



STATE AND LOCAL GOVERNMENT FINANCE DIVISION  
AND THE LOCAL GOVERNMENT COMMISSION

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Memorandum #2019-07

**TO:** State Agencies, Independent Auditors, North Carolina Local Governments and Public Authorities, Interested Parties

**FROM:** Sharon Edmundson, Director, Fiscal Management Section

**SUBJECT:** 2018 Revision – Government Auditing Standards (GAGAS) AKA “The Yellow Book”

**DATE:** April 29, 2019 **\*\*REVISED JUNE 12, 2019\*\***

The United States Government Accountability Office (GAO) has issued revised *Government Auditing Standards*, also known as the “Yellow Book,” which provide a framework for high-quality audit work of entities that receive governmental financial awards. These standards, commonly referred to as GAGAS (general accepted government auditing standards), will be effective for financial audits of units of local governments and public authorities (units) with periods ending on or after June 30, 2020. Units of government and their external auditors need to be aware of these changes and begin to plan accordingly. The 2018 *Government Auditing Standards* revision will supersede the 2011 revision.

The scope of this memorandum is limited to the applicable sections of the Yellow Book as they relate to the financial audits of North Carolina local governments and public authorities conducted by their independent auditors. GAO also has updated its Standards for Attestation Engagements and Reviews of Financial Statements, Fieldwork Standards for Performance Audits, and Reporting Standards for Performance Audits. Those updates are not covered in this document. Auditors are encouraged to familiarize themselves with the entire document.

### Chapter 3 – Ethics, Independence, and Professional Judgment

Perhaps the most impactful changes in the 2018 Yellow Book Standards are in the area of auditor independence and how that is potentially affected when the auditor prepares draft financial statements and/or performs certain non-attest services. **We highly recommend that auditors that perform any non-audit services for their governmental audit clients review this section of the new Yellow Book in its entirety (3.64 through 3.108, 2018 Yellow Book).**

While auditors are held to the standard of maintaining independence by not auditing their own work (in addition to other requirements), there are many interpretations of what exactly that entails. In its 2018 revisions, GAO has stated that the auditor’s **preparation of draft financial statements in their entirety**, from a unit’s trial balance or underlying accounting records, **creates significant threats to independence** that will require the application of safeguards to reduce the threats to an acceptable level (United States Government Accountability Office, *Government Auditing Standards - 2018 Revision*, p. 51).

How does the Yellow Book define “acceptable level”? An acceptable level is when a reasonable and informed third party would conclude that the firm could perform the audit without compromising its professional judgement (United States Government Accountability Office, *Government Auditing Standards - 2018 Revision*, pp. 37-38).

Auditors that believe they can do this **are required to document the evaluation, including the safeguards that were applied.**

GAO has identified the following bookkeeping and financial statement preparation services as threats to the auditor's independence (United States Government Accountability Office, Government Auditing Standards - 2018 Revision, pp. 51-52). **Previous guidance did not specifically call these services threats:**

- a. recording transactions for which management has determined or approved the appropriate account classification, or posting coded transactions to an audited entity's general ledger;
- b. preparing certain line items or sections of the financial statements based on information in the trial balance;
- c. posting entries that an audited entity's management has approved to the entity's trial balance;
- d. and preparing account reconciliations that identify reconciling items for the audited entity management's evaluation.

If providing any of these bookkeeping or financial statement preparation services, the auditor should evaluate the significance of threats to independence. If, in the auditor's professional judgment, he or she determines the threats are **not significant**, then the **basis for this conclusion should be documented** by the auditor. If the threats are **considered significant**, the **type of safeguards that were applied to reduce or eliminate the threats should be documented.** If **safeguards cannot be applied to reduce to an acceptable level or eliminate the threat, the auditor cannot provide the services referenced nor perform the audit** because the auditor is no longer considered independent. Documentation is a critical step that auditors must not overlook. "If you don't document it, it didn't happen" is a good rule of thumb.

