

### **Government Auditing Standards**

As referenced in part in state law, the objectives of financial compliance, performance, and information system audits are formulated, defined, and conducted in accordance with industry standards. Consequently, audits conducted by the Legislative Audit Division (LAD) are obligated to and conform with several industry standards, including those established by the federal U.S. Government Accountability Office (GAO). These GAO standards are gathered in a publication entitled the Government Auditing Standards, which is more commonly known as the Yellowbook.

The concept of accountability for the use of public resources is key to our nation's governing process. The foundations and principles outlined within the Yellowbook standards are centered on the notion that governmental auditing is an essential service in providing accountability to legislators, oversight bodies, those charged with governance, and the public. The Yellowbook standards provide a framework for conducting high-quality audit work, with competence, integrity, objectivity, and independence. In turn, the audits conducted within this framework provide an independent, objective, and nonpartisan assessment of the stewardship of public resources.

### **Foundation and Principles for the Use and Application of Government Auditing Standards: Chapter 1**

The Yellowbook begins with overall guidance for implementing the standards, providing direction on concepts such as accountability, the need for government programs, the importance of transparency, and how auditing is essential for the stewardship of public resources. This chapter establishes the standards as a framework for high-quality work and indicate that the requirements apply in totality, whether required or voluntarily adopted. This chapter also outlines key terms, the format of the Yellowbook, the types of entities that use the Yellowbook, including what types of work may be conducted under the standards, such as financial audits and performance audits.

### **General Requirements for Complying with Government Auditing Standards: Chapter 2**

This chapter of the Yellowbook outlines requirements for complying with government auditing standards. It provides information on how auditors apply the requirements. Section 2.02 describes the two categories of requirements for auditors, namely unconditional requirements and presumptively mandatory requirements. The first relates to requirements which audit organizations must comply with. The second refers to requirements for which compliance is required, except in rare circumstances. This chapter of the Yellowbook also describes how the standards may intersect with other standards and how stating compliance with the Yellowbook during reporting is required.

### **Ethics, Independence, and Professional Judgement: Chapter 3**

The Yellowbook sets forth fundamental principles for auditors, including the establishment of ethical and practical frameworks for auditors working in the government environment.

#### **Ethical Principles**

Sound ethics provide the foundation, discipline, and structure for the application of the Yellowbook. Because auditing is essential to government accountability, the public expects audit organizations and auditors to follow ethical principles. Section 3.03 of the Yellowbook describes how management of an audit organizations sets the tone for ethical behavior by maintaining an ethical culture, communicating acceptable behavior and expectations to each employee, and creating an environment that reinforces and encourage ethical behavior. LAD staff are introduced to and frequently engaged in the importance of ethical behavior to our audit work, with those expectations modeled by management and clearly communicated to staff.

Common in all of this is the idea that audit work performed in accordance with ethical principles is integral to maintaining integrity and objectivity when work is conducted. The ethical principles which guide LAD staff as they conducted work in accordance with the Yellowbook include: the public interest; integrity; objectivity; proper use of government information, resources, and positions; and professional behavior.

#### **Independence**

The concept of independence is the most important aspect of the standards for an auditor and audit organization. The Yellowbook provides a practical approach to independence, with the idea that auditors and their organizations must be independent of the audited entity. Auditors and audit organizations should avoid situations that could lead reasonable and informed third parties to conclude that the auditors are not independent. Section 3.21 of the Yellowbook indicates that independence is comprised of two factors, namely:

- Independence of mind: The state of mind that permits the conduct of an audit without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.
- Independence in appearance: The absence of circumstances that would cause a reasonable and informed third party to conclude that the integrity, objectivity, or professional skepticism of an auditor or audit organization had been compromised.

The Yellowbook provides a conceptual framework for auditors to identify, evaluate, and apply practices that address any threats to independence. Sections 3.38 through 3.44 provide descriptions of these broad categories. Selected and abbreviated examples from the Yellowbook

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of circumstances than may result in a particular type of threat are as follows. These are examples of threats which are inappropriate or unsuitable intrusions which can negatively impact the credibility and integrity of audit work conducted by LAD.

