

Memorandum

Date: February 2008

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. 49

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

Auditing Standards and Guidance

GAO/PCIE

- *Financial Audit Manual (FAM)*

GAO

- *Government Auditing Standards: Implementation Tool*
- *Guidance on Complying with Government Auditing Standards Reporting Requirements for the Report on Internal Control for Audits of Certain Entities Subject to the Requirements of the Sarbanes-Oxley Act of 2002 and Government Auditing Standards.*

AICPA Auditing Standards Board (ASB)

- Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control*
- Center for Audit Quality (CAQ) Alert #2007-51, accounting issues related to current illiquid market conditions.
- *Navigating the Crossroads of Control and Independence*, published in the December 2007 issue of the Journal of Accountancy
- Question (Q) & Answers (A)s related to the Risk Assessment Standards, SAS Nos. 104-111.

Public Company Accounting Oversight Board (PCAOB)

- Staff Audit Practice Alert No. 2: *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*

International Auditing and Assurance Standards Board (IAASB)

- International Standard on Auditing (ISA) 230 (Redrafted), *Audit Documentation*
- ISA 260 (Revised and Redrafted), *Communication with Those Charged with Governance*
- ISA 720 (Redrafted), *The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements*

Accounting Standards

Federal Accounting Standards Advisory Board (FASAB)

- Concepts Statement No. 5, *Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements*

Financial Accounting Standards Board (FASB)

- Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*
- Statement No. 141R, *Business Combinations*

Government Accounting Standards Board (GASB)

- Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*

Auditing Standards and Guidance

Financial Audit Manual (FAM)

The GAO/PCIE Financial Audit Manual (FAM) has been updated to reflect significant changes in auditing standards and guidance that have occurred since 2004. GAO/PCIE issued FAM exposure drafts of Volumes 1 and 2 for public comment. Comments received will be reviewed and incorporated as appropriate, after which Volumes 1 and 2 will be issued in final form this spring. The final version of FAM Volume 3 was issued on August 28, 2007. Electronic versions of these documents are available at <http://www.gao.gov/special.pubs/gaopcie/>.

FAM Volume 1 update includes changes based on (1) AICPA Statement of Auditing Standards (SAS) Nos. 100 through 114, including the risk assessment standards; (2) the 2007 revision of *Government Auditing Standards*; (3) audit guidance in Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements (September 4, 2007)*; and (4) financial reporting guidance in OMB Circular No. A-136, *Financial Reporting Requirements* (June 29, 2007). The exposure draft also includes the effects of Federal Accounting Standards Advisory Board (FASAB) accounting concepts and standards issued through SFFAS No. 32. Revisions were made for new terminology, changes in the federal audit environment, and effects of applicable laws and regulations.

In addition to changes based on the accounting and auditing standards and guidance noted above, FAM Volume 2 also identifies the accounting, reporting and disclosure requirements for social insurance, heritage assets, stewardship land and earmarked funds.

FAM Volume 3 supersedes FAM 1050, *Checklist for Federal Accounting Reporting and Disclosures* and contains two checklists, FAM 2010, *Federal Accounting Checklist* and FAM 2020, *Federal Reporting and Disclosure Checklist*. These checklists incorporate the most recent AICPA and FASAB standards and requirements from OMB Circular A-136, *Financial Reporting Requirements*.

To highlight significant updates, FAM volumes 1 and 2 contain a table of major changes by FAM section.

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Government Auditing Standards

GAO has issued a guidance document, ***Government Auditing Standards: Implementation Tool -- Professional Requirements Tool for Use in Implementing Requirements Identified by “Must” and “Should” in the July 2007 Revision of Government Auditing Standards***. The Professional Requirements Tool lists requirements for audit organizations and auditors included in the July 2007 Revision of generally accepted government auditing standards (GAGAS), also commonly known as the Yellow Book. The Professional Requirements Tool is available electronically on GAO’s Yellow Book Web page at <http://www.gao.gov/govaud/ybk01.htm>.