What are sufficient safeguards? These are some examples from the 2018 Yellow Book but auditors should not consider these to be the only safeguards that can be put in place (United States Government Accountability Office, Government Auditing Standards - 2018 Revision, pp. 38-39).

- not including individuals who provided the non-audit service as engagement team members;
- having another auditor, not associated with the engagement, review the engagement and non-audit work as appropriate;
- engaging another audit organization to evaluate the results of the non-audit service; or
- having another audit organization re-perform the non-audit service to the extent necessary to enable that other audit organization to take responsibility for the service.

If the auditor believes that sufficient safeguards cannot be applied to reduce the threat to an acceptable level, then the auditor should not perform both the non-audit service of preparation of draft financial statements and the audit.

The issuance of the 2018 revision presents us an opportunity to remind governing officials that the **responsibility** for the preparation and fair presentation of the financial statements in accordance with generally accepted accounting principles **is with the unit's management.** If the auditor assumes this responsibility it impairs the auditor's independence. This requirement has existed in the previous Yellow Book standards and has not changed.

Before an auditor agrees to perform an audit engagement to provide certain non-audit services, such as preparing draft financial statements or performing year-end bookkeeping to prepare for the audit, the auditor

should determine that management of the unit of government has designated an individual who possesses suitable skill, knowledge, or experience (SKE) to sufficiently oversee the non-audit services. This person does not have to have the SKE to perform or re-perform the services but must be able to have a sufficient understanding to oversee them. The identified person must be able “to determine the reasonableness of the results of the non-audit services provided and to recognize a material error, omission, or misstatement in the results of the non-audit services provided.” (2018 Yellow Book, 3.79).

We understand that there are competent finance officers that can perform their duties in accordance to the requirements of G.S. 159-25 but may not have the specific SKE necessary to oversee a given non-audit service. The responsible person does not have to be the finance officer. However, the unit of government may wish to consider if the finance officer would benefit from additional training in the area or areas for which he or she does not have sufficient SKE to serve in that role. Once again, sufficient documentation is required; auditors must document considerations of management’s ability to oversee the non-audit services provided.

If the auditor determines that the unit’s staff (employed or contracted) does not have the appropriate SKEs to adequately oversee the performance of the non-attest service, the auditor cannot perform the non-attest service. The auditor can still conduct the audit if another party performs the non-attest service. In more direct terms, if the auditor is planning to draft a client’s financial statements but determines that no one at the unit has sufficient SKEs to oversee the process, the auditor cannot draft the statements and maintain his or her independence. The unit would need to find a third-party accountant to write the financial report to enable the auditor to complete the audit.

The auditor’s responsibility to apply the conceptual framework approach to independence has not changed from the 2011 revision. This requires the auditor to identify threats, evaluate the significance, and apply safeguards. To assist the auditors in understanding and applying the conceptual framework, GAO has modified its “Conceptual Framework of Independence” flow chart that can now be found in Chapter 3 with the guidance on independence. To assist auditors in applying the conceptual framework to certain bookkeeping related services, GAO has added a new flow chart “Independence Considerations for Preparing Accounting Records and Financial Statements.” Copies of both of those flow charts are attached to this memorandum.

### **Competence and Continuing Professional Education**

The requirements and guidance on Competency can now be found in Chapter 4 titled *Competence and Continuing Professional Education*. Effective with the implementation dates for the 2018 revision, GAO is retiring *Government Auditing Standards: Guidance on GAGAS Requirements for Continuing Professional Education* (GAO-05-058G, April 2005). The content from the GAGAS guidance document on continuing professional education (CPE) (GAO-05-568G) is largely incorporated into Chapter 4 of the 2018 guidance.

CPE requirements have not significantly changed from the 2011 revision. Auditors who plan, direct, perform engagement procedures for, or report on, Yellow Book engagements must complete at least 80 hours of CPE every two years. Twenty-four hours must be directly related to the government environment, government auditing, or the specific or unique environment in which the entity operates. Fifty-six hours must be on subject matters that directly enhance auditors’ professional expertise to conduct engagements. At least 20 hours of CPE should be completed each year of the 2-year period. Audit firms should maintain documentation of each auditor’s CPE.

