

PCIE/GAO

FINANCIAL AUDIT MANUAL ALERT
August 2006

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Introduction/Background

The AICPA has issued eleven standards since the last time the PCIE/GAO Financial Audit Manual (FAM) was updated. These standards are effective upon issuance or for periods either beginning or ending after December 15, 2006. The PCIE and GAO have formed a work group to update the relevant sections of the FAM for the new standards requirements. However, because this update will not be completed in time to be used in this year's audits, the PCIE prepared this document to alert the PCIE community of the change in standards, the implementation date, and key revisions to the standards. The PCIE community should take these standards into consideration and develop appropriate adjustments to their audit procedures.

We also added a brief description of the changes to *Financial Reporting Requirements*, OMB Circular A-136 and key changes to the *Audit Requirements for Federal Financial Statements*, OMB Bulletin 06-03.

We also want to make you aware that the GAO is updating the *Government Auditing Standards* to incorporate the new standards. The draft is currently out for comment.

Additionally, GAO will make two of their internal alerts available to the PCIE community, *Professional Standards Update* Number 45 and Number 46. These documents discuss the changes in standards in more detail. The links to these documents will be made available on their web page at the following address <http://www.gao.gov/govaud/psu.htm>.

New Standard on Defining Professional Requirements in the SASs

In December 2005, Statement on Auditing Standards (SAS) #102, *Defining Professional Requirements in Statements on Auditing Standards* was issued to define the level of auditor responsibility for following sections of the SAS. This standard adds AU section 120 and amends SAS 95, *Generally Accepted Auditing Standards*.

Implementation Date: This standard was effective upon issuance (December 2005) and is applicable to the FY 2006 audit.

Key Revisions:

- The SASs use ***must*** or ***is required*** to indicate “unconditional requirements”. The auditor is required to comply with all of these requirements.
- The SASs use ***should consider*** to indicate “presumptively mandatory requirements”. The auditor is also required to comply with all of these requirements. However, in the rare circumstances that the auditor departs from these requirements, the auditor should document the justification for the departure from those requirements.
- Other words such as may, might, and could do not impose a requirement on the auditor to perform the procedure.

New Standard on Audit Documentation

In December 2005, Statement on Auditing Standards (SAS) #103, *Audit Documentation*, was issued to provide guidance on audit documentation. It supersedes SAS #96, *Audit Documentation*.

Implementation Date: Audits of financial statements for periods ending on or after December 15, 2006 and will apply to the FY 2007 audit. Earlier application is permitted.

Key Revisions:

- Amends AU 530, Dating of the Independent Auditor’s Report. The date is no longer the last day of fieldwork but when the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements.
- Requires the auditor to complete audit documentation within 60 days of report release with no deletion of data afterwards. Any subsequent additions are to be documented. Documentation must be retained for a minimum of 5 years and the auditor should protect client confidentiality.
- Changes the requirement of the form, content, and extent of audit documentation. In addition to other requirements, this section requires the auditor to prepare audit

- documentation in sufficient detail to allow an experienced auditor having no previous connection with the audit to understand:
- a. The nature, timing, and extent of audit procedures performed to comply with auditing requirements;
 - b. The results of audit procedures performed and the audit evidence obtained;
 - c. The conclusions reached on significant matters; and
 - d. That the accounting records agree or reconcile with the audited financial statements or other audited information.
- Requires the auditor to document significant findings or issues, any contradictory items, preparer and reviewer of the audit documentation, specific items tested, and any departures from auditing standards.

Audit Risk

SASs 104 – 111 comprises a suite of standards addressing audit risk. The standards are intended to enhance the auditor’s application of the audit risk model. They call for more in-depth understanding of the entity and its control environment, more rigorous assessment of the risks of material misstatements and the entity’s actions to mitigate those risks, and improved linkages between the risks and the type and sufficiency of audit procedures performed in response to the risks.

Amendment to Due Professional Care

In March 2006, Statement on Auditing Standards (SAS) #104, *Amendment to Statement on Auditing Standard No. 1, Codification of Auditing Standards and Procedures (Due Professional Care in the Performance of Work)* was issued to expand the definition of reasonable assurance.

Implementation Date: This amendment is effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted.

