

GAO

Exposure Draft

April 1998

**Government Auditing
Standards**

Meaning of "Present Fairly in
Conformity with Generally Accepted
Accounting Principles" in Reports on
Financial Statements of the Federal
Government and Its Component
Entities

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United States
General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

April 30, 1998

**TO AUDIT OFFICIALS AND OTHERS INTERESTED IN
GOVERNMENT AUDITING STANDARDS**

GAO invites your comments on the accompanying proposed change to *Government Auditing Standards* (GAGAS), commonly known as the "yellow book," adding a reporting standard for financial statement audits to define the sources of generally accepted accounting principles for the financial statements of the federal government and its component entities. 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 in order to provide more timely revision of the standards for emerging audit issues. The approach will continue the practice of exposing all revisions for public comment. 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 the addition of a new reporting standard in reports on financial statement audits on the meaning of generally accepted accounting principles (GAAP) for financial statements of the federal government and its component entities. The American Institute of Certified Public Accountants (AICPA), in issuing Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*, established an accounting hierarchy for audits of nongovernmental entities and state and local governmental entities. This hierarchy establishes criteria for auditors regarding the relative weight to give to accounting guidance from various sources as they determine the type of report they will provide after an audit (i.e., unqualified,

qualified, or adverse). This SAS was effective for audits ending after March 15, 1992. While SAS No. 69 specifically identifies GAAP for financial statements of entities other than governmental entities and for financial statements of state and local governmental entities, it does not identify the appropriate GAAP for financial statements of the federal government and its component entities. This exposure draft will address this issue for an auditor conducting an audit of financial statements of the federal government and of its component entities in accordance with the generally accepted government auditing standards by establishing the meaning of generally accepted accounting principles in reports on financial statements of the federal government and its component entities.

This exposure draft provides the revised text as it is proposed to appear in the codified standards. The revision will be effective for financial statement audits of periods ending on or after September 15, 1998.

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 July 15, 1998, to:

Government Auditing Standards Comments
FASAB Recognition Standard
U.S. General Accounting Office
Room 5089
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.



Gene L. Dodaro
Assistant Comptroller General

Proposed Change to Government Auditing Standards

5.3 The AICPA has issued statements on auditing standards (SAS) that interpret its standards of reporting.¹ This chapter incorporates these SASs and prescribes additional standards on

- a. the meaning of present fairly in conformity with generally accepted accounting principles in auditor's reports of financial statements of the federal government and its component entities (See paragraphs 5.10.1 through 5.10.12.),

[Paragraphs 5.3 a. to 5.3 d. will be renumbered when this exposure draft becomes finalized.]

THE MEANING OF "PRESENT FAIRLY IN CONFORMITY WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES" IN THE AUDITOR'S REPORT ON FINANCIAL STATEMENTS OF THE FEDERAL GOVERNMENT AND ITS COMPONENT ENTITIES

5.10.1 AICPA standards and GAGAS require the following:

The meaning of the phrase "present fairly . . . in conformity with generally accepted accounting principles" in the auditor's report is based on an established hierarchy defined for nongovernmental entities and for state and local governmental entities.

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

5.10.2 The first additional reporting standard for financial statement audits is:

For financial statements of federal governmental entities, the meaning of the phrase "present fairly . . . in conformity with generally accepted accounting principles" in the auditor's report is based on an established hierarchy defined for the federal government and its component entities.

5.10.3 The purpose of this section is to explain the meaning of the phrase "present fairly . . . in conformity with generally accepted accounting principles" in the auditor's report when the financial statements being audited are those of the federal government or one of its component entities.²

5.10.4 The phrase "generally accepted accounting principles" is a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures. Those conventions, rules, and procedures provide a standard by which to measure financial presentations.

²Certain federal government entities, such as some government corporations and government sponsored enterprises, are required by law or policy to follow generally accepted accounting principles applicable to nongovernmental entities as defined in SAS No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*. When financial information on such entities is included in general purpose financial statements of a larger federal government entity (including the consolidated statements of the federal government) the accounting principles described in the generally accepted government auditing standards should be followed. Preparers of financial statements describe in the notes to the financial statements the basis of accounting principles followed.

5.10.5 Auditors agree on the existence of a body of generally accepted accounting principles, and they are knowledgeable about these principles and in the determination of their general acceptance. Nevertheless, the determination that a particular accounting principle is generally accepted may be difficult because no single reference source exists for all such principles. The AICPA has defined the sources of established accounting principles that are generally accepted in the United States for (1) financial statements of entities other than governmental entities and (2) financial statements of state and local governmental entities.