Other than the requirements listed above, the remaining guidance on CPE is application guidance, most of which was previously in the GAGAS guidance document on CPE; however, there are some modifications. Many of the proposed changes for CPE in the 2017 exposure draft, including the 4-hour GAGAS qualification requirement, to be required each time a new version of GAGAS is issued, were not included in the final 2018 revision. GAO

has included as guidance the necessity of having auditors obtain CPE specifically on GAGAS, particularly during years in which there are revisions to the standards, to maintain their competency to conduct GAGAS engagements. Certain auditors may be exempted from the 56-hour CPE requirement if they only are involved in performing engagement procedures and charge less than 20 percent of their time annual to GAGAS engagements.

GAO has issued guidance on competency in the 2018 revised standards that defines key terms related to the activities performed by the auditor on audit engagements. These terms, used throughout the standards, are *planning, directing, performing engagement procedures, and reporting*. In prior revisions of the Yellow Book, these activities or tasks were referenced but were not defined. These terms are defined as follows (United States Government Accountability Office, Government Auditing Standards - 2018 Revision, pp. 65-66):

- **Planning:** Determining engagement objectives, scope, and methodology; establishing criteria to evaluate matters subject to audit; or coordinating the work of the other audit organizations. This definition excludes auditors whose role is limited to gathering information used in planning the engagement.
- **Directing:** Supervising the efforts of others who are involved in accomplishing the objectives of the engagement or reviewing engagement work to determine whether those objectives have been accomplished.
- **Performing Engagement Procedures:** Performing tests and procedures necessary to accomplish the engagement objectives in accordance with GAGAS.
- **Reporting:** Determining the report content and substance or reviewing reports to determine whether the engagement objectives have been accomplished and the evidence supports the report's technical content and substance prior to issuance. This includes signing the report.

In addition, GAGAS discusses the levels of proficiency required for the various roles on an engagement as well as a description of the tasks generally expected to be performed by auditors filling these roles. Roles generally include nonsupervisory auditors, supervisory auditors, and partners and directors.

GAO has included a competency requirement for someone deemed to be and utilized as a specialist. The engagement team should determine whether specialists are qualified and competent in their areas of specialization. Specialists do not include individuals with special skills or knowledge within the field of accounting or auditing, such as information technology or taxation. These individuals are considered auditors and are subject to CPE requirements. Internal specialists that are not involved in planning, directing, performing engagement procedures, or reporting, as well as external specialists, are not subject to GAGAS CPE requirements.

### **Quality Control and Peer Review**

GAO has relocated the sections on Quality Control and External Peer Review from the General Standards and has expanded them into one individual chapter (Chapter 5) – *Quality Control and Peer Review*. Some of the key points from the chapter are as follows:

- The audit organization should obtain written affirmation of compliance with its policies and procedures from all its personnel required to be independent at least annually. Applicable guidance suggest that this may be obtained on a per-engagement basis when such engagements are less than one year.

- The audit organization should establish policies and procedures to provide reasonable assurance that their GAGAS auditors meet the CPE requirements, including maintaining documentation and any exemptions granted.
- The audit organization should undertake engagements only if it has the capabilities, including time and resources, to do so.
- The audit organization should establish policies and procedures designed to provide reasonable assurance that appropriate consultation takes place on difficult or contentious issues that arise among engagement team members during conducting a GAGAS engagement.
- If an engagement is terminated before it is completed, and an audit report is not issued, auditors should document the results of the work to the date of termination and why the engagement was terminated.
- The audit organization should establish policies and procedures that require engagement team members with appropriate levels of skill and proficiency in auditing to supervise engagements and review work performed by other engagement team members.
- The audit organization should assign responsibility for each engagement to an engagement partner or director with authority designated by the audit organization to assume that responsibility. This should be communicated to the management and governing board of the entity.
- The requirement that audit organizations should analyze and summarize the results of its monitoring process at least annually has been expanded. Communication should be sufficient to enable the audit organization to take prompt corrective action related to deficiencies. The audit organization should evaluate the effects of deficiencies to determine and implement appropriate action to address the deficiencies.