- Self-Interest
  - Income from an audited entity
  - Entering into employment negotiations with an audited entity
- Self-Review
  - Reviewing systems designed by audit staff
  - Audit staff recently having been employed by an audited entity
- Bias
  - Audit staff having preconceptions about the operations of a program
  - Membership in an organization that could affect an auditor's objectivity
- Familiarity
  - Close or immediate family members who is employed with the audited entity
  - Accepting gifts or preferential treatment from the audited entity
- Undue Influence
  - External influence or interference that could improperly limit or modify the scope of work
  - External interference with the selection or application of work procedures
  - Unreasonable restrictions on the time allowed to complete work
  - External influence over staff assignments, appointments, compensation, or promotion
  - Authority to overrule or inappropriately influence auditor judgement
  - Threat of replacing the auditor or the audit organization based on a disagreement of a report's contents
  - Influences that jeopardize the auditor's employment for reasons other than incompetence or misconduct
- Management Participation
  - A member of the audit team being or having recently been a senior management of the audited entity
  - An auditor serving as a voting member of an entity's management function
  - An auditor preparing management's corrective action plan for identified deficiencies
- Structural
  - Placement of the audit function within the reporting lines of the areas under audit

Within LAD, threats to independence are evaluated both at an individual level and in the aggregate. As part of every project, audit teams sit down early on in the process to discuss these

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potential threats and how to mitigate them. If threats are identified, LAD staff discuss how to apply safeguards to eliminate or reduce those threats, with those safeguards being documented. Examples of safeguards might be having an outside party review the work or removing an auditor from the team. While this practice happens early in the audit process, it isn't an isolated or siloed mindset. If threats to independence are identified during the course of audit work such as with the assignment of new staff, LAD has an obligation to respond to and address those threats.

LAD also requires an annual independence and conflict-of-interest disclosure where staff provide information about various potential risks to independence, including whether audit staff have family members employed by a state agency, or if audit staff receive compensation from or have an ownership interest in an entity that receives payments from the state. These practices, in concert with the location of LAD within the legislative branch of government, mitigate threats to independence from staff working with other branches of government. The point of all this is that the notion of independence is a key requirement of the audit standards that LAD follows when conducting audit work. In practice, LAD management and staff engage in a robust process to continually evaluate and mitigate these risks when conducting work.

**Professional Judgement**

Section 3.109 of the Yellowbook requires auditors to use professional judgement in planning, conducting, and reporting the results of audit work. Professional judgment includes exercising reasonable care and professional skepticism. Reasonable care is defined as acting in accordance with professional standards and ethical principles. Professional skepticism is having a questioning mind, being aware of possible fraud or errors, and critically assessing evidence. It is frequently framed as a mindset where auditors are neutral as to management's intentions and consider records as genuine unless there is reason to believe the contrary. The concept of professional judgement is a collective effort within an audit organization, and includes numerous interrelated aspects such as assigning and training competent staff, defining the scope of work, evaluating results, and maintaining a quality control process.

**Competence and Continuing Professional Education: Chapter 4**

The Yellowbook also includes standards related to staff competence and requirements of continuing professional education. Competence includes being knowledgeable about audit standards and having the skills and abilities to conduct work, with continuing professional education (CPE) requirements contributing to competence.

**Competence**

Section 4.05 of the Yellowbook defines competence as the knowledge, skills, and abilities, obtained from education and experience, necessary to conduct audit work. Competence enables auditors to make sound professional judgements, including possessing the technical knowledge and skills for their assigned role. The Yellowbook further outlines indicators of competence, including how auditors may achieve the needed knowledge, skill, and abilities through prior experience, completing CPE, and obtaining relevant degrees or certifications. LAD actively considers these elements when assigning auditors to work. In addition, LAD has assigned minimum qualifications for new staff, with staff position descriptions used on an ongoing basis to evaluate performance.