As described in the July 2007 Revision, GAGAS use two categories of professional requirements, identified by “must” and “should,” to describe the degree of responsibility they impose on auditors and audit organizations. The Professional Requirements Tool contains general requirements for audit organizations and specific requirements for financial audits, attestation engagements, and performance audits. The general requirements section contains entity-wide requirements for the audit organization and is intended for use in addition to the specific sections for financial audits, attestation engagements, and performance audits.

The Professional Requirements Tool does not include explanatory material from the July 2007 Revision of GAGAS. Audit organizations and auditors should read the entire text of the July 2007 Revision of GAGAS, including the explanatory material when planning the audit and making professional judgments about compliance with professional requirements.

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

- *Government Auditing Standards: Answers to Independence Questions* (GAO-02-870G, July 2002) and
- *Government Auditing Standards: Guidance on GAGAS Requirements for Continuing Professional Education* (GAO-05-568G, April 2005).

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GAO has also issued *Guidance on Complying with Government Auditing Standards Reporting Requirements for the Report on Internal Control for Audits of Certain Entities Subject to the Requirements of the Sarbanes-Oxley Act of 2002 and Government Auditing Standards*. The guidance document is available electronically on GAO's Yellow Book Web page at <http://www.gao.gov/govaud/ybk01.htm>.

Certain companies subject to the Securities Exchange Act of 1934 ("issuers") may have an audit conducted in accordance with standards issued by both the Public Company Accounting Oversight Board (PCAOB), as required by the Sarbanes-Oxley Act of 2002, and the Comptroller General, as contained in *Government Auditing Standards* (GAGAS). Some examples include lending institutions that participate in federally-sponsored loan programs such as housing and education. For such entities, auditors must satisfy both sets of standards in conducting their work.

GAGAS may be used in conjunction with standards issued by the PCAOB, even though these standards are not incorporated into GAGAS. GAO recognizes that the use of PCAOB's framework for assessing control deficiencies could result in inconsistencies in reporting on internal control under GAGAS. This guidance was issued to facilitate reporting of internal control deficiencies identified during audits conducted under both PCAOB and GAGAS standards, to ensure the consistency of information included in the GAGAS report on internal control, and to assist auditors in complying with GAGAS.

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AICPA Auditing Standards Board (ASB)

Statement on Quality Control Standards (SQCS) No. 7, A Firm's System of Quality Control (Issued October 2007), which replaces all previously issued AICPA statements on quality control, establishes standards and provides guidance for a CPA firm's responsibilities for its system of quality control related to its accounting and auditing practice. Under SQCS No. 7, CPA firms must establish and document their quality control systems to provide reasonable assurance that the firms' accounting and auditing practice as well as their personnel comply with professional standards and applicable legal and regulatory requirements. The statement also requires monitoring procedures that are rigorous enough to assess compliance with quality control policies and procedures. The Statement covers audits, reviews, compilations and attestation engagements. In addition, SQCS No. 7 defines a number of terms, including engagement quality control review, and provides guidance on policies and procedures for performing engagement quality control reviews.

In developing this standard, the ASB considered International Standard on Quality Control (SQC) No. 1, *Quality Control for Audit, Assurance and Related Services Practices* issued by the International Auditing and Assurance Standards Board. We believe SQCS No. 7 is consistent with the quality control provisions of the 2007 Yellow Book.

Although the Statement was written for CPA firms, IG organizations and internal audit organizations may find it helpful.

The provisions of this statement are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2009, however early application is permitted. A summary of SQCS No. 7 can be accessed at http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Authoritative+Standards/quality_control_standards.htm

The AICPA has also issued a Practice Aid on Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice. The practice aid 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/quality_control_standards.htm. The full document is in the December print edition of the *Journal of Accountancy*.