The 2018 revision has also updated External Peer Review requirements. Audit organizations that are affiliated with any one of five recognized peer review organizations, such as the American Institute of Certified Public Accountants, should comply with those organizations' requirements, in addition to the GAGAS requirements. The five recognized peer review organizations are:

1. American Institute of Certified Public Accountants
2. Council of the Inspectors General on Integrity and Efficiency
3. Association of Local Government Auditors
4. International Organization of Supreme Audit Institutions
5. National State Auditors Association

The GAGAS peer review requirements for auditors affiliated with one of these recognized organizations can be found in Chapter 5 of the 2018 Yellow Book, sections 5.66 through 5.80. Audit organizations that are not affiliated with a recognized peer review organization have additional requirements. These additional requirements can be found in Chapter 5, sections 5.82 – 5.95.

Additional requirements to the 2018 revised standards for all audit organizations regardless of peer review organization affiliation, are as follows:

- The peer review team should determine the type of peer review rating to issue based on the observed matters' importance to the audit organization's system of quality control as a whole and the nature, causes, patterns, and pervasiveness of those matters. The matters should be assessed both alone and in the aggregate.
- The peer review team should aggregate and systematically evaluate any observed matters (circumstances that warrant further consideration by the peer review team) and document their evaluation.

## **Considerations for Addressing Waste and Abuse**

Chapter 6 - *Standards for Financial Audits* - has added new and modified requirements for addressing waste and abuse. Waste is defined as the “act of using or expending resources carelessly, extravagantly, or to no purpose. Waste can include activities that do not include abuse and do not necessarily involve a violation of law. Waste relates primarily to mismanagement, inappropriate action, and inadequate oversight.”

The 2018 guidance defines abuse as “behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances, but excludes fraud and noncompliance with provisions of laws, regulations, contracts, and grant agreements. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate.”

Auditors are not required to perform procedures to detect or report abuse or waste. Due to the subjective nature of waste and abuse, auditors should use their judgment on how or whether to communicate instances if the auditor becomes aware of them. Evaluating internal control in a government environment may include consideration of internal control deficiencies that result in waste or abuse. The 2018 revised standard provides examples of waste and abuse.

GAO has added the requirement that auditors should consider internal control deficiencies in their evaluation of identified findings when developing the cause element of the identified findings. This is applicable to compliance findings that are direct and material. Auditors should determine the level of the control deficiency that caused the finding and if the deficiency is at least a significant deficiency, it should be cited in the report.

## **Revised Format**

A noticeable change in the appearance of the 2018 Yellow Book from its predecessors is that all chapters are presented in a revised format. Requirements are presented in bordered text boxes, followed by applicable guidance to those requirements. Each chapter has requirements and applicable guidance followed by more requirements and applicable guidance, depending on the subtopics. Chapters have been reorganized and, in some cases, combined. Supplemental Guidance found in Appendix I of the 2011 revision has either been removed or incorporated into the individual chapters.

## **Effective Dates**

The 2018 revision of Government Auditing Standards is effective for financial audits, attestation engagements, and reviews of financial statements for periods ending on or after June 30, 2020 and for performance audits beginning on or after July 1, 2019. Early implementation is not permitted. Auditors that are currently drafting financial statements or performing other non-attest services for their clients that have Yellow Book audits should begin planning now for implementation. We strongly recommend that you discuss with your clients what changes will be made in order to comply with the revised standards. These discussions should be a part of your preparation for the 2019 fiscal year audits as the standard is effective July 1, 2019. Units that need to find other parties to draft financial statements will need to do so sooner rather than later.

