

# Reviewer alert

## June 2018 Special Reviewer Alert

### Focus on Engagements Subject to *Government Auditing Standards* and Single Audit Requirements

The following articles are designed to alert reviewers of potential challenges faced by auditors performing engagements under *Government Auditing Standards* and single audits and provide related resources to assist reviewers in performing peer reviews. These types of engagements continue to be under intense regulatory scrutiny, including quality control reviews and desk reviews performed by federal cognizant and oversight agencies. Increased scrutiny is likely as the Uniform Guidance provides that a study of audit quality be performed once every six years to determine compliance to standards, requirements, and procedures for governmental and single audits. Engagements selected for review will be those engagements that are submitted to the Federal Audit Clearinghouse no earlier than 2018, but the timing and scope of the study has not yet been determined by OMB.

This article contains the following topics:

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### Consideration of Yellow Book Independence in Peer Review

Independence for engagements performed under *Government Auditing Standards* (GAS) (2011 revision) “Yellow Book” continues to be a topic of discussion during peer reviews, technical reviews, and RAB observations. This article addresses professional standards, peer review perspectives, and other resources.

### Yellow Book: Evaluating Independence Documentation Requirements

While AICPA Code of Professional Conduct ET 1.200 provides conceptual frameworks for independence and general requirements for performing nonattest services, the Yellow Book builds on top of those requirements, especially related to documentation. GAS paragraph 3.59 indicates the following documentation is required when performing nonaudit services for attest engagements performed under GAS:

1. Document management's ability to oversee the nonaudit services to be provided via documentation of management's skills, knowledge, and expertise (SKE).
2. Document the auditor's understanding with the entity for which the auditor will perform nonaudit services including: a) objectives of the nonaudit service, b) services to be performed, c) auditee's acceptance of its responsibilities, d) auditor's responsibilities, and e) any limitations of the nonaudit service. ET 1.295.040c indicates that this understanding should be documented before performing nonattest services.
3. Document significant threats to independence that require the application of safeguards, along with safeguards applied using conceptual framework of GAS paragraph 3.24.

The failure of the auditor to document any of the three items above should be evaluated **independently** and must be satisfied to conform to the relevant professional standards. For example, the failure to document the understanding with the client of nonaudit services to be provided is noncompliance with the documentation requirements. The engagement would be nonconforming even if the auditor 1) applied appropriate safeguards, and 2) documented management's SKE to oversee the nonaudit services, and 3) obtained a representation letter where the auditee accepted responsibility for nonaudit services (after the service was performed). Another example is the failure to document whether or not the nonaudit service was a significant threat and the related safeguard applied if it was a significant threat. Even if there is evidence of the performance of a safeguard procedure and all the other required independence elements are present, this would also be nonconforming because the performance of the procedure was not documented to be in relation to the assessment of the threat. GAS paragraph 3.16 requires the auditor to apply safeguards that address the specific facts and circumstances under which threats to independence exist.

Reviewers should evaluate whether the reviewed firm understands the independence and related documentation requirements. Reviewers should also remind the reviewed firm that the response to any material departures from Yellow Book Independence standards should focus on remediation of the step(s) that were not previously performed or not documented.

#### Yellow Book: Consideration of Financial Statement Preparation as a Significant Threat to Independence

Government Accountability Office (GAO) has indicated that financial statement preparation, except in rare circumstances (e.g., very limited auditor involvement), should generally be considered a significant threat to independence. While not officially stated in the 2011 Yellow Book, practitioners and widely used third party practice aids for Yellow Book engagements often consider financial statement preparation as a significant threat to independence. Therefore, peer reviewers should carefully evaluate whether self-review threats have been properly considered if the reviewed firm (auditor) prepares the audited entity's financial statements.

However, reviewers should not automatically create an MFC and deem an engagement nonconforming when the auditor has not identified financial statement preparation as a significant threat. For example, consider the following situations where it might be reasonable to conclude financial statement preparation is not a significant threat to independence:

- Auditor only provides pro-forma financial statements to be completed by the auditee with sufficient SKE to correctly prepare the statements.
- Auditor keys or pencils the figures into the pro-forma financial statements from an auditee's internally prepared financial statements or categorically grouped final trial balance where there were no material auditor adjusting journal entries proposed during the audit.