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The Center for Audit Quality (CAQ) of the AICPA issued **CAQ Alert #2007-51**, a set of white papers to address **accounting issues auditors may encounter related to current illiquid market conditions**. The "liquidity crisis" that began in the subprime mortgage-related markets has spread to other credit markets and has a potentially pervasive impact on the U.S. economy. The CAQ papers provide guidance on how to apply existing GAAP in these current market conditions.

The white papers include the following topics:

1. *Measurements of Fair Value in Illiquid (or Less Liquid) Markets*—This paper discusses issues related to the measurement of fair value and the fair value framework as defined in FAS 157 and how they apply specifically in the existing illiquid market conditions.
2. *Consolidation of Commercial Paper Conduits*—This paper outlines the basic concepts of commercial paper conduits and the application of FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* and provides guidance to auditor's with respect to the current market conditions.

3. *Accounting for Underwriting and Loan Commitments* –This paper provides guidance for companies with commitments to lend money or underwrite securities and the application of GAAP in the context of illiquid market conditions. How companies should account for deterioration in the fair value of the securities and loan commitments based on their intention of holding the commitments is a main focus of the paper.

The white papers can be found at:

http://thecaq.org/members/alerts/CAQAlert2007_51_10032007.pdf

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Navigating the Crossroads of Control and Independence, published in the December 2007 issue of the Journal of Accountancy, provides practical nonauthoritative guidance for understanding and implementing provisions of SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*. The Journal of Accountancy can be accessed at http://www.aicpa.org/pubs/jofa/dec2007/control_and_independence.htm. SAS 112 is posted on the AICPA web site at http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Authoritative+Standards+and+Related+Guidance+for+Non-Issuers/auditing_standards.htm

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The Fall 2007 Issue (Vol.23, No. 4) of the AICPA newsletter *In Our Opinion* includes nonauthoritative implementation guidance in the form of **Question (Q) & Answers (A)s related to the Risk Assessment Standards, SAS Nos. 104-111**. The newsletter can be accessed at <http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion/> SAS Nos. 104-111 are posted on the AICPA web site at http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Authoritative+Standards+and+Related+Guidance+for+Non-Issuers/auditing_standards.htm

Public Company Accounting Oversight Board

Staff Audit Practice Alert No. 2: *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, issued by the PCAOB in December 2007, provides guidance on auditing fair value measurements and disclosures in financial statements and discusses auditor's responsibilities when using the work of specialists. Existing accounting standards related to fair value measurements and disclosures are highlighted to remind auditors of their responsibilities for auditing fair value measurements and when using the work of specialists. This guidance was issued for auditors of publicly-traded companies; however other auditors may find it useful.

The Practice Alert can be found at:

http://www.pcaobus.org/standards/staff_questions_and_answers/index.aspx

International Auditing and Assurance Standards Board (IAASB)

The IAASB, an independent standard-setting board under the auspices of the International Federation of Accountants (IFAC), issued three standards that reflect its new clarity drafting conventions:

- International Standard on Auditing (ISA) 230 (Redrafted), *Audit Documentation*;
- ISA 260 (Revised and Redrafted), *Communication with Those Charged with Governance*; and
- ISA 720 (Redrafted), *The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements*.

These standards are part of the IAASB's ambitious 18-month program to redraft existing standards and develop new and revised standards following the clarity drafting conventions, which include establishing an objective for the auditor with respect to the subject matter of each standard; clearly distinguishing requirements from guidance; avoiding ambiguity through eliminating the present tense to describe actions by the auditor and using more imperative language where a requirement was intended; and other structural and drafting improvements to enhance the overall readability and understandability of the standards.

The Auditing Standards Board of the AICPA has indicated its intent to harmonize U.S. generally accepted auditing standards with the ISAs while also avoiding the creation of unnecessary differences with PCAOB standards. The approach taken by the ASB is to use the ISAs as a base in developing its auditing standards. The ISA base is modified only where modifications are deemed necessary to better

serve the needs of the U.S. users of audited financial statements of nonissuers or where modifications are appropriate for U.S. legal and regulatory reasons. The ASB's intention is that there will be very few or no differences between the requirements of the ISAs and U.S. Statements on Auditing Standards (SASs).