The 2018 Revision of the Yellow Book is available on the GAO’s website at [www.gao.gov/yellowbook](http://www.gao.gov/yellowbook).

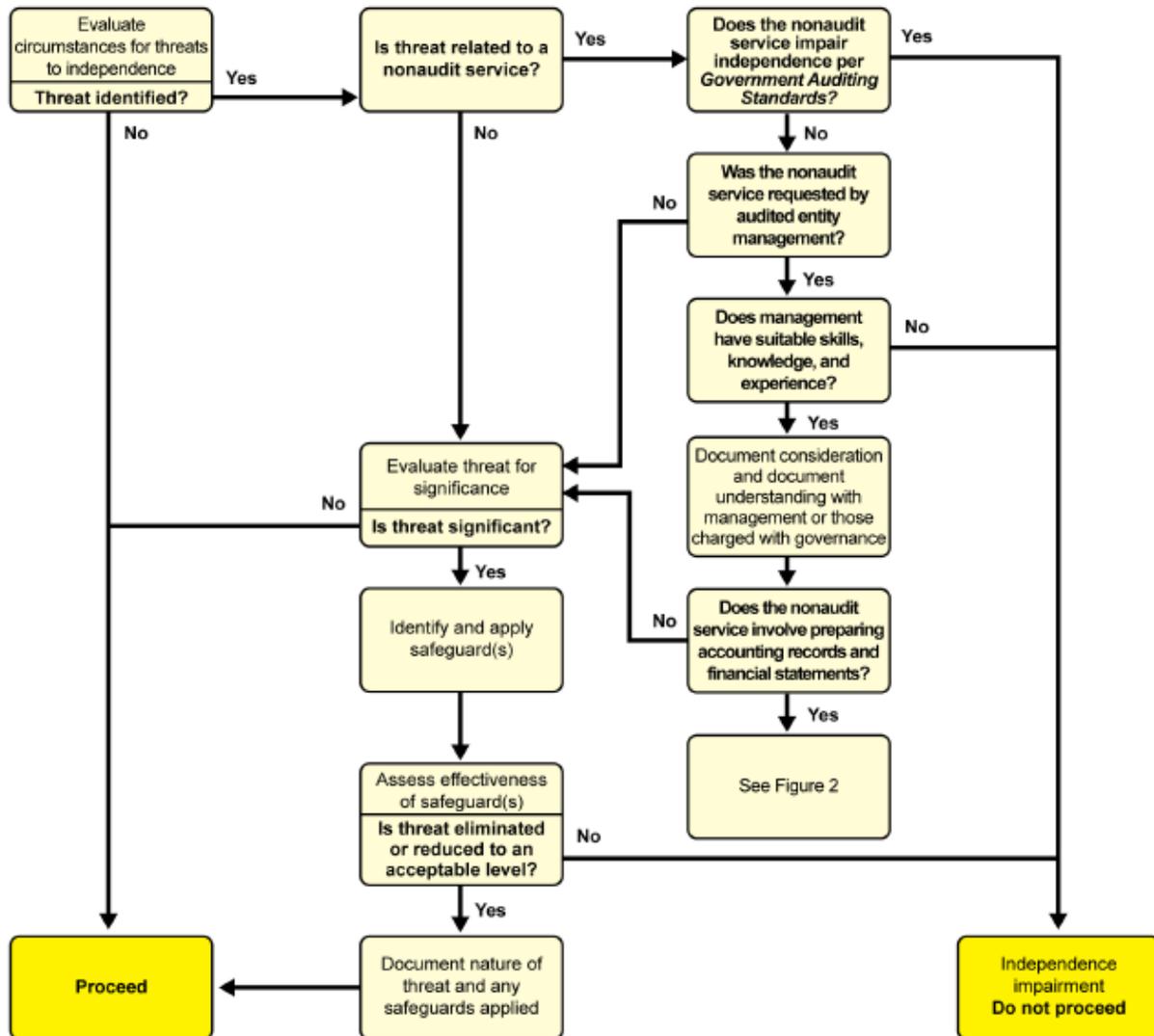
For local governments and public authorities in North Carolina, a Yellow Book audit is required if a unit of government’s combined federal and State financial assistance expenditures for a fiscal year are \$100,000 or greater.

