






RED BOOK
V.S.
YELLOW BOOK

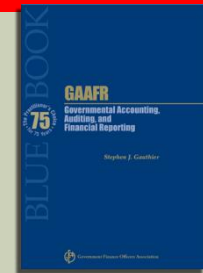
OBJECTIVES

- Overview of existing standards
- Comparison of GAGAS to IPPF
- Issues
 - Terminology
 - Ethics taken as a whole
 - Risks and audit planning
 - Quality assurance
 - Who audits the auditors? (Peer Review)
 - Reporting Compliance
 - Dirty, Rotten Scoundrels & Others (Fraud)
 - Told You So (Follow-Up Audit)
 - Smarty Pants (Competence)
- WOW

THE COLOR OF STANDARDS

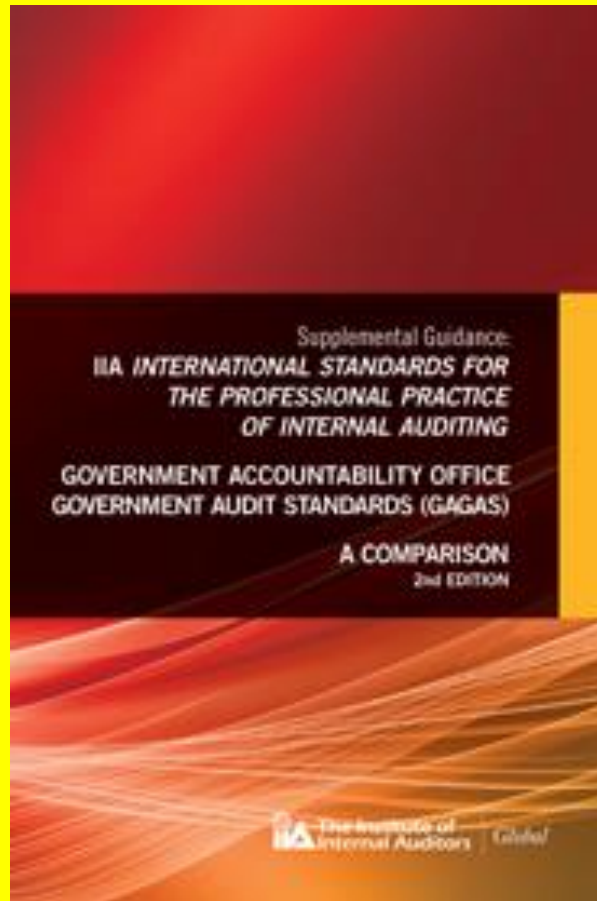
A BRIEF HISTORY

-  The BLUE BOOK – GAAFR: Governmental Accounting, Auditing, and Financial Reporting (by the GFOA)
-  The YELLOW BOOK – GAGAS: Generally Accepted Government Audit Standards (by the GAO)
-  The RED BOOK – IPPF: International Professional Practices Framework (by the IIA)
-  The GREEN BOOK - Principles and Standards for Offices of Inspector General (by the AIG)
-  The GREEN BOOK - Standards For Internal Control In The Federal Government: 2013 Exposure Draft (by the GAO)



WOW: WHICH ONE WHEN?

- When Specific Set of Standards is Mandated by Federal State or Local Law.
- When Specific Set of Standards Is Identified in the Audit Organization Charter.
- When the Majority of Audit Organization Resources are Used for on Consulting, Fraud Investigations and Other Nonaudit Services.



The IIA's
published
guide
comparing
the two
standards

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WHAT'S BETWEEN THE COVERS?

YELLOW BOOK = GAGAS

Contains 7 Chapters:

- 1) Foundation & Ethical Principles**
- 2) Standards for Use & Application of GAGAS**
- 3) General Standards**
- 4) Standards for Financial Audits**
- 5) Standards for Attestation Engagements**
- 6) Field Work Standards for Performance Audits**
- 7) Reporting Standards for Performance Audits**

Appendices of Supplemental Guidance

RED BOOK = IPPF

Comprised of Three Documents:

- 1) Definition of Internal Auditing**
- 2) Code of Ethics**
- 3) International Standards for the Professional Practice of Internal Auditing**

**Categories of Authoritative Guidance:
Practice Advisories**

Position Papers, & Practice Guides

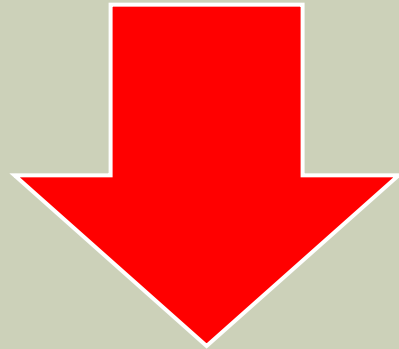
WHAT ARE THE ISSUES ?