In such circumstances, if the firm has documented its understanding with the client about the nonaudit service to be provided and the limited extent of the service is evident, the auditor is not required to document a threat nor document or apply safeguards as long as management possesses sufficient SKE that is documented by the auditor. The reviewer should consider whether the firm's Quality Control Policies & Procedures require documentation of the auditor's rationale when nonaudit services do not pose a significant threat to independence. While not required by professional standards, such documentation is a best practice that is often encouraged in third party practice aids. The peer review engagement profile also provides the reviewed firm an opportunity to explain their rationale for reaching the conclusion that financial statement assistance was not a significant threat. The Yellow Book checklist PRP §22,110 and PRP §22,120 (question GA108) also asks the reviewer to explain in the primary engagement checklist, section V, "Explanation of 'No' Answers and Other Comments and in the Summary Review Memorandum Findings and Conclusions section, question K, the rationale if the preparation of financial statements is not identified as a significant threat.

The GAO's [2017 Yellow Book Exposure Draft](#) proposed changes to the independence standards relating to nonaudit services. Yellow Book revisions undergo an extensive process, including consideration of all public comments and input from the Yellow Book Advisory Council, and final issuance is anticipated before the end of 2018. Please stay tuned as we await the new Yellow Book!

#### Other Yellow Book Independence Resources

Reviewers are encouraged to read additional peer review [guidance](#) on this topic and consult the Governmental Audit Quality Center's (GAQC) [Government Auditing Standards \(Yellow Book\) Practice Aids and Tools](#) for resources related to documentation of nonaudit services and auditor independence. Reviewers should also refer to the [July 2017](#) Reviewer Alert which also references prior alerts on this topic.

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#### **Compliance Audits Below the Single Audit Threshold**

Reviewers should consider potential implications if an auditor performed an audit following the requirements of the Uniform Guidance (The Office of Management and Budget 'OMB'– *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* at 2 CFR 200) when the auditee's total federal expenditures are less than \$750,000.

The Uniform Guidance audit requirements were effective for audits with fiscal years beginning on or after December 26, 2014 (generally December 31, 2015, years and beyond); however, reviewers should also consider the applicability of this article for audits with fiscal years beginning prior to December 24, 2014, performed under OMB Circular A-133, *Audits of States, Local Governments, and Nonprofit Organizations* (except that under Circular A-133 the threshold for audit was \$500,000 versus \$750,000).

#### When is a Single Audit Required?

A single audit is required to be performed under the Uniform Guidance when a non-federal entity expends \$750,000 or more in total federal awards during the fiscal year (Uniform Guidance §200.501).

Non-federal auditees that expend less than \$750,000 in federal awards are generally exempted from the single audit requirement (Uniform Guidance §200.501 (d)). While the Uniform Guidance does not explicitly prohibit the use of its audit requirements for entities expending less

than \$750,000, if total federal expenditures are below \$750,000 reviewers should question why a single audit was performed.

#### When an Auditee Engages the Auditor to Perform a Single Audit When Not Required

Two common scenarios where an auditee may engage an auditor to perform a single audit when total federal expenditures are below the threshold include the following:

- 1) The auditee's federal expenditures fluctuate from year-to-year above and below the \$750,000 threshold so auditee requests a single audit for purposes of consistent reporting.
- 2) The auditee was subject to a single audit in the prior year and believes federal expenditures will be above the \$750,000 threshold at the time of auditor engagement; however, final actual federal expenditures are less than the threshold.

