

Memorandum

Date: August 2007

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

From: Jeanette M. Franzel, Director - FMA
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Subject: Professional Standards Update No. 48

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

Auditing Standards and Guidance

- National Single Audit Sampling Project (Project)
- *Financial Audit Manual (FAM)*
- *Government Auditing Standards*, July 2007 revision
- AICPA Auditing Standards Board (ASB)
 - Interpretation of AU Section 330, *The Confirmation Process*
 - Practice Alert 2007-1, *Dating of the Auditor's Report and Related Practical Guidance*
 - Practice Alert 03-1, (updated June 2007) *Audit Confirmations*
 - Technical Practice Aid 8350.01, *Current year Audit Documentation Contained in the Permanent File*
 - Technical Practice Aid 9100.06, *The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report*
- Public Company Accounting Oversight Board (PCAOB): Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*
- Securities and Exchange Commission (SEC): Release No. 33-8810 *Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting Under Section 13(A) or 15(d) of the Securities Exchange Act of 1934*
- Institute of Internal Auditors (IIA) Practice Advisories (PAs)
 - PA 1310-1: Quality Program Assessments,
 - PA 1311-1: Internal Assessments,
 - PA 1312-1: External Assessments,
 - PA 1312-2: Self-assessment With Independent Validation,
 - PA 2030-1: Resource Management

Regulatory Guidance

- OMB Circular A-136, *Financial Reporting Requirements*
- June 26, 2007, Federal Register Notice updating Circular A-133 for SAS No. 112 terminology and related AICPA Auditing Interpretation No. 9325.01, “Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget Circular A-133 Audit”
- Illustrative Circular A-133 audit reports
- 2007 Compliance Supplement to OMB Circular A-133, *Audits of Institutions of Higher Education and Other Non-Profit Organizations*

Accounting Standards

- Federal Accounting Standards Advisory Board (FASAB)
 - Interpretation 7, *Items Held for Remanufacture*
 - Technical Release 7, *Clarification of Standards Relating to the National Aeronautics and Space Administration’s Space Exploration Equipment*
- Financial Accounting Standards Board (FASB): Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
- Government Accounting Standards Board (GASB)
 - Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*
 - Statement No. 50, *Pension Disclosures—an amendment of GASB Statements No. 25 and No. 27*
 - Concepts Statement No. 4, *Elements of Financial Statements*

Auditing Standards and Guidance

National Single Audit Sampling Project (Project)

The Project was conducted under the auspices of the Audit Committee of the President's Council on Integrity and Efficiency (PCIE), as a collaborative effort involving members of the PCIE, the Executive Council on Integrity and Efficiency (ECIE) and state auditors. It was performed to determine the quality of single audits using statistical methods and to make recommendations to address audit quality issues. The Project report was issued June 21, 2007, and is available on the PCIE web page at <http://www.ignet.gov/new1.html>.

The Chairman and the Ranking Member of the Senate Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, expressed concern about the potential impact of the project findings in terms of the federal government's oversight and assurance over the proper use of federal grant funds. They have requested that GAO "conduct additional audit work and analysis as necessary to identify further actions to improve federal oversight and accountability for grant funds."

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Financial Audit Manual (FAM)

An exposure draft of Volumes 1 and 2 of the revised FAM will be issued soon by the joint FAM Working Group, which is comprised of auditors from GAO and several offices of the inspectors general with experience in conducting audits of federal entity financial statements.

The revised FAM has been updated for significant changes affecting audits of financial statements in the federal government.

A new FAM Volume 3 containing checklists for Federal Accounting (FAM 2010) and Federal Reporting and Disclosures (FAM 2020) will be issued in final format for use in the fiscal year 2007 audits of federal financial statements.

The revised FAM includes changes based on

- AICPA Statements of Auditing Standards (SAS) Nos. 100 through 114, which include the audit risk standards;
- *Government Auditing Standards*, July 2007 revision;
- Financial reporting guidance in OMB Circular No. A-136, *Financial Reporting Requirements* (June 29, 2007);

- Federal Accounting Standards Advisory Board (FASAB) accounting concepts and standards issued through May 31, 2007, on financial audits, particularly with respect to accounting, reporting, and disclosure requirements for social insurance, heritage assets and stewardship land, and earmarked funds; and
- New terminology, changes in the federal audit environment, and effects of applicable laws and regulations.

