detail to report relevant and reliable information in note disclosures. It also explores factors affecting the level of detail such as management's selection of categories for reporting and choice of physical units within categories, as portrayed in various examples. In addition, a discussion of supporting documentation is included.

- *Assessing and Reporting Condition* discusses approaches for meeting condition reporting requirements for HA/SL. This section provides guidance for identifying criteria to assess condition, discusses sources of information to support reporting, and provides examples of reporting condition.
- *Government-Wide Reporting* discusses the balance sheet note reference and a note disclosure of HA/SL information in the U.S. Government-wide financial statement.

These technical releases supplement the relevant federal accounting standards, but are not a substitute for and do not take precedence over the accounting standards issued by FASAB. The technical releases are available on the FASAB web site at <http://fasab.gov/aapc/technical.html>.

Financial Accounting Standards Board

Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*, was issued March 2008 to enhance the current disclosure framework in Statement 133. This Statement requires enhanced disclosures about an entity's derivative and hedging activities and thereby improves the transparency of financial reporting. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. This Statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption.

Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, issued May 2008, identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy).

The Board believes that the GAAP hierarchy should be directed to entities because it is the entity (not its auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. Accordingly, the Board concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB and issued this Statement to achieve that result.

The sources of accounting principles that are generally accepted are categorized in descending order of authority as follows:

- a. FASB Statements of Financial Accounting Standards and Interpretations, FASB Statement 133 Implementation Issues, FASB Staff Positions, and American Institute of Certified Public Accountants (AICPA) Accounting Research Bulletins and Accounting Principles Board Opinions that are not superseded by actions of the FASB
- b. FASB Technical Bulletins and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides and Statements of Position
- c. AICPA Accounting Standards Executive Committee Practice Bulletins that have been cleared by the FASB, consensus positions of the FASB Emerging Issues Task Force (EITF), and the Topics discussed in Appendix D of *EITF Abstracts* (EITF D-Topics)
- d. Implementation guides (Q & As) published by the FASB staff, AICPA Accounting Interpretations, AICPA Industry Audit and Accounting Guides and Statements of Position not cleared by the FASB, and practices that are widely recognized and prevalent either generally or in the industry.

This Statement is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

Statement No. 163, *Accounting for Financial Guarantee Contracts*, issued May 2008, requires that an insurance enterprise recognize a claim liability prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. It is effective for financial statements issued for fiscal years beginning after December 15, 2008, and all interim periods within those fiscal years, except for some disclosures about the insurance enterprise's risk-management activities. This Statement requires that disclosures about the risk-management activities of the insurance enterprise be effective for the first period (including interim periods) beginning after issuance of this Statement. Except for those disclosures, earlier application is not permitted.

Statements 161-163 are posted at <http://www.fasb.org/st/#161>

Governmental Accounting Standards Board

Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, issued June 2008, addresses the recognition, measurement, and disclosure of

information regarding derivative instruments entered into by state and local governments. Derivative instruments are often complex financial arrangements used by governments to manage specific risks or to make investments. By entering into these arrangements, governments receive and make payments based on market prices without actually entering into the related financial or commodity transactions. Derivative instruments associated with changing financial and commodity prices result in changing cash flows and fair values that can be used as effective risk management or investment tools. Derivative instruments, however, also can expose governments to significant risks and liabilities. Common types of derivative instruments used by governments include interest rate and commodity swaps, interest rate locks, options (caps, floors, and collars), swaptions, forward contracts, and futures contracts.

A key provision in this Statement is the requirement to report at fair value derivative instruments covered in its scope, with the exception of synthetic guaranteed investment contracts (SGICs) that are fully benefit-responsive. For many derivative instruments, historical prices are zero because their terms are developed so that the instruments may be entered into without a payment being received or made. The changes in fair value of derivative instruments that are used for investment purposes or that are reported as investment derivative instruments because of ineffectiveness are reported as investment revenue. Alternatively, changes in fair value of derivative instruments that are classified as hedging derivative instruments are reported in the statement of net assets as deferrals.

This Statement also describes methods of evaluating the effectiveness of derivative instruments in reducing exposures to identified financial risks and therefore are considered hedging derivative instruments.

The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2009. Earlier application is encouraged. For potential hedging derivative instruments existing prior to the fiscal period during which this Statement is implemented, the evaluation of effectiveness should be performed as of the end of the current period. If determined to be effective, hedging derivative instruments are reported as if they were effective from their inception. If determined to be ineffective, the potential hedging derivative instrument is then evaluated as of the end of the prior reporting period.

A summary of this statement is posted at <http://www.gasb.org/st/index.html>