If the auditor is engaged to perform a single audit when an auditee's federal expenditures for the fiscal year are below the single audit threshold, the auditor should consider the impact on performance and reporting. Attempting to perform a single audit for an auditee that is not technically subject to the Uniform Guidance creates several complications that should be considered, such as, but not limited to:

- 1) Certain aspects of the audit may not be applicable as defined in the Uniform Guidance, such as
  - the major program determination steps and thresholds (e.g., the Type A/B program threshold is based on an entity having \$750,000 or more of federal expenditures)
  - submission of the audit to the Federal Audit Clearinghouse (Uniform Guidance §200.512).
- 2) Several aspects of the OMB *Compliance Supplement*, other guidance, and practice aids may not be applicable.
- 3) The auditor's single audit reporting may be misleading if not appropriately tailored. For example:
  - The title of the report should not indicate that the engagement was 'Required by the Uniform Guidance'
  - The body of the report should not state that the audit was performed in accordance with the Uniform Guidance without modification
  - The report should properly identify the applicable compliance requirements, refer to the document that describes the applicable compliance requirements, or identify the governmental audit requirement or program-specific audit guide
  - The report should identify the program(s) audited or refer to a separate schedule which identifies the program(s) audited.
- 4) The auditee should consider that audit costs for entities that are exempted from having a single audit under Uniform Guidance because federal expenditures are less than \$750,000 are not an allowable federal expenditure eligible for reimbursement (Uniform Guidance §200.425).
- 5) The compliance audit performed will not qualify the auditee as a low risk under the Uniform Guidance in the subsequent year as the audit was not technically performed in accordance with the Uniform Guidance, which includes submission of the data collection form and reporting package to the Federal Audit Clearinghouse. (Uniform Guidance §200.520).

- 6) The testing of a program as a “major program” will not count towards the 2-year look back for program risk assessment purposes in subsequent years’ major program determination.

#### Peer Reviewer Considerations when a Single Audit was not Required

If the reviewed firm (auditor) issues a report stating that a single audit was performed under the Uniform Guidance, but total federal expenditures are less than the Uniform Guidance threshold and a specific program audit was not required by the governmental agency, the peer reviewer should obtain a clear understanding of the auditor’s considerations.

An auditor’s failure to:

- make appropriate considerations of relevant factors,
- document significant conclusions for the application of or departure from professional standards and applicable legal and regulatory requirements (AU-C 230.02 and AU-C 230.08), and
- failure to issue appropriately tailored auditor’s reports when a single audit was not required

***are considered material departures from professional standards that would cause the engagement to be deemed nonconforming for peer review purposes.***

If a single audit was performed when it was not required under the Uniform Guidance, the engagement may not be counted towards the peer reviewer’s single audit must-select requirement under Interpretation 63-1. However, the selection may meet the must-select criteria for an engagement performed under *Government Auditing Standards*. This would require the additional selection of the compliance section of a Single Audit engagement if the reviewed firm performs such engagements.

Other reviewer considerations which should be documented in the peer review working papers include:

- Whether PRP §22,100 Part A-UG and 22,100 Part B-UG Supplemental Checklists are applicable to the engagement or modified appropriately to accommodate the engagement.
- Whether there are implications to the firm’s System of Quality Control such as the lack of knowledge of Uniform Guidance.

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#### **Single Audit Documentation**

Enhanced oversight reviewers have commonly observed that peer reviewers fail to identify or report noncompliance with professional standards when the documentation did not support the overall audit opinion. Key single audit documentation deficiencies that warrant attention from peer reviewers include:

- Auditor does not document the rationale for concluding that an applicable compliance requirement was not direct and material and thus not tested.
- Auditor does not properly document the understanding of internal controls over each direct and material compliance requirement for each major program.

- Auditor does not properly document testing of internal controls over each direct and material compliance requirement.
- Auditor does not specifically assess and document the risk of material noncompliance with each major program's compliance requirement occurring due to fraud.
- Auditor does not perform or properly document testing of compliance over each direct and material compliance requirement.
- Auditor does not document consideration of controls surrounding preparation of the Schedule of Expenditures of Federal Awards (SEFA) or procedures used to determine that the SEFA was presented fairly in relation to the financial statements as a whole.