The exposure draft of FAM Volumes 1 and 2 will be posted on GAO's Web page at <http://www.gao.gov/special.pubs/gaopcie/>, as will the final FAM Volume 3.

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Government Auditing Standards

GAO issued the July 2007 revision of *Government Auditing Standards*, which supersedes the 2003 revision and updates the quality control and peer review sections in chapter 3 of the January 2007 revision. The July 2007 revision represents the completed 2007 revision of *Government Auditing Standards*, and is the version that should be used when effective. An electronic version of this document is at <http://www.gao.gov/govaud/ybk01.htm>.

The July 2007 revision contains the following changes from the 2003 revision that reinforce the principles of transparency and accountability and provide the framework for high quality government audits that add value.

- Heightened the 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 the discussion of the impact of professional services other than audits and attestation engagements (nonaudit services) and their impact on auditor independence.
- Enhanced and clarified the requirements for an audit organization's system of quality control by specifying the elements of quality that an organization's policies and procedures should collectively address.
- Added a requirement that external audit organizations make their most recent peer review reports publicly available.
- Updated the 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, significance, and the levels of evidence used to support audit findings and conclusions.
- Clarified the standards through standardized language to define the auditor's level of responsibility and distinguish between auditor requirements and additional guidance.
- Reinforced the key role of auditing in maintaining accountability and providing information for making improvements in government operations.

The July 2007 revision of *Government Auditing Standards* is 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 encouraged. For financial audits, certain standards of the AICPA Auditing Standards Board (ASB) that affect *Government Auditing Standards* become effective prior to these dates. We encourage audit organizations to implement the relevant sections of the 2007 revision for financial audits concurrent with the implementation of the related ASB standards.

The following documents are also posted on the Yellow Book Web page and may be helpful for implementing and interpreting the revised July 2007 revision:

- *Government Auditing Standards: Guidance on GAGAS Requirements for Continuing Professional Education* (GAO-05-568G, April 2005),
- Summary of Major Changes, which highlights significant changes from the 2003 revision, and
- Listing of technical changes made since the January 2007 revision.

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AICPA Auditing Standards Board (ASB)

Interpretation of AU Section 330, *The Confirmation Process* clarifies that electronic confirmations can be reliable audit evidence if the auditor is satisfied that the electronic confirmation process is secure and controlled and the confirmation is directly from a third party who is a bona fide authorized respondent. This interpretation can be accessed at <http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Authoritative+Standards+and+Related+Guidance+for+Non-Issuers/Recently+Issued+Audit+and+Attestation+Interpretations.htm>

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Practice Alert 2007-1, *Dating of the Auditor's Report and Related Practical Guidance* is designed to assist auditors in applying SAS No. 103, *Audit Documentation*. SAS 103 indicates that the auditors' report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the auditors' opinion.

This practice alert discusses audit procedures that may be impacted by SAS 103 and provides guidance for addressing them. Among the procedures discussed in the practice alert are attorney letters, waivers from financial institutions related to violations of loan covenants, subsequent events testing, financial statement preparation and management assertions, and engagement quality control review. This subject is also discussed in the FAM Exposure Draft. In general, all audit documentation should be completed and reviewed by the date of the auditors' report.

Practice Alert 03-1, (updated June 2007) *Audit Confirmations* provides guidance to auditors on the use of audit confirmations and discusses the following issues:

- techniques to improve confirmation response rates
- positive vs. negative confirmation requests
- dealing with positive confirmation nonresponses and exceptions
- electronic and faxed confirmations and responses
- management requests not to confirm certain information
- alternative procedures in lieu of confirmations
- confirming accounts receivable
- confirming terms of unusual or complex agreements or transactions
- confirming accounts payable
- confirming related party transactions

These practice alerts are available at

http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force/pract_alerts.htm

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Technical Practice Aid 8350.01, *Current Year Audit Documentation Contained in the Permanent File* provides guidance on implementing SAS No. 103, *Audit Documentation*, with respect to documentation completion and retention. The interpretation states that SAS No. 103 applies to current year audit documentation maintained in any type of file, including permanent files, if such documentation supports the current year's audit report.