Key Revisions:

- The auditor is required to obtain a high, but not absolute level of assurance in order to report that the auditor obtained “reasonable assurance” that the financial statements are free of material misstatement.

Amendment to Generally Accepted Auditing Standards

In March 2006, Statement on Auditing Standards (SAS) #105, *Amendment to Statement on Auditing Standard No. 95, Generally Accepted Auditing Standards* was issued to expand the audit work needed to afford a reasonable basis for an opinion regarding a financial audit.

Implementation Date: This amendment is effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted.

Key Revisions:

- Expands the second standard of field work from “internal control” to “entity and its environment including internal controls”.
- Recognizes that audit procedures are performed by the auditor while obtaining an understanding of the entity’s environment and including internal controls. Thus, the standard replaces ‘tests to be performed’ with “further audit procedures”.
- Replaces “evidential matter” with “audit evidence”

New Standard on Audit Evidence

In March 2006, Statement on Auditing Standards (SAS) #106, *Audit Evidence* was issued to clarify the requirement for the third standard of field work: “the auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.” This standard supersedes SAS 31, Evidential Matter.

Implementation Date: This amendment is effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted.

Key Revisions:

- Defines Sufficient Appropriate Audit Evidence.
“Sufficiency is a measure of quantity of audit evidence.
Appropriateness is the measure of the quality of audit evidence, that is, its relevance and its reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions.”
- Defines five relevant assertions for classes of transactions and events, four assertions for account balances at period end, and five assertions for presentation and disclosure.
- Provides guidance on the use of relevant assertions for assessing risks and designing appropriate audit procedures.
- Provides guidance on qualitative aspects of evidence that the auditor should consider in determining the sufficiency and appropriateness of audit evidence.

New Standard on Audit Risk and Materiality in Conducting the Audit

In March 2006, Statement on Auditing Standards (SAS) #107, *Audit Risk and Materiality in Conducting the Audit* was issued to provide the auditor guidance on the consideration of risk and materiality in performing a financial statement audit. This standard supersedes SAS 47, *Audit Risk and Materiality in Conducting the Audit*.

Implementation Date: This amendment is effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted.

Key Revisions:

- Provides the auditor guidance on the treatment and documentation of misstatements.
- The auditor should request management to record the adjustments needed to correct all known misstatements, including the effect of prior period misstatements, other than those the auditor believes are trivial.

New Standard on Planning and Supervision

In March 2006, Statement on Auditing Standards (SAS) #108, *Planning and Supervision* was issued. This standard supersedes SAS#1, *Appointment of the Independent Auditor*, and SAS 22, *Planning and Supervision*.

Implementation Date: Audits of financial statements for audit periods beginning on or after December 15, 2006. Earlier application is permitted.

Key Revisions:

- Provides specific requirements for auditor to establish an understanding with the auditee for each engagement.
- Establishes certain requirements for the supervision of subcontractors. The standard refers to subcontractors as “assistants”.

New Standard on Understanding the Entity Control Environment

In March 2006, Statement on Auditing Standards (SAS) #109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* was issued to provide the auditor guidance on the use of relevant financial statement assertions to assess risks, and to design and perform appropriate audit procedures. This standard (together with SAS 110) supersedes SAS 55, *Consideration of Internal Controls in a Financial Statement Audit*.

Implementation Date: This amendment is effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted.

Key Revisions:

- This standard makes significant changes to the auditor’s requirements for understanding the entity and its environment, internal control components, and conditions and events that may indicate risks of material misstatements.

New Standard on Performing Audit Procedures

In March 2006, Statement on Auditing Standards (SAS) #110 *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* was issued to establish standards and provide guidance on the sufficiency of audit evidence and auditor response to the results of audit testing. This standard (together with SAS 109) supersedes SAS 55, *Consideration of Internal Controls in a Financial Statement Audit*, and “*Substantive Tests Prior to the Balance-Sheet Date*” SAS No. 45, *Omnibus Statement of Auditing Standards – 1983*.

Implementation Date: This amendment is effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted.