Easy steps to
comply with
both sets of
standards...

TERMINOLOGY

**Issue
#1**

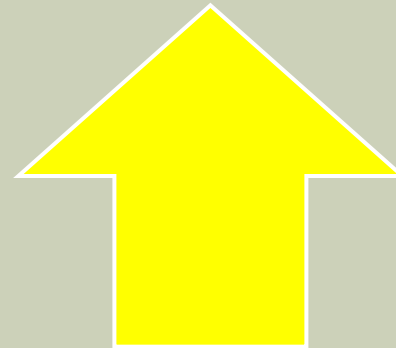
RELATIONSHIP OF COMMON TERMS



Consulting

Independence in Performance of Audit Services

**Nonaudit
Work**



THE DEFINITION OF “CONSULTING”

Red Book

- ▶ Includes “consulting” in the definition of internal auditing:

“Internal auditing is an independent, objective assurance and consulting activity designed to add value to an organization’s operations”

- ▶ Consulting Services are:

“advisory and related client services...without the internal auditor assuming management responsibility”

Yellow Book

Intertwines “consulting services” with nonaudit services and impairment of independence.

Taken from the Index:

- ▶ **consulting services** (see nonaudit services)
- ▶ **nonaudit services 2.12-2.13** independence, see “independence, nonaudit services”

THE DEFINITION OF “OBJECTIVITY”

■ Red Book

► Code of Ethics:

2. Objectivity – Internal auditors:

2.1 Shall not participate in any activity or relationship that **may impair or be presumed to impair their unbiased assessment**. This participation includes those activities or relationships that may be in conflict with the interests of the organization.

2.2 Shall not accept anything that may impair or be presumed to **impair their professional judgment**.

2.3 Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

■ Yellow Book

■ 1.19 “Objectivity includes independence of mind and appearance when providing audits, maintaining an attitude of impartiality, having intellectual honesty, and being free of conflicts of interest.

■ Maintaining objectivity includes a continuing assessment of relationships with audited entities and other stakeholders in the context of the auditors’ responsibility to the public. **The concepts of objectivity and independence are closely related. Independence impairments impact objectivity.**

THE DEFINITION OF “INDEPENDENCE”

Red Book

- May provide consulting services relating to operations for which they had previous responsibilities. (Standard 1130)
- IIA's *Practice Guide Independence and Objectivity* (October 2011) provides further guidance.

Yellow Book

- Provides conceptual framework (§§3.07-3.26).
- Removed specific references to personal, external, and organizational impairments, and overarching independence principles.
- However, the underlying concepts related to these categories have been retained.
- Identifies “Threats”.

YELLOW BOOK FRAMEWORK OF INDEPENDENCE

3.06 GAGAS's practical consideration of independence consists of four interrelated sections, providing:

- a.** a conceptual framework for making independence determinations based on facts and circumstances that are often unique to specific environments;
- b.** requirements for and guidance on independence for audit organizations that are structurally located within the entities they audit;
- c.** requirements for and guidance on independence for auditors performing nonaudit services, including indication of specific nonaudit services that always impair independence and others that would not normally impair independence; and
- d.** requirements for and guidance on documentation necessary to support adequate consideration of auditor independence.

YELLOW BOOK FRAMEWORK OF THREATS

¶3.46 Auditors may be able to provide nonaudit services in the broad areas indicated in paragraphs 3.49 through 3.58 without impairing independence if:

- (1) The nonaudit services are not expressly prohibited,
- (2) The auditor has determined that the requirements for performing nonaudit services in paragraphs 3.34 through 3.44 have been met, and
- (3) Any significant threats to independence have been eliminated or reduced to an acceptable level through the application of safeguards.

