

United States General Accounting Office

GAO

Exposure Draft

July 1998

**Government Auditing
Standards**

Auditor Communication

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United States
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Accounting and Information
Management Division

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TO AUDIT OFFICIALS AND OTHERS INTERESTED IN
GOVERNMENT AUDITING STANDARDS

GAO invites your comments on the accompanying proposed changes to *Government Auditing Standards* (GAGAS), commonly known as the "yellow book." These changes add a field work standard and amend a reporting standard for financial statement audits to improve auditor communication concerning the auditor's work on compliance with laws and regulations and internal control over financial reporting with the auditee and users of the auditor's reports. This letter describes the process followed in revising the standards, discusses the proposed changes, outlines the format of this exposure draft, and requests comments from interested parties on these proposed revisions.

To help ensure that the standards continue to meet the needs of the audit community and the public it serves, the Comptroller General of the United States appointed the Advisory Council on Government Auditing Standards to review the standards and recommend necessary changes. The Council includes experts in financial and performance auditing drawn from all levels of government, private enterprise, public accounting, and academia. In February 1997, the Advisory Council on Government Auditing Standards endorsed a revised approach of issuing individual standards issue-by-issue as the Council reaches consensus on a particular issue, with periodic codification of the standards. This revised approach was adopted to provide more timely revision of the standards for emerging audit issues. The approach will continue the practice of seeking public comment on all draft revisions. The Council will consider those comments in making recommendations to the Comptroller General of the United States in finalizing revisions to the standards.

This exposure draft reflects the Council's recommendations to the Comptroller General regarding a new field work standard for financial statement audits on auditor communication and revisions to the reporting standard for reporting on compliance with laws and regulations and on internal control over financial reporting. The American Institute of Certified Public Accountants (AICPA), in issuing Statements on Auditing Standards (SAS) No. 61, *Communication With Audit Committees*, and SAS No. 83, *Establishing an Understanding With the Client*, set requirements for auditors to establish an understanding with the client regarding the services to be performed and to determine that certain matters related to the conduct of an audit under generally accepted auditing

standards are communicated to those who have responsibility for oversight of the financial reporting process. This exposure draft requires specific communication with the auditee, including the audit committee if applicable or other equivalent group, regarding the scope of compliance and internal control work to be performed under government auditing standards, and strengthens the linkage of the auditor's report on the financial statements with the auditor's reports on compliance with laws and regulations and internal control over financial reporting when these reports are issued separately. This exposure draft should reduce the risk that either the auditor or auditee may misinterpret the needs or expectations of the other party and should improve the usefulness of the auditor's reports required under government auditing standards.

This exposure draft moves a reporting standard on auditor communication, with some modification, to a field work standard, as communication on the scope of work to be performed on an audit is viewed more appropriately as a field work standard. In addition, this exposure draft amends the reporting standard on reporting on compliance with laws and regulations and internal control over financial reporting. This exposure draft also presents conforming changes to GAGAS field work standards for financial statement audits to recognize where applicable, the effect of SAS No. 78 on GAGAS for internal control, the effect of SAS No. 82 on GAGAS for consideration of fraud, and the effect of OMB Circular A-133 on GAGAS for audits of state and local governments and nonprofit organizations. These changes principally consist of updating terminology to conform with SAS Nos. 78 and 82, and to reflect the consolidation of OMB Circulars A-133 and A-128.

In the exposure draft, the proposed changes are indicated by highlighting proposed added language and striking-out the proposed deleted language. The revision will be effective for financial audits of periods ending on or after September 15, 1999.

The exposure draft is being sent to financial management and audit officials at all levels of government, the public accounting profession, academia, professional organizations, and public interest groups. Your comments on the proposed changes are encouraged. To facilitate review of the exposure draft, it is located on the Internet on GAO's Home Page (www.gao.gov). Additional copies of these proposed standards can be obtained from the U. S. General Accounting Office, Room 1100, 700 4th Street, NW, Washington, D.C. 20548, or by calling (202) 512-6000.