If the auditor's working papers do not properly document compliance with applicable professional standards and guidance, the applicable question in the checklist should be marked "No" even if the auditor can verbally explain the rationale. All "No" answers must be thoroughly explained in section V (Conclusion) of the applicable audit checklist, regardless of whether the peer reviewer ultimately concludes that the engagement conforms to professional standards in all material respects.

PRP §22,100 Part A-UG and 22,100 Part B-UG, *Supplemental Checklists for Review of Single Audit Act Engagements* were recently updated to provide emphasis points on common single audit findings that have been identified during enhanced oversights, including findings related to lack of documentation. Please watch for a future Reviewer Alert article announcing availability of the revised checklists.

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### Identifying High-Risk Type B Programs

A frequent issue that has been noted during peer reviews and oversights includes the auditor's failure to test as major all identified high-risk Type B programs. This is a material departure from professional standards.

Risk assessments of Type B programs is not required if there are no low-risk Type A programs, and the auditor is only required to perform risk assessments on Type B programs that exceed 25% of the determined Type A threshold. However, the Uniform Guidance explicitly requires that all **identified** high-risk Type B programs be audited as a major program [Uniform Guidance §200.518(e)(2)]. For example, with 10 low-risk Type A programs an auditor only needs to perform risk assessment until three Type B programs have been assessed as high-risk ( $\frac{1}{4}$  or 25% of the number of low-risk Type A programs, rounded up). Therefore, if the first three Type B programs assessed are high-risk stop there. If the first program assessed is low-risk and the next three programs are assessed as high-risk stop there (four programs assessed). But if the auditor conducted risk assessments on 10 Type B programs and seven are deemed high-risk, the auditor will have to audit all seven as major programs. *Note:* The Uniform Guidance encourages an approach that could lead to different high-risk Type B programs audited as a major program over a period of time.

Peer reviewers are reminded to consider if:

- the audit documentation supports the auditor's performance of required Type B risk assessments when the auditor has identified low-risk Type A programs.
- all identified high-risk Type B programs are tested as major.

- the Single Audit Data and Single Audit Major Program Determination Worksheet that accompanies the peer review engagement profile is correct.

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### **Addition of a New Program to an Other Cluster**

Reviewers are reminded that the 2017 OMB *Compliance Supplement* added guidance related to the 2-year look back criterion for major program determination purposes when a program is added to an other cluster. Under this guidance the other cluster cannot qualify as having been audited as a major program in one of the two most recent audit periods unless:

- The auditees current-year expenditures for the newly added program are less than or equal to 25% of the type A threshold, or
- All of the programs included in the resulting other cluster meet the 2-year look back criterion.

The additional criteria in Uniform Guidance §200.518 (c) must also be evaluated to determine if the other cluster can be considered a low-risk Type A program in the current year. *Note:* This guidance does not apply to the Student Financial Assistance and Research and Development clusters. Please refer to [Appendix VII, Other Audit Advisories, Effect of Changes to Compliance Requirements and Other Clusters](#), to learn more about the changes made, including illustrative examples.

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### **2018 Compliance Supplement Now Available!**

On May 17, 2018, the Office of Management and Budget (OMB) released the 2018 OMB Audit Requirements, Appendix XI – Compliance Supplement (the Supplement), effective for fiscal years beginning after June 30, 2017. Reviewers can access the Supplement in one large PDF file at <https://www.whitehouse.gov/wp-content/uploads/2018/05/2018-Compliance-Supplement.pdf>. Additionally, the GAQC has posted a PDF version, [broken down by Supplement section](#), on the GAQC Web site, which is open to the public.

The 2018 Supplement is not a full update on the 2017 Supplement and only amends the programs with major changes. In addition, guidance is added in Part 3.I, Procurement and Suspension and Debarment and Appendix VII of the Supplement. All programs, parts, and appendices contained in the 2017 Supplement that are not listed for updates remain unchanged and applicable for audits. ***Auditors will need to use the 2018 and 2017 Supplements together to perform single audits of fiscal years beginning after June 30, 2017.***

Reviewers are encouraged to review [Appendix 5, List of Changes for the 2018 Supplement](#), to learn more about the types of changes made as well as the [2018 Table of Contents](#), a critical roadmap for determining how to use the 2017 and 2018 Supplements together. Additionally, a no-CPE archive of the GAQC Web event, 2018 OMB Compliance Supplement and Single Audit Update, is available to GAQC members related to this topic.