YELLOW BOOK

7 DEADLY THREATS

- 1) Management Responsibilities**
- 2) Preparing Accounting Records and Financial Statements**
- 3) Internal Audit Assistance Services Provided by External Auditors**
- 4) Internal Control Monitoring as a Nonaudit Service**
- 5) Information Technology Systems Services**
- 6) Valuation Services**
- 7) Other Nonaudit Services**

YELLOW BOOK

PROHIBITED OTHER NONAUDIT SERVICES

¶3.58 Provision of certain other nonaudit services always impairs an external auditor's independence with respect to an audited entity. These activities include:

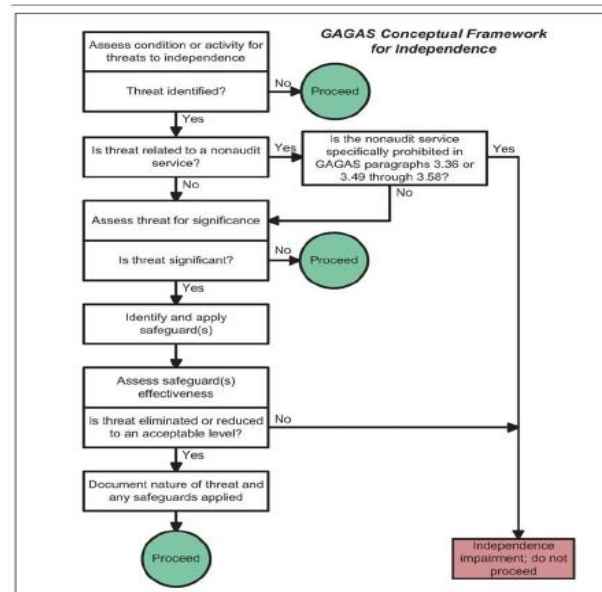
- a. Non tax disbursement**
- b. Benefit plan administration**
- c. Investment — advisory or management**
- d. Corporate finance — consulting or advisory**
- e. Executive or employee personnel matters**
- f. Business risk consulting**

YELLOW BOOK FLOW CHART FOR INDEPENDENCE

Attachment I

Appendix II

GAGAS Conceptual Framework for Independence



Source: GAO.

ALGA'S GUIDANCE FOR COMPLYING WITH GOVERNMENT AUDITING STANDARDS RELATED TO NONAUDIT SERVICES

Figure 1
Auditor as part of a three-party relationship

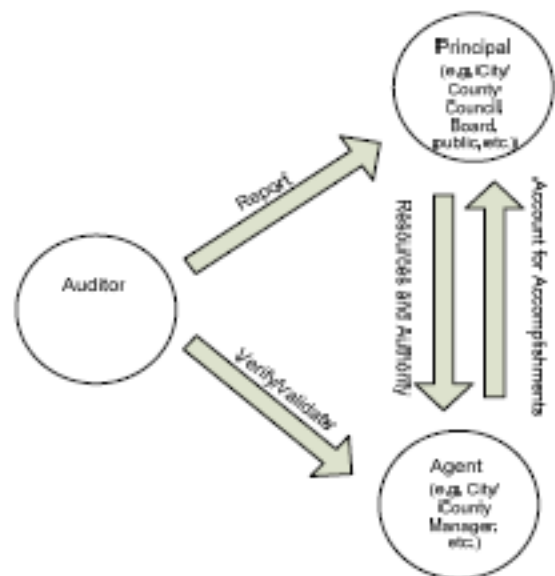


Figure 1
Auditor as part of a three-party relationship

A three-party relationship is between the principal (those charged with governance), an agent (management) to whom the principal has given responsibility for resources and authority, and an independent auditor who reports to the principal on the agent's activities. In local government, either the elected legislative body delegates resources to city/county managers, or the voters delegate resources to a chief executives, such as an elected mayor. In the case of internal auditors who are independent to report internally under GAGAS 3.31, the principal is a senior executive, elected or appointed, and the agents are the managers who report to the executive. Figure 1, adapted from *The Role of Auditing in Public Sector Governance*, illustrates these relationships.¹

Audits and attestation engagements represent a three-party relationship because the agent has more information than the principal about the use of the resources, and the principal relies on an independent auditor to provide assurance that the agent's representations are accurate or that the agent's activities are effective.

Nonaudit services that fit the three-party relationship model are those in which the auditor independently examines activities of the agent and reports to the principal. These nonaudit services would generally not pose a threat to independence, even when related to the broad areas identified in GAGAS as management responsibilities.