To facilitate analysis of your comments, it would be helpful if you sent them both in writing and on diskette (in ASCII format). To ensure that your comments are considered in preparing the final revised standard, please submit them by September 30, 1998, to:

Government Auditing Standards Comments
Auditor Communication Standard
U.S. General Accounting Office
Room 5089 (AIMD)
441 G Street, NW
Washington, DC 20548

If you need additional information, please call Robert W. Gramling, Director,
Corporate Audits and Standards, at (202) 512-9406.

A handwritten signature in black ink, appearing to read "Gene L. Dodaro". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Gene L. Dodaro
Assistant Comptroller General

Proposed Changes to Government Auditing Standards - Chapter 4

4.3 The AICPA has issued statements on auditing standards (SAS) that interpret its standards of field work (including a SAS on compliance auditing).¹ This chapter incorporates these SASs and prescribes additional standards on

a. audit follow-up (see paragraphs 4.7, 4.10, and 4.11),

b. communication with the auditee (see paragraphs 4.7.1, and 4.11.1 through 4.11.5)

[Paragraphs 4.3 b. and 4.3 c. will be renumbered when this exposure draft becomes finalized.]

4.7.1 ~~The second additional planning standard for financial statement audits is:~~

~~Auditors should communicate certain information related to the conduct and reporting of the audit to the audit committee or to individuals with whom they have contracted for the audit auditee regarding the nature and extent of testing and reporting on internal control and compliance with laws and regulations.²~~

¹GAGAS incorporate any new AICPA standards relevant to financial statement audits unless the General Accounting Office (GAO) excludes them by formal announcement.

²~~The auditee is the individual(s) within the organization being audited who possess a sufficient level of authority and responsibility for the financial reporting process such as the individual with whom the auditor establishes a clear understanding regarding the terms of the engagement. The auditor should also communicate such information to the audit committee or to an otherwise formally designated group who has oversight of the financial reporting process and is equivalent to an audit committee, and to representatives of legislative bodies or others requesting the audit services.~~

Communication With Audit Committees or Other Responsible Individuals ~~the Auditee~~

4.11.1 Auditors should communicate the following information to the ~~audit committee or to individuals with whom they contract to perform the audit~~ ~~auditee~~:

- a. the auditors' responsibilities in a financial statement audit, including their responsibilities for testing and reporting on internal control and compliance with laws and regulations, ~~and~~
- b. the nature of any additional testing of internal control and compliance required by laws and regulations, ~~and~~

~~c. whether the planned work on internal control and compliance with laws and regulations provides a basis for an opinion on internal control and compliance with laws and regulations, and accordingly whether the auditor is providing such opinions.~~

~~4.11.2 AICPA standards and GAGAS require the auditor to establish an understanding with the client and to communicate with audit committees. This standard provides guidance on specific information regarding the nature and extent of testing and reporting on internal control and compliance with laws and regulations that the auditor should communicate during the planning stages of a financial statement audit to reduce the risk that either the auditor or the auditee may misinterpret the needs or expectations of the other party.~~

4.11.3 Auditors should use their professional judgment to determine the form and content of the communication. The communication may be oral or written. If the information is communicated orally, the auditors should document the communication in the working papers. Auditors may use an engagement letter to communicate the information described in paragraph 5.7 ~~4.11.1~~. To help audit

~~committees and other responsible parties the auditee~~ understand the limitations of auditors' responsibilities for testing and reporting on internal controls and compliance, auditors should contrast those responsibilities with other financial related audits of controls and compliance. The discussion in paragraphs 5.9 and 5.10 ~~4.11.4 and 4.11.5~~ may be helpful to auditors in ~~preparing to explain those explaining their responsibilities for testing and reporting on internal control and compliance with laws and regulations to the auditee~~

4.11.4 Tests of internal control and compliance with laws and regulations in a financial statement audit contribute to the evidence supporting the auditors' opinion on the financial statements. However, they do not provide a basis for opining on internal control or compliance. To meet certain audit report users' needs, laws and regulations often prescribe testing and reporting on internal control and compliance to supplement the financial statement audit's coverage of these areas.³