Technical Practice Aid 9100.06, *The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report*, indicates that management's assertion of responsibility for the final financial statements is part of the sufficient appropriate audit evidence that auditors are required to obtain by the date of the auditors' report. The technical practice aid indicates that this requirement does not mean that the auditors need to have physical receipt of the representation letter on the date of the auditors' report. However, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the final representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditors' report, since management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

These technical practice aids are accessible at

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

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Public Company Accounting Oversight Board (PCAOB) Securities and Exchange Commission (SEC)

The PCAOB adopted and the SEC approved **Auditing Standard No. 5, *An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements***, to replace Auditing Standard No. 2. The new standard is required for all audits of internal control over financial reporting of publicly-traded companies for fiscal years ending on or after November 15, 2007, but may be used immediately. AS No. 5 is posted on the PCAOB website at

[http://www.pcaobus.org/Standards/Standards and Related Rules/Auditing Standard No.5.aspx](http://www.pcaobus.org/Standards/Standards+and+Related+Rules/Auditing+Standard+No.5.aspx)

In a related development, the SEC approved **Release No. 33-8810 *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(A) or 15(d) of the Securities Exchange Act of 1934***. This interpretive guidance is designed to help public companies design and evaluate their internal control over financial reporting. The SEC aligned the interpretive guidance with the PCAOB's auditing standard. The guidance, which takes effect June 27, 2007, is organized around two broad principles: (1) management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner, and (2) management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. The release is posted at <http://www.sec.gov/rules/interp.shtml>

The Institute of Internal Auditors (IIA)

The IIA updated Practice Advisories pertaining to Quality Assurance and Improvement Programs and Resource Management.

The IIA amended four Practice Advisories (PAs) to help internal auditors interpret their responsibilities regarding Standard 1300: Quality Assurance and Improvement Program from The IIA's International Standards for the Professional Practice of Internal Auditing. According to Standard 1300, chief audit executives (CAEs) "should develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness. This program includes periodic internal and external quality assessments and ongoing internal monitoring."

The amended PAs are:

- **PA 1310-1: Quality Program Assessments.** The updated PA clarifies the definition and timing requirements of quality program assessments and expands on the two recommended external assessment approaches: a full external assessment and an independent external review of an internal self-assessment.
- **PA 1311-1: Internal Assessments.** Internal assessments include ongoing reviews of the performance of the internal audit activity and periodic reviews performed through self-assessment or by other persons within the organization who have knowledge of internal audit practices and the Standards.
- **PA 1312-1: External Assessments.** The overview section of this PA has been expanded to clarify the scope of the external assessment process. Reiterating the requirement to have an external assessment at least every five years, the PA suggests that the CAE consider and discuss with the board the potential need for more frequent external assessments, as well as the qualifications and independence of the external reviewer or review team.
- **PA 1312-2: External Assessments: Self-assessment With Independent Validation.** The updated PA takes into account concerns that an external assessment by an independent reviewer may be burdensome for smaller internal audit activities, or that there may be circumstances where a full external assessment by an independent team is not necessary.

The IIA also updated **Practice Advisory 2030-1: Resource Management**. The update expands and clarifies the previous Practice Advisory.

Additional information on the Practice Advisories is at

<http://www.theiia.org/guidance/standards%2Dand%2Dpractices/professional%2Dpractices%2Dframework/cae%2Dbulletin%2Darticle/>

Regulatory Guidance

Office of Management and Budget

The 2007 revision of OMB Circular A-136, Financial Reporting

Requirements was issued by the Office of Management and Budget (OMB), in conjunction with the Chief Financial Officers (CFO) Council. This update includes the following information:

- Guidelines for the FY 2007 pilot establishing an alternative to the consolidated Performance and Accountability Report (PAR) (Section II);
- Advance PAR guidance for FY 2008 and beyond (Section II);
- Clarifications and minor reporting changes relating to the FY 2007 Performance and Accountability Report (PAR) (Section II); and
- Agency due dates to support Treasury in preparing the 2007 Financial Report of the U.S. Government (Section V).