ALGA'S GUIDANCE FOR COMPLYING WITH GOVERNMENT AUDITING STANDARDS RELATED TO NONAUDIT SERVICES

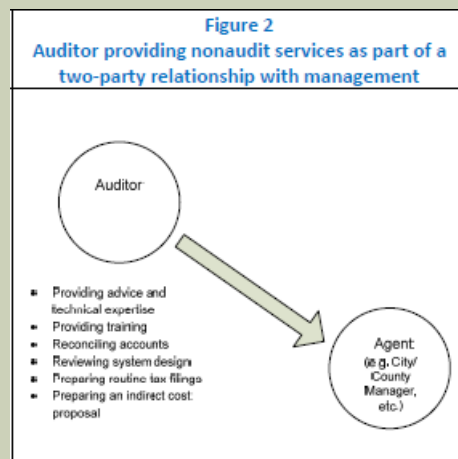


Figure 2
Auditor providing nonaudit services as part of a two-party relationship with management

Nonaudit services that represent a two-party relationship between the auditor and the agent, illustrated in figure 2, often pose both management participation and self-review threats. The severity of the threats depends on the scope and nature of the work.

GAGAS 3.40 and 3.41 list examples of routine nonaudit services to management that generally do not impair an auditor's independence because the nature of the service is limited in scope, and decisions about how to use the information clearly rest with management.

GAGAS 3.36 and 3.45-3.58 list a number of prohibited nonaudit services for which the management participation threat is too great for safeguards to reduce it to acceptable levels. These services are integral to the financial management of the entity and auditors who perform them are not independent to conduct financial audits. However, according to GAGAS 3.47, provision of these services does not necessarily impair the auditor's independence to conduct performance audits or agreed-upon procedures, depending on the subject matter of the engagement.

For other allowable nonaudit services conducted for management, safeguards required in GAGAS 3.37-3.39 would most likely apply.

ALGA'S GUIDANCE FOR COMPLYING WITH GOVERNMENT AUDITING STANDARDS RELATED TO NONAUDIT SERVICES

Figure 3

Auditor providing nonaudit services as part of a two-party relationship with the principal

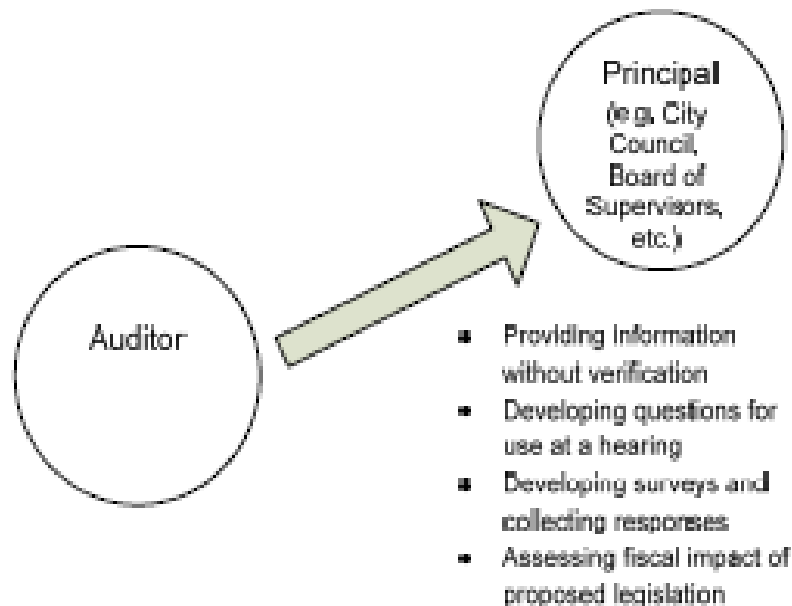


Figure 3

Auditor providing nonaudit services as part of a two-party relationship with the principal

Nonaudit services that represent a two-party relationship between the auditor and the principal, illustrated in figure 3, likely do not create a management participation threat, but could create a self-review threat for subsequent related audits. For example, an auditor who reviews contracts for propriety before they are executed may face a self-review threat if asked to audit contracting processes.

Situations could arise in which a principal loses confidence in management and requests the auditor to take over management functions. These situations would pose a management participation threat. If the services are prohibited under GAGAS, providing the service even in emergency circumstances would impair the auditor's independence to conduct financial audits.

Similarly, a constitutional or statutory provision could require a government auditor to perform a nonaudit service for which a management participation threat exists. GAGAS 3.44 applies in these cases and the auditor should disclose the nature of the threat that could not be eliminated or reduced to an acceptable level and modify the GAGAS compliance statement accordingly.