**Continuing Professional Education**

Regarding CPE, auditors working under Yellowbook standards are required to develop and maintain their professional competency. Section 4.16 of the Yellowbook requires auditors complete at least 80 hours of CPE every two-year period, with 24 of those hours comprised of subject matter directly related to government auditing, and 56 of those hours comprised of subject matter to enhance auditor professional expertise. In practice, as part of staff onboarding and ongoing training, LAD provides structured opportunities for obtaining CPE. These include internally developed group trainings, conference attendance, and individually attended seminars. LAD employs a training administrator who in part identifies auditors CPE requirements, assists in locating relevant training opportunities, and monitors and documents CPE requirements.

**Quality Control and Peer Review: Chapter 5**

The Yellowbook establishes guidance for quality control and assurance activities and participating in peer review of audit organizations subject to the standards.

**Quality Control and Assurance**

Section 5.02 of the Yellowbook requires that audit organizations establish and maintain a system of quality control designed to provide reasonable assurance that the organization and its staff comply with professional standards and applicable legal and regulatory requirements. Audit organizations should document their quality policies and procedures and communicate those to their staff, including their compliance with those policies and procedures. The Yellowbook outlines several requirements for inclusion within those policies and procedures:

- Organizational leadership responsibilities for quality control, including defining that those assigned operational responsibility have sufficient and appropriate experience, ability, and authority.

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- Independence, legal, and ethical requirements, including an annual affirmation of compliance on the part of staff with independence requirements.
- Organizational direction for initialing, accepting, and continuing audit projects, in compliance with audit standards, legal requirements, and ethical principles.
- Human resource practices that ensure that auditors who are performing work have the competence to do so and meet CPE requirements.
- Practices for the ongoing performance or audit work to ensure that audit work is consistently conducted in accordance with standards, such as through the use of manuals, software tools, or other standardized practices.
- Supervision expectations to ensure audit staff have the appropriate skill levels to supervise and review the work of others.
- Monitoring requirements to assess compliance and analyze the results of quality controls process at least annually, including the identification of any systemic issues needing improvement.

In practice, the concepts of quality control are intertwined with numerous other organizational activities within LAD, many of which are outlined within LAD policy and procedure manuals, including recruiting, performance evaluations, and practices to ensure the consistency of audit work. An internal quality control process is coordinated by management, with review assignments made on an ongoing basis. The results of these reviews are compiled annually, made available to staff, and the subject of staff discussions and training opportunities. The review process is used in assessing future training needs for individual staff and the organization as a whole.

**External Peer Review**

Section 5.60 of the Yellowbook outlines the requirement that audit organizations must obtain an external peer review conducted by independent reviewers. The peer review should be sufficient in scope to provide a reasonable basis for determining whether, (1) the reviewed audit organization's system of quality control was suitably designed and (2) the organization is complying with its quality control system so that it has reasonable assurance that it is performing and reporting in conformity with professional standards and applicable legal and regulatory requirements. Audit organizations generally receive peer reviews from groups comprised of auditors from similar audit organizations also performing audits within the boundaries of government auditing standards. An audit organization should obtain an external peer review at least once every three years.

Peer review teams perform an initial assessment of risk to determine the number and types of audits to review, with a cross section of all types of work within the organization. The peer review work is designed then to test risk areas where it is possible that work is not being conducted or reported in conformity with professional standards and other requirements. A peer

review is not intended to test all work, but to review a sample of work from each of the organization's major functional areas. Any noted deficiencies are generally findings that could create a situation in which the audit organization would not have reasonable assurance of performing or reporting, in conformity with professional standards and other requirements. Audit organizations with deficiencies, respond in writing to the review, including a description of corrective actions taken to remedy those deficiencies. The results of these reviews must be made publicly available. The most recent peer review of LAD occurred in the October of 2020. The results of that review indicated that the system of quality control at LAD has been suitably designed. LAD received a peer review rating of pass.