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If you have questions or comments regarding this memorandum, please contact Jim Burke at (919) 814-4301 or at [james.burke@nctreasurer.com](mailto:james.burke@nctreasurer.com) or Sharon Edmundson at (919) 814-4289 or [Sharon.edmundson@nctreasurer.com](mailto:Sharon.edmundson@nctreasurer.com).

Chapter 3: Ethics, Independence, and Professional Judgment

Figure 1: Generally Accepted Government Auditing Standards Conceptual Framework for Independence

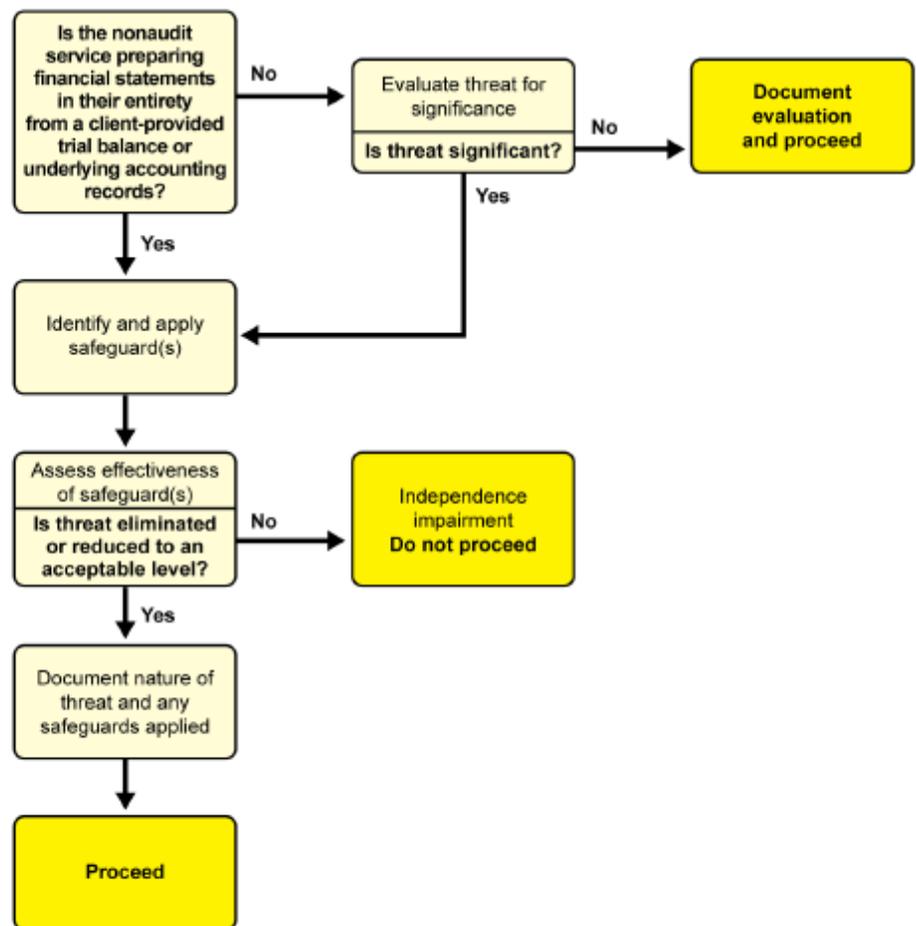


Source: GAO. | GAO-18-568G

<sup>1</sup> (United States Government Accountability Office, Government Auditing Standards - 2018 Revision, p. 61)

**Chapter 3: Ethics, Independence, and Professional Judgment**

**Figure 2: Independence Considerations for Preparing Accounting Records and Financial Statements**



Source: GAO. | GAO-18-568G