5.10.6 Generally accepted government auditing standards define the sources of generally accepted accounting principles in reports on financial statements of the federal government and its component entities as

a. Category (a), officially established accounting principles, consists of Statements of Federal Financial Accounting Standards recommended by the Federal Accounting Standards Advisory Board (FASAB) and approved by the Director of the Office of Management and Budget (OMB), the Secretary of the Treasury, and the Comptroller General of the United States and published by OMB and GAO and Interpretations recommended by FASAB and approved by the Board members representing OMB, Treasury, and GAO and published by OMB and GAO.

b. Category (b) consists of FASAB Technical Bulletins and Accounting and Auditing Policy Committee Technical Releases, if cleared by FASAB and approved and issued by OMB and GAO, and promulgations of AICPA Committees, if made specifically applicable to the federal government and its component entities and upon recommendation by FASAB and approved by OMB and GAO.

- c. Category (c) consists of other guidance provided by OMB in Form and Content of Agency Financial Statements and by GAO in Accounting Principles and Standards.
- d. Category (d) includes other guidance provided by the FASAB staff such as implementation guides and practices or pronouncements that are widely recognized and prevalent in the federal government and its component entities.

5.10.7 In the absence of a pronouncement covered by the hierarchy described above, the auditor of financial statements of the federal government and of its component entities may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example, FASAB Statements of Federal Financial Accounting Concepts; the pronouncements of the other standard-setting bodies (Financial Accounting Standards Board (FASB) or Governmental Accounting Standards Board (GASB)) as formally recognized in the accounting hierarchy established by AICPA standards; the pronouncements of the Public Sector Committee of the International Federation of Accountants; the pronouncements of other professional associations or regulatory agencies; Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles. The appropriateness of other accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, the FASAB Concept Statements would normally be more influential than other sources in this category.

5.10.8 If the accounting treatment of a transaction or event is not specified in a pronouncement recommended by FASAB and approved by its three principals, auditors should consider whether the accounting treatment specified by

another accounting principle from one or more sources in category (b), (c), or (d) is relevant to the circumstances and should be prepared to justify a conclusion that another treatment is generally accepted. If there is a conflict between accounting principles relevant to the circumstances from one or more sources in category (b), (c), or (d), auditors should follow the treatment specified by the higher category—for example, follow category (b) treatment over category (c)—or be prepared to justify a conclusion that a treatment specified by a source in the lower category better presents the substance of the transaction in the circumstances.

- 5.10.9 The auditors' judgment concerning the "fairness" of the overall presentation of financial statements should be made within the framework of generally accepted accounting principles. Without that framework, the auditor would have no uniform standard for judging the presentation of the financial statements of the federal government and its component entities.
- 5.10.10 Generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance. Auditors should consider whether the substance of transactions or events differs materially from their form.
- 5.10.11 The auditors' opinion that financial statements are presented fairly in accordance with generally accepted accounting principles should be based on the auditors' judgment as to whether (a) the accounting principles selected and applied have general acceptance, (b) the accounting principles are appropriate in the circumstances, (c) the financial statements, including the related notes, are informative of matters that may affect the use, understanding, and interpretation of the financial statements, (d) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed, and

(e) the financial statements reflect the underlying transactions and events in a manner that presents the principal statements within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.³

³The concept of materiality is inherent in auditors' judgment. That concept involves qualitative as well as quantitative judgments.

5.10.12 GAAP Hierarchy Summary for the Federal Government and its Component Entities⁴

<i>Federal Government And Its Component Entities</i>	
<i>Established Accounting Principles</i>	
5.10.6a	Statements of Federal Financial Accounting Standards (SFFAS) recommended by FASAB and approved by its three principals, and Interpretations recommended by FASAB and approved by Board members representing the three principals.
5.10.6b	FASAB Technical Bulletins and the following pronouncements if cleared by FASAB: Accounting and Auditing Policy Committee Technical Releases issued by OMB and GAO and promulgations of AICPA Committees if specifically made applicable to the federal government and its component entities and approved by OMB and GAO.
5.10.6c	Other guidance provided by OMB in <u>Form and Content of Agency Financial Statements</u> and by GAO in <u>Accounting Principles and Standards</u> .
5.10.6d	Guidance provided by the FASAB staff such as implementation guides and practices or pronouncements that are widely recognized and prevalent in the federal government and its component entities.
<i>Other Accounting Literature⁵</i>	
5.10.7	Other accounting literature, including FASAB Concepts Statements; pronouncements of FASB or GASB recognized in the accounting hierarchy established by AICPA standards; pronouncements of the Public Sector Committee of the International Federation of Accountants; pronouncements of other professional associations or regulatory agencies; AICPA <i>Technical Practice Aids</i> ; and accounting textbooks, handbooks, and articles.

⁴Paragraph references correspond to the paragraphs of this section that describe the categories of the GAAP hierarchy.

⁵In the absence of established accounting principles, the auditor may consider other accounting literature, depending on its relevance in the circumstances.

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