³For example, when auditing state and local government entities and nonprofit organizations that receive federal financial assistance, auditors should be familiar with the Single Audit Act ~~Amendments of 1996~~ of 1984 and Office of Management and Budget (OMB) Circular A-128 ~~133~~. The act and circular include specific audit requirements, mainly in the areas of internal controls and compliance with laws and regulations, that exceed the minimum audit requirements in the standards in chapters 4 and 5 of this document. ~~Audits of nonprofit organizations under OMB Circular A-133 and audits conducted under the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994,~~ also have specific audit requirements ~~prescribed by OMB~~ in the areas of internal controls and compliance. Many state and local governments have additional audit requirements.

4.11.5 Even after auditors perform, and report the results of, additional tests of internal control and compliance required by laws and regulations, some reasonable needs of report users still may be unmet. Auditors may meet these needs by performing further tests of internal control and compliance with laws and regulations in either of two ways:

- a. supplemental (or agreed-upon) procedures or
- b. examination, resulting in an opinion.

Proposed Changes to Government Auditing Standards - Chapter 5

~~[Paragraphs throughout Chapter 5 will be renumbered when this exposure draft becomes finalized.]~~

5.3 The AICPA has issued statements on auditing standards (SAS) that interpret its standards of reporting.⁴ This chapter incorporates these SASs and prescribes additional standards on

~~a. communication with audit committees or other responsible individuals (see paragraphs 5.5 through 5.10);~~

~~b. reporting compliance with GAGAS (see paragraphs 5.11 through 5.14),~~

~~c. reporting on compliance with laws and regulations and on internal controls over financial reporting (see paragraphs 5.15 through 5.28),~~

~~COMMUNICATION WITH AUDIT COMMITTEES OR OTHER RESPONSIBLE INDIVIDUALS~~

~~5.5 The first additional reporting standard for financial statement audits is:~~

~~**Auditors should communicate certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit.**~~

⁴GAGAS incorporate any new AICPA standards relevant to financial statement audits unless the General Accounting Office (GAO) excludes them by formal announcement.

- ~~5.6 This standard applies in all situations where either the auditee has an audit committee or the audit is performed under contract. In other situations, auditors may still find it useful to communicate with management or other officials of the auditee.~~
- ~~5.7 Auditors should communicate the following information to the audit committee or to individuals with whom they contract to perform the audit:~~
- ~~a. the auditors' responsibilities in a financial statement audit, including their responsibilities for testing and reporting on internal controls and compliance with laws and regulations and;~~
 - ~~b. the nature of any additional testing of internal controls and compliance required by laws and regulations.~~
- ~~5.8 Auditors should use their professional judgment to determine the form and content of the communication. The communication may be oral or written. If the information is communicated orally, the auditors should document the communication in the working papers. Auditors may use an engagement letter to communicate the information described in paragraph 5.7. To help audit committees and other responsible parties understand the limitations of auditors' responsibilities for testing and reporting on internal controls and compliance, auditors should contrast those responsibilities with other financial related audits of controls and compliance. The discussion in paragraphs 5.9 and 5.10 may be helpful to auditors in preparing to explain those responsibilities.~~
- ~~5.9 Tests of internal controls and compliance with laws and regulations in a financial statement audit contribute to the evidence supporting the auditors' opinion on the financial statements. However, they do not provide a basis for opining on internal controls or compliance. The limited purpose of these tests in a financial statement~~

~~audit may not meet the needs of some users of auditors' reports who require additional information on internal controls and on compliance with laws and regulations.~~

~~5.10 To meet certain audit report users' needs, laws and regulations often prescribe testing and reporting on internal controls and compliance to supplement the financial statement audit's coverage of these areas.⁵ Nevertheless, even after auditors perform, and report the results of, additional tests of internal controls and compliance required by laws and regulations, some reasonable needs of report users still may be unmet. Auditors may meet these needs by performing further tests of internal controls and compliance with laws and regulations in either of two ways:~~