BUT WHAT ABOUT...

- **Mandated Nonaudit Services:**

GAGAS paragraph 3.44 recognizes that an auditor in a government entity may be required to perform a nonaudit service that could impair the auditor's independence with respect to a required audit. If the auditor cannot, as a consequence of constitutional or statutory requirements over which the auditor has no control, implement safeguards to reduce the resulting threat to an acceptable level, or decline to perform or terminate a nonaudit service that is incompatible with audit responsibilities, the auditor should:

- (1) Disclose the nature of the threat that could not be eliminated or reduced to an acceptable level.
- (2) Modify the GAGAS compliance statement.

ETHICS: TAKEN AS A WHOLE

**Issue
#2**

REVIEW OF ORGANIZATION'S ETHICS PROGRAM

■ Red Book

- ▶ IIA Standard 2110.A1: "...the internal audit activity must evaluate the design, implementation, and effectiveness of the organization's ethics-related objectives, programs, and activities."
- ▶ More detailed than Yellow Book requiring periodic evaluation of the organization's program taken as a whole.

■ Yellow Book

- ▶ GAGAS §1.12 Conducting audit work in accordance with ethical principles is a matter of personal and organizational responsibility. Ethical principles apply in preserving auditor independence, taking on only work that the audit organization is competent to perform, performing high-quality work, and following the applicable standards cited in the auditors' report. Integrity and objectivity are maintained when auditors perform their work and make decisions that are consistent with the broader interest of those relying on the auditors' report, including the public.
- ▶ §1.13 Other ethical requirements or codes of professional conduct may also be applicable to auditors who conduct audits in accordance with GAGAS. For example, individual auditors who are members of professional organizations or are licensed or certified professionals may also be subject to ethical requirements of those professional organizations or licensing bodies. Auditors employed by government entities may also be subject to government ethics laws and regulations.

REVIEW OF ORGANIZATION'S ETHICS PROGRAM



Suggestion:

To comply with the additional requirements of The IIA Standards, a periodic evaluation should be made of the organization's ethics program, and that evaluation should be documented through a note or memos to the file or through an audit on the subject matter

RISKS & AUDIT PLANNING

**Issue
#3**

RISK ASSESSMENT FOR OVERALL AUDIT PLANNING



The Red Book requires risk assessments and establishment of risk based plans to determine the priorities of the internal audit activity. (Standard 2010 & IIA Practice Guide Assessing the Adequacy of Risk Management – Dec 2010)



The Yellow Book Standards do not require a risk based approach to annual audit plans but focus on the planning of individual audits.

RISK ASSESSMENT FOR OVERALL AUDIT PLANNING



Suggestion:

Comply with the additional requirements of the Red Book by completing an annual plan of engagements that is based on a documented risk assessment.

QUALITY ASSURANCE

**Issue
#4**

QUALITY ASSURANCE SYSTEMS



The Red Book requires maintaining a Quality Assurance and Improvement Program (QAIP). See Standard 1300

- ▶ Internal assessments
 - On-going Monitoring of Performance
 - ▶ Periodic Self-assessments
- ▶ External assessments
- ▶ Periodic assessments
- ▶ IIA's Practice Guide Measuring Internal Audit Effectiveness and Efficiency – Dec 2010



The Yellow Book requires a Quality Assurance Program that collectively address:

- ▶ Leadership responsibilities
- ▶ Independence, legal and ethical requirements
- ▶ Initiation, acceptance, & continuance of audits
- ▶ Human resources
- ▶ Audit performance, documentation and reporting
- ▶ Monitoring of quality
- ▶ Annual assessment but specific instructions on elements and reporting
- ▶ See ¶3.82-3.107, A3.10-A3.12

QUALITY ASSURANCE SYSTEMS



Suggestion:

Audit organizations should follow Yellow Book Standards for quality assurance programs and the recommendations in the IIA Practice Advisory 1311-1

WHO AUDITS THE AUDITORS?

**Issue
#5**

EXTERNAL QUALITY ASSURANCE REVIEW (PEER REVIEW)



The Red Book requires that an external assessment must be conducted at least once every 5 years by a qualified, independent reviewer or team from outside the organization. (See Standard 1312)



The Yellow Book requires an external peer review performed by reviewers independent of the audit organization at least once every 3 years.

A copy of the peer review report must be provided to those charged with governance.