Key Revisions:

- Uses the risk based approach established in SAS 109 to provide additional guidance on designing and performing control and substantive testing.
- Provides guidance to the auditor for evaluating the sufficiency and appropriateness of the audit evidence obtained.
- Provides the auditor with factors for limiting the reliance on interim substantive testing.
- Provides guidance to the auditor on documentation. The auditor should document:
 - a. The overall responses to address the assessed risks of misstatement at the financial statement level.
 - b. The nature, timing, and extent of further audit procedures.
 - c. The linkage of those procedures with the assessed risks at the relevant assertion level.
 - d. The results of audit procedures.
 - e. The conclusions reached with regard to the use in the current audit of audit evidence about the operating effectiveness of controls that were learned in prior audits.

Amendment to Standards on Statistical Sampling

In March 2006, Statement on Auditing Standards (SAS) #111 *Amendment to SAS 39, Audit Sampling* was issued to update the statistical sampling framework to incorporate SAS 99 and SAS107. This standard supersedes SAS 39, *Audit Sampling*.

Implementation Date: This amendment is effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted.

Key Revisions:

- The auditor should set the tolerable misstatement for a specific audit procedure at less than financial statement materiality so that when the results of the audit procedures are aggregated, the required overall assurance is attained.
- Risk of material misstatement replaces control risk in the statistical frame work.

New Standard on Communicating Internal Control Weaknesses

In May 2006, Statement on Auditing Standards (SAS) #112, *Communicating Internal Control Related Matters Identified in an Audit*, established standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. It supersedes SAS # 60, *Communication of Internal Control Related Matters Noted in an Audit*.

Implementation Date: Audits of financial statements for periods ending on or after December 15, 2006. Earlier application is permitted.

Key Revisions:

- Requires the auditor to communicate control deficiencies that are significant deficiencies or material weaknesses in internal control. Adopts more rigorous definitions of the terms “significant deficiency” and “material weakness”, which are consistent with PCAOB Auditing Standard 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit*, and currently proposed GAGAS revisions.
- Provides guidance on evaluating the severity of a control deficiency identified in an audit of financial statements.
- Requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit no later than 60 days following the report release date (as defined). This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.

Revisions of OMB Circular A-136

On July 24, 2006, OMB issued a revision to OMB Circular A-136, *Financial Reporting Requirements*, to update and consolidate reporting requirements of Federal entities subject to the CFO Act of 1990, the Accountability of Tax Dollar's Act of 2002, and Annual Management Reports under the Government Corporations Control Act into one OMB document.

Implementation Date: FY 2006.

Key Revisions:

- Clarifications and minor reporting changes relating to the FY 2006 Performance and Accountability Report (PAR) (Section II).
- Advance PAR guidance for FY 2007 and beyond (Section II).
- Guidelines for PAR Highlights Document (Section III).
- Agency requirements for Quarterly and Interim Financial Statements for FY 2006 PAR (Section IV).
- Agency requirements and due dates to support Treasury in preparing the 2006 Financial Report of the U.S. Government (Section V).

Revisions to Audit Requirements for Federal Financial Statements (OMB Bulletin No. 06-03)

On August 23, 2006, OMB issued a revision to *Audit Requirements for Federal Financial Statements* to establish minimum requirements for audits of Federal financial statements.

Implementation Date: FY 2006.

The Key Revisions:

- Includes a listing of entities subject to the Accountability of Tax Dollars Act and the Government Corporation Control Act. (Section 1, Appendix C, and Appendix D)
- Redefined reportable condition/significant deficiency and material weakness to be consistent with the changes in AICPA's SAS 112 (Section 2.11).
- Added required communications of material prior period adjustments with management. (Section 5.2)

- Added references to the Statement of Social Insurance. (Section 6.2)
- Added discussion on Service Organizations audits and use of SAS 70 reports. (Section 6.14)
- Added discussion on compliance with FMFIA and OMB Circular A-123, Appendix A. (Section 7.19)
- Added representation on management's materiality threshold used for reporting items in the management representation letter. (Section 8.4)
- Requires a management representation on the consistency of budgetary data used to produce the Statement of Budgetary Resources and the SF 133 (Section 8.6).
- Streamlines the appendices by referencing the GAO FAM templates or the OPM website (OPM AUP) rather than duplicating this info in this bulletin.
- Eliminates the requirement to perform Agreed - Upon Procedures for the Intragovernmental Activities and Balances and the additional requirement to audit the trading partner footnote (GFRS Module 4).