~~a. supplemental (or agreed-upon) procedures or~~

~~b. examination, resulting in an opinion.~~

⁵For example, when auditing state and local government entities that receive federal financial assistance, auditors should be familiar with the Single Audit Act of 1984 and Office of Management and Budget (OMB) Circular A-128. The act and circular include specific audit requirements, mainly in the areas of internal controls and compliance with laws and regulations, that exceed the minimum audit requirements in the standards in chapters 4 and 5 of this document. Audits of nonprofit organizations under OMB Circular A-133 and audits conducted under the Chief Financial Officers Act of 1990 also have specific audit requirements in the areas of internal controls and compliance. Many state and local governments have similar requirements.

REPORTING ON COMPLIANCE WITH LAWS AND REGULATIONS AND ON INTERNAL CONTROLS ~~OVER FINANCIAL REPORTING~~

5.15 The ~~third~~ ~~second~~ additional reporting standard for financial statement audits is:

The report on the financial statements should either (1) describe the scope of the auditors' testing of compliance with laws and regulations and internal controls ~~over financial reporting~~ and present the results of those tests or (2) refer to separate reports containing that information. In presenting the results of those tests, auditors should report ~~irregularities~~ ~~fraud~~, illegal acts, other material noncompliance, and reportable conditions in internal controls.⁶ In some circumstances, auditors should report ~~irregularities~~ ~~fraud~~ and illegal acts directly to parties external to the audited entity.

5.16 Auditors may report on compliance with laws and regulations and internal controls ~~over financial reporting~~ in the report on the financial statements or in separate reports. When auditors report on compliance and ~~internal~~ controls ~~over financial reporting~~ in the report on the financial statements, they should include an introduction summarizing key findings in the audit of the financial statements and the related compliance and internal controls work. Auditors should not issue this introduction as a stand-alone report. ~~When auditors report separately on~~

⁶These responsibilities are in addition to and do not modify auditors' responsibilities under AICPA standards to (1) address the effect ~~irregularities~~ ~~fraud~~ or illegal acts may have on the report on the financial statements and (2) determine that the audit committee or others with equivalent authority and responsibility are adequately informed about ~~irregularities~~ ~~fraud~~, illegal acts, and reportable conditions.

compliance and controls, the report on the financial statements should state that they are issuing those additional reports.

5.16.1 When auditors report separately on compliance and internal control over financial reporting, the report on the financial statements should state that they are reporting separately. If the separate report(s) on compliance with laws and regulations and internal control over financial reporting identify any reportable instances of noncompliance or any reportable conditions in internal control, the report on the financial statements should disclose the existence of those findings.

Scope of Compliance and Internal Controls Work

5.17 Auditors should report the scope of their testing of compliance with laws and regulations and of internal controls ~~over financial reporting~~. If the tests they performed did not exceed those the auditors considered necessary for a financial statement audit, then a statement that the auditors tested compliance with certain laws and regulations, obtained an understanding of internal controls, and assessed control risk would be sufficient to satisfy this requirement. Auditors should also

Auditors are not required to include in the report on the financial statements the details concerning the findings, nor are they required to include a statement that there were no findings on internal control or instances of noncompliance with laws and regulations. In instances where the auditor reports on compliance with laws and regulations and internal control over financial reporting at a later date than the report on the financial statements, the auditor's work on the financial statement audit must be sufficient to meet AICPA and GAGAS requirements. Accordingly, the auditor must know the significance of internal control weaknesses identified during the audit and their effect individually and cumulatively on the financial statements before rendering an opinion on the financial statements. Therefore, when issuing the compliance and internal control reports at a later date, the auditor should disclose the existence of known reportable conditions in internal control over financial reporting or known instances of noncompliance in the auditor's report on the financial statements.

report whether or not the tests they performed provided sufficient evidence to support an opinion on compliance or internal controls. ~~If auditors report separately on compliance with laws and regulations and internal control over financial reporting, auditors should include a statement in the report on the financial statements as to whether or not the tests they performed provided sufficient evidence to support an opinion on compliance or internal control over financial reporting.~~