(See ¶ 3.96 & 3.105)

PEER REVIEW RESOURCES

IIA Peer Review Program:



IIA Quality Services, LLC provides the most appropriate external assessment approach to enhance conformance with Red Book Standards, either through an independent team quality assessment, self-assessment with independent validation or readiness assessment. Free quote on fees upon request.



For more information go to: www.theiia.org/Quality

PEER REVIEW RESOURCES

ALGA Peer Review Program



Peer Review Program offers Yellow Book and



Red Book Reviews and can perform both for audit organizations that comply with both set of standards.

Audit organization must be a member of ALGA and agree to volunteer at least one staff member to participate on another review team before the next review. ALGA bills for the travel expense of the team members. Team members' salary is paid by their respective employers.

For more information go to: www.algaonline.org

EXAMPLE OF PEER REVIEW REPORT FOR BOTH SETS OF STANDARDS



Association of Local Government Auditors

December 8, 2011

Sam M. McCall, City Auditor
City of Tallahassee, Office of the City Auditor
300 S. Adams Street
Mail Box A-22
Tallahassee, FL 32301

Dear Mr. McCall,

We have completed a peer review of the City of Tallahassee, Office of the City Auditor, for the period October 1, 2008, to September 30, 2011. In conducting our review, we followed the standards and guidelines contained in the *Peer Review Guide* published by the Association of Local Government Auditors (ALGA).

We reviewed the internal quality control system of your audit organization and conducted tests in order to determine if your internal quality control system operated to provide reasonable assurance of compliance with *Government Auditing Standards* issued by the Comptroller General of the United States.


Our procedures included:

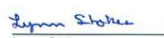
- Reviewing the audit organization's written policies and procedures.
- Reviewing internal monitoring procedures.
- Reviewing a sample of audit and attestation engagements and working papers.
- Reviewing documents related to independence, training, and development of auditing staff.
- Interviewing auditing staff, management, and members of the Audit Committee to assess their understanding of, and compliance with, relevant quality control policies and procedures.

Due to variances in individual performance and judgment, compliance does not imply adherence to standards in every case, but does imply adherence in most situations.

Based on the results of our review, it is our opinion that the City of Tallahassee, Office of the City Auditor's internal quality control system was suitably designed and operating effectively to provide reasonable assurance of compliance with *Government Auditing Standards* for audits and attestation engagements during the period October 1, 2008, to September 30, 2011.

We have prepared a separate letter offering suggestions to further strengthen your internal quality control system.


Kathy Knox
Director of Audit
Los Angeles County Metro
Transportation Authority


Lynn Stokes
Director of Internal Audit
City of Clarksville


Gary S. Chapman
Senior Auditor
City of Tampa



Association of Local Government Auditors

December 8, 2011

Sam M. McCall, City Auditor
City of Tallahassee, Office of the City Auditor
300 S. Adams Street
Mail Box A-22
Tallahassee, FL 32301


Dear Mr. McCall,


We have completed a peer review of the City of Tallahassee, Office of the City Auditor, for the period October 1, 2008, to September 30, 2011. In conducting our review, we followed the standards and guidelines contained in the *Peer Review Guide for Assessing Conformance with International Standards for the Professional Practice of Internal Auditing*, published by the Association of Local Government Auditors (ALGA).

We reviewed the internal quality control system of your audit organization and conducted tests in order to determine if your internal quality control system operated to provide reasonable assurance of conformance with the *International Standards for the Professional Practice of Internal Auditing (the Standards)* issued by the Institute of Internal Auditors as part of their *Professional Practices Framework*. Due to variances in individual performance and judgment, conformance does not imply adherence to standards in every case, but does imply adherence in most situations.

Based on the results of our review, it is our opinion that the City of Tallahassee, Office of the City Auditor, internal quality control system was suitably designed and operating effectively to provide reasonable assurance of conformance with the *Standards* for assurance and consulting engagements for the period October 1, 2008, to September 30, 2011.

We have prepared a separate letter offering suggestions to further strengthen your internal quality control system.


Kathy Knox
Director of Audit
Los Angeles County Metro
Transportation Authority


Lynn Stokes
Director of Internal Audit
City of Clarksville


Gary S. Chapman
Senior Auditor
City of Tampa

OTHER PEER REVIEW RESOURCES

Independent Certified Public Accounting Firms
(Consider the experience of the firm in providing
Internal audit peer review.)

Red Book or Yellow Book Peer Review Guides
available for download at the ALGA website with no
charge: <http://www.algaonline.org>

The IIA Bookstore has resources with discounted
member or non-member prices.