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### **Defined Benefit Pension Peer Reviewer Considerations**

This article is to help improve consistency in completing PRP §22,130 *Supplemental Checklist for Review of Audit Engagements of State and Local Governments Participating in Defined*

*Benefit Pension Plans* related to cost-sharing multi-employer plans (cost-sharing). Cost-sharing plans are those in which pension assets of more than one employer are pooled and may be used to pay the benefits of the employees of any employer that provides pensions through the plan.

#### *Audited Financial Statements of the Plan and Actuarial Report*

To support the amounts and disclosures in the financial statements related to a defined benefit pension plan, the employer auditor should obtain the audited financial statements of the pension plan and the actuarial valuation. The employer auditor's failure to obtain and document those two documents would ordinarily result in a nonconforming engagement. Neither the audited financial statements nor the actuarial report are required to be included in the audit working papers if the audit and actuarial report are publicly available **and** the working papers include a reference to where the reports may be obtained.

- Evaluate the plan auditor's competence and objectivity.
- Confirm that the auditor's report is appropriate for the employer auditor's purposes.
- Compare and recalculate amounts in the plan audit to the employer records.
- Evaluate the actuary's skills, knowledge, and experience.
- Document the reasonableness of assumptions used in the report including discount rates.
- Consider whether the actuarial valuation date of the report is appropriate for the employer auditor's purposes.

#### *Census Data*

While the omission of explicitly documenting the items below may not result in a nonconforming engagement, reviewers should educate firms via an exit conference comment at a minimum. Reviewers should ensure the employer auditor did not rely on the plan auditor's testing of census data except in rare circumstances. More commonly, the employer's allocation of the plan is so insignificant, inaccurate or incomplete census data reported to the plan would not result in a material misstatement and thus, detail testing of census data is not necessary. The employer auditor should document (and reviewer should consider) the following as it relates to census data:

- The processes and controls at the employer to provide accurate and complete census data to the plan.
- An understanding of significant elements of census data which could result in a material misstatement to the employer's financial statements, such as years of service or contributions.
- The reasonableness of amounts reported to the plan such as comparing amounts in the plan audit for the employer to the employer auditor's testing of salary expense.

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#### **Additional Resources and Tools for Reviewers and Auditors**

Below are some resources to assist reviewers in reviewing and performing engagements under *Government Auditing Standards* and Single Audits and to share with auditors, as applicable:

- [Uniform Guidance – Electronic Code of Federal Regulations \(e-CFR\) version](#)
- [GAQC 2018 Compliance Supplement Access Tool](#)
- [Uniform Guidance FAQ document \(Updated: July 2017\)](#)

- [Various additional Uniform Guidance related documents](#)
- [Federal Audit Clearinghouse](#)
- [AICPA Competency Framework Governmental Auditing](#)
- [Single Audit Certificate Program](#)
- [GAQC: Archived Web Events \(some may only be available to GAQC members\)](#)
  - The Challenges of Loans and Loan Guarantees in a Single Audit
  - Uniform Guidance Year 3: A Deeper Dive into Challenging Audit Areas
  - Single Audits: New Insights on Factors Driving Quality
  - Uniform Guidance: Challenging Compliance Areas
  - Crucial First Steps: The Schedule of Expenditures of Federal Awards and Major Program Determination
  - Commonly Asked Uniform Guidance and Yellow Book Questions
  - Avoiding Common Deficiencies in Yellow Book and Single Audits
  - 2018 OMB Compliance Supplement and Single Audit Update

Reviewers are also encouraged to visit the [GAQC Uniform Guidance Resources page](#) to access other resources relating to performing single audits under the Uniform Guidance. Also, be on the lookout for more information from GAQC on *Government Auditing Standards* and the new Yellow Book.

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