This Circular is effective for fiscal year 2007, and earlier implementation is permitted, unless otherwise specified. The revision is at http://www.whitehouse.gov/omb/financial/offm_circulars.html#136.

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OMB issued a **June 26, 2007, Federal Register Notice** updating Circular A-133 for SAS No. 112 terminology. The notice updates the internal control terminology and related definitions used in the Circular for consistency with SAS 112 and simplifies the reporting package submission requirement to the Federal Audit Clearinghouse. It is effective for A-133 audits of fiscal years ending on or after December 15, 2006. The notice is at http://www.whitehouse.gov/omb/grants/grants_docs.html.

The AICPA, working with OMB and other federal agency staff, issued **AICPA Auditing Interpretation No. 9325.01, “Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget Circular A-133 Audit”**, which can be found at <http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Authoritative+Standards+and+Related+Guidance+for+Non-Issuers/Recently+Issued+Audit+and+Attestation+Interpretations.htm>

In addition, the AICPA issued updated **illustrative Circular A-133 audit reports** that is at <https://gaqc.aicpa.org/Resources/Illustrative+Auditors+Reports/>

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The 2007 Compliance Supplement to OMB Circular A-133, Audits of Institutions of Higher Education and Other Non-Profit Organizations was issued in March 2007. The 2007 supplement provides information on the Federal program's objectives, procedures, and compliance requirements relevant to the audit as well as audit objectives and suggested audit procedures for determining compliance with these requirements. It also provides guidance in determining compliance requirements relevant to the audit, audit objectives, and suggested audit procedures for programs not specifically discussed in the Compliance Supplement. The 2007 supplement, which is effective for audits of fiscal years beginning after June 30, 2006, and supersedes the 2006 supplement, is at http://www.whitehouse.gov/omb/circulars/a133_compliance/07/07toc.html

Accounting Standards

Federal Accounting Standards Advisory Board (FASAB)

Interpretation 7, *Items Held for Remanufacture*, identifies options for classification, valuation and reporting by applying existing standards, in particular Statement of Federal Financial Accounting Standards (SFFAS) 3, *Accounting for Inventory and Related Property*.

The Interpretation applies to reparable parts and subassemblies that are in the process of (or awaiting) inspection, disassembly, evaluation, cleaning, rebuilding, refurbishing and/or restoration to serviceable or technologically updated/upgraded condition. This Interpretation addresses remanufacturing activity for items intended for sale or for internal use. Items held for remanufacture may consist of direct materials (including repairable parts and subassemblies, also referred to as "carcasses" at the Department of Defense (DoD), and work-in-process where products are restored to serviceable condition and/or improved/upgraded condition for sale or internal use.

Issued in March 2007, this interpretation is effective when issued.

Technical Release 7, *Clarification of Standards Relating to the National Aeronautics and Space Administration's Space Exploration Equipment*, provides technical guidance to the National Aeronautics and Space Administration (NASA) regarding the accounting treatment of NASA's space exploration equipment for financial reporting. The issue is whether to treat the acquisition or development costs of any of this equipment as research and development costs.

This technical release guidance is limited to transactions involving NASA's space exploration equipment. However, the guidance related to the application of the Generally Accepted Accounting Principles (GAAP) hierarchy applies broadly to all federal entities. Issued in May 2007, this technical release is effective when issued. Technical Release 7 is at <http://www.fasab.gov/codifica.html>

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Financial Accounting Standards Board (FASB)

Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, permits entities to choose to measure many financial instruments and certain other items at fair value. The standard allows entities to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting.

This Statement applies to all entities, including not-for-profit organizations. Most of this Statement applies only to entities that elect the fair value option. However, the amendment to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, applies to all entities with available-for-sale and trading securities. Some requirements apply differently to entities that do not report net income.

Issued in February 2007, this Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply FASB Statement No. 157, *Fair Value Measurements*.

Statement No. 159 is at <http://www.fasb.org/st/#fas159>

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Government Accounting Standards Board (GASB)

Statement No. 51, *Accounting and Financial Reporting for Intangible Assets* (Issued June 2007) establishes accounting and financial reporting standards for intangible assets (including easements, water rights, timber rights, patents, trademarks, and computer software). All intangible assets not specifically excluded should be classified as capital assets.