REPORTING COMPLIANCE

**Issue
#6**

REPORTING COMPLIANCE



Red Book Standards 1321 and 2430 address the use of wording that “may” be used to report the audit work was “Conducted in conformance with the International Standards for the Professional Practice of Internal Auditing”



Yellow Book ¶7.30 provides specific wording that the Report “should” use to indicate that the work was performed in accordance with GAGAS and a general description of related work.

REPORTING COMPLIANCE WITH THE STANDARDS

Suggestion:

If applicable and the audit organization has met the peer review requirements of the Yellow Book include the following clause in your reports:

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

And whether or not Yellow or Red Books, when auditors do not comply with all applicable requirements, they should disclose such by including modification to a compliance statement in the audit report.

For Yellow Book performance audits, auditors should use a statement that includes either (1) the language in 7.30, modified to indicate the requirements that were not followed or (2) language that the auditor did not follow GAGAS.170

DIRTY, ROTTEN, SCOUNDRELS & OTHERS

**Issue
#7**

FRAUD



The Red Book Standards address evaluating potential for fraud & how the organization manages fraud risk.

- ▶ **IIA Practice Guide Internal Auditing and Fraud (2009)**
- ▶ **Reporting to Senior Management and the Board.**



The Yellow Book Standards (§6.30- 6.32) address specific audit procedures including brainstorming with team members regarding fraud risks and designing additional audit procedures (tests) for any identified fraud risks.

- ▶ Include in the audit report the finding of fraud if **significant** to audit objective

FRAUD



Suggestion:

Implement Yellow Book Standards. Although both standards provide guidance in the area of fraud, GAGAS has specific guidance requiring the documentation of the consideration of fraud and developing additional audit procedures to address any identified risks. Also, GAGAS has more detailed fraud reporting requirements.

TOLD YOU SO

**Issue
#8**

FOLLOW-UP AUDITS



Red Book describes greater responsibility of the auditor to monitor and ensure management actions have been effectively implemented or that Sr. Management has accepted the risk of inaction (see: IIA Standard 2500 Monitoring Process)



Yellow Book requires consideration of the status of previous findings & recommendations in the planning of future audits.



But, doesn't directly require the auditor to monitor subsequent actions by management on the report findings. (See Appendix 1, ¶1.08)

FOLLOW-UP AUDITS


Suggestion:

Establish a process to follow-up on previous audit findings and recommendations that meet the requirement of the more detailed IIA Standards while not assuming management's responsibilities.


SMARTY PANTS

Issue
#9

COMPETENCE: CONTINUING PROFESSIONAL EDUCATION

 Red Book requires the enhancement of knowledge, skills, and other competencies through continuing education in Standard 1120.

- ▶ Does not specify the number of CPE hours required for auditors who are not certified
- ▶ Practice Advisory 1230-1 suggests that internal auditors with professional certifications are responsible for obtaining sufficient CPE to satisfy related requirements.

-  Yellow Book provides more restrictive requirements as to allowable topics and hours of education regardless of the auditor's certifications. (See ¶3.76)
- ▶ Complete, every two years, at least 24 hours of CPE that directly relates to government related topics.
 - ▶ Additional 56 hours of CPE within the 2 year period for a total of 80 hours for anyone directing, planning, or >20% of time spent on GAGAS audits.
 - ▶ No distinction between certified or non-certified staff.

COMPETENCE: CONTINUING PROFESSIONAL EDUCATION

Suggestion:

Audit organizations should follow the more detailed CPE requirements of the Yellow Book for ALL auditors and internal specialists performing work in accordance with Generally Accepted Government Auditing Standards.

WHICH ONE WHEN?
IT DOESN'T HAVE
TO BE EXCLUSIVE

**GO
ORANGE!**

RESOURCES USED IN THIS PRESENTATION

**The YELLOW BOOK – GAGAS: Generally Accepted Government Audit Standards
(by the GAO)**

**The RED BOOK – IPPF: International Professional Practices Framework (by the
IIA)**

**Supplemental Guidance: IIA *International Standards for the Professional
Practice of Internal Auditing*
Government Accountability Office Government Audit Standards (GAGAS)
A Comparison, 2nd Edition**

**Guidance for Complying with Government Auditing Standards Related to
Nonaudit Services (by the ALGA Board)**

THANK YOU!

James D. Boyd

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