The clarified ISAs can be downloaded free-of-charge from the IFAC online bookstore at <http://www.ifac.org/Members/Pubs-Details.tmpl?PubID=11707140961378015&Category=Auditing%2C%20Assurance%20%26%20Related%20Services>.

Accounting Standards

Federal Accounting Standards Advisory Board

Concepts Statement No. 5, *Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements* (Issued December 2007), established definitions for the five elements (asset, liability, net position, revenue, and expense) of accrual-basis financial statements of the federal government. Elements are the building blocks of financial statements. The statement also established the following basic recognition criteria that an item must meet in order to be recognized in the body of a financial statement:

- (1) the item must meet the definition of an element, and
- (2) the item must be measurable, meaning a monetary amount can be determined with reasonable certainty or is reasonably estimable. An item that meets the definition of an element but is not measurable is a candidate for disclosure in the notes to financial statements or as supplementary information.

The statement also includes a discussion of the effects of uncertainty on financial reporting but does not otherwise address the assessment of probabilities or other measurement issues. The Board intends to address those considerations for recognition decisions in future pronouncements. In the meantime, this statement does not change existing standards for assessing probabilities or for selecting the appropriate measurement attribute, which the Board expects will continue to be based on the reporting objectives, qualitative characteristics, and cost-benefit constraints applicable to financial information.

The board believes that a concepts statement that defines the elements of federal accrual-basis financial statements and establishes criteria for recognition will play an important part of its conceptual frame work. It also will provide more consistent, useful and enduring guidance to the Board and its constituents.

The concepts in this statement are consistent with those established in earlier Statements of Federal Financial Accounting Concepts, which are not superseded or modified by this Statement. The definitions of elements and basic recognition criteria in this statement are generally consistent with current practice and do not imply a need for radical change, but they are expected to guide the Board's future deliberations.

This statement can be accessed at <http://www.fasab.gov/pdffiles/sffac5.pdf>

Financial Accounting Standards Board (FASB)

Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (Issued December 2007) amends Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*. The objective of this statement is to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It also amends certain ARB 51 consolidation procedures for consistency with the requirements of FASB Statement No. 141R, *Business Combinations*.

This statement applies to all entities that prepare consolidated financial statements except not-for profit organizations. It is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. This statement shall be applied prospectively as of the beginning of the fiscal year in which the statement is initially adopted, except for the presentation and disclosure requirements, which shall be applied retrospectively for all periods presented.

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Statement No. 141R, *Business Combinations* (Revised December 2007) replaces Statement No. 141, *Business Combinations*, and establishes principles and requirements for how the acquirer (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquired, (2) recognizes and measures the goodwill acquired in the business combination or a gain from bargain purchase, and (3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

The statement applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquiree), including those sometimes referred to as “true mergers” or “mergers of equals” and combinations achieved without the transfer of consideration. The statement applies to all business entities, including mutual entities that previously used the pooling-of-interests method of accounting for some business combinations. The statement does not apply to (1) the formation of a joint venture, (2) the acquisition of an asset or a group of assets that does not constitute a business, (3) a combination between entities or businesses under common control, and (4) a combination between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization.

Statement No. 141R is designed to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. For example, the statement applies the same method of accounting—the acquisition method—to all transactions and other events in which one entity obtains control over one or more other businesses.

This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date.

Statements No. 160 and 141R are posted at <http://www.fasb.org/st/#fas160>

Governmental Accounting Standards Board (GASB)

Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments* (Issued November 2007), establishes standards for the reporting of land and other real estate held as investments by essentially similar entities. It requires government endowments to report their land and other real estate investments at fair value. Governments also are required to (1) report the changes in fair value as investment income, and (2) disclose the methods and significant assumptions employed to determine fair value, and other information that they currently present for other investments reported at fair value.

The Statement is effective for financial statements for periods beginning after June 15, 2008. Earlier implementation is encouraged.

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