This Statement requires that an intangible asset be recognized in the statement of net assets only if it is identifiable. Additionally, this Statement establishes a specified-conditions approach to recognizing intangible assets that are internally generated. Effectively, outlays associated with the development of such assets should not begin to be capitalized until certain criteria are met. Outlays incurred prior to meeting these criteria should be expensed as incurred. This Statement also provides guidance on recognizing internally generated computer software as an intangible asset.

This Statement also establishes guidance for amortization. It provides guidance on determining the useful life of intangible assets when the length of their life is limited by contractual or legal provisions.

This Statement is effective for financial statements for periods beginning after June 15, 2009. This Statement generally is to be applied retroactively. There are special requirements for governments that were classified as phase 1 or phase 2 governments for the purpose of implementing GASB Statement 34.

Statement No. 50, *Pension Disclosures—an amendment of GASB Statements No. 25 and No. 27*, (Issued May 2007) more closely aligns the financial reporting requirements for pensions with those for other post employment benefits (OPEB) and enhances information disclosed in notes to financial statements or presented as required supplementary information (RSI) by pension plans and by employers that provide pension benefits. The reporting changes Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27, *Accounting for Pensions by State and Local Governmental Employers*, to conform with Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

This Statement requires defined benefit pension plans and sole and agent employers to present the following information related to note disclosures or RSI:

- The funded status of the plan as of the most recent actuarial valuation date. Defined benefit pension plans also should disclose actuarial methods and significant assumptions used in the most recent actuarial valuation in notes to financial statements instead of in notes to RSI.

- If the aggregate actuarial cost method is used to determine the annual required contribution of the employer (ARC), the funded status of the plan, and a schedule of funding progress presented as RSI, using the entry age actuarial cost method.
- A reference linking the funded status disclosure in the notes to financial statements to the required schedule of funding progress in RSI.
- Legal or contractual maximum contribution rates. The maximum contribution rates have not been explicitly taken into consideration in the projection of pension benefits for financial accounting measurement purposes.
- The initial and ultimate rates if an actuarial assumption is different for successive years.

This Statement requires defined benefit pension plans and defined contribution plans to disclose the methods and assumptions used to determine the fair value of investments, if the fair value is based on other than quoted market prices.

This Statement is effective for periods beginning after June 15, 2007, except for requirements related to the use of the entry age actuarial cost method for the purpose of reporting a surrogate funded status and funding progress of plans that use the aggregate actuarial cost method, which are effective for periods for which the financial statements and RSI contain information resulting from actuarial valuations as of June 15, 2007, or later. Early implementation is encouraged.

Concepts Statement No. 4, *Elements of Financial Statements*, (Issued June 2007) establishes definitions for the seven elements of historically based financial statements of state and local governments. Elements are the fundamental components of financial statements. The elements of a statement of financial position are defined as follows:

- *Assets* are resources with present service capacity that the government presently controls.
- *Liabilities* are present obligations to sacrifice resources that the government has little or no discretion to avoid.
- A *deferred outflow of resources* is a consumption of net assets by the government that is applicable to a future reporting period.
- A *deferred inflow of resources* is an acquisition of net assets by the government that is applicable to a future reporting period.
- *Net position* is the residual of all other elements presented in a statement of financial position.

The elements of the resource flows statements are defined as follows:

- An *outflow of resources* is a consumption of net assets by the government that is applicable to the reporting period.
- An *inflow of resources* is an acquisition of net assets by the government that is applicable to the reporting period.

Central to most of these definitions is a *resource*, which in the governmental context is an item that can be drawn on to provide services to the citizenry. These definitions apply to an entity that is a governmental unit (that is, a legal entity) and are applicable to any measurement focus under which financial statements may be prepared.

Summaries of GASB releases are posted at <http://www.gasb.org/st/index.html>. Statement No. 50 was reprinted in the August 2007 issue of the Journal of Accountancy. Statements 50 and 51 and Concepts Statement No. 4 will be added to the electronic audit library soon