### **Financial Audits: Chapter 6**

Financial audits of entities receiving federal assistance are required to adhere to the Yellowbook standards. In Section 6.01, the Yellowbook incorporates the American Institute of Certified Public Accountants' (AICPA) Statements on Auditing Standards into the standards applicable to financial audits. The Yellowbook includes some requirements in addition to the AICPA. Combined, these constitute the industry standards referenced in state law for financial audits. The Yellowbook does not incorporate the AICPA Code of Professional Conduct but recognizes certain CPAs may be required to use that code in conjunction with the other standards.

### **AICPA**

The AICPA is the organization responsible for promulgating standards governing professional services performed by Certified Public Accountants (CPA), including audits. Part of the AICPA's mission is, "...protecting the evolving public interest." The standards applicable to audit services provide a framework for ensuring the evolving public interest is protected. Because we complete the federal Single Audit, all financial team members are required to adhere to AICPA issued standards regardless of licensure status.

The Code of Professional Conduct defines appropriate professional and ethical behaviors for CPAs. This includes establishing a framework for navigating conflicts of interest; further defining independence considerations; and identifying acts considered discreditable to the profession, such as failure to comply with applicable standards when conducting an audit. The Board of Public Accountants (Board) requires all Montana CPAs to comply with the AICPA Code of Professional Conduct. Because the financial Deputy and Managers are required to be CPAs as a condition of employment, the Code of Professional Conduct is adhered to during the course of our audits. The Board also places additional continuing professional education requirements on Montana CPAs, including training in ethics and other technical subject matter.

### AICPA Statements on Professional Standards

Since 1972, the AICPA issued a total of 145 Statements on Auditing Standards. Some of these standards supersede or amend previously issued standards, while others establish new requirements, all in a continual effort to ensure CPAs provide high-quality, objective audit services. These individual standards are codified into a publication called the AICPA Professional Standards which are considered authoritative. Attachment A summarizes the current content of the AICPA Professional Standards.

It is our responsibility to understand the audit standards in their entirety and develop policies and procedures to ensure we comply with them. We use standardized audit programs and templates to ensure teams properly address applicable standards during their assigned audits. Certain procedures, such as establishing materiality, assessing risk, responding to risk, determining the need for professionals with specialized skills, evaluating audit evidence, and forming an opinion on financial statements involve significant professional judgment. Examples include determining the scope of contracts for actuarial services and considering the needs of individuals and organizations using financial statements for decision making purposes. In addition to the Yellowbook quality control requirements, the AICPA Professional Standards require quality control reviews of certain aspects of audits, such as significant judgments made by the audit team, significant findings or issues, and conclusions supporting the auditor's report. Each financial audit receives a quality control review completed by an Audit Manager not otherwise involved in the audit.

### AICPA Interpretive Guidance

In addition to the Professional Standards, the AICPA issues interpretive guidance which assists the auditor in applying the audit standards to specific industries or types of financial activity. We are required to consider this guidance in the conduct of our audits, and if we do not apply this guidance, are required to document how we complied with the AICPA Professional Standards addressed by the guidance. The interpretative guidance is often compiled into publications referred to as audit guides. We most frequently use the audit guides governing Single Audits and Audits of State and Local Governments in our work.

### Additional Yellowbook Requirements

Chapter 6 of the Yellowbook contains additional requirements for financial audits. Some of these requirements impact the nature of our work. Other requirements directly impact the content of our audit reports. Further discussion on financial audit standards will occur in conjunction with future Legislative Audit Committee meetings.

*Professional Standards followed by the Legislative Audit Function*Attachment A  
AICPA Professional Standards

Section	Description
AU-C 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards
AU-C 210	Terms of Engagement
AU-C 220	Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards
AU-C 230	Audit Documentation
AU-C 240	Consideration of Fraud in a Financial Statement Audit
AU-C 250	Consideration of Laws and Regulations in an Audit of Financial Statements
AU-C 260	The Auditor's Communication With Those Charged With Governance
AU-C 265	Communicating Internal Control Related Matters Identified in an Audit
AU-C 300	Planning an Audit
AU-C 315	Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement
AU-C 320	Materiality in Planning and Performing an Audit
AU-C 330	Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained
AU-C 402	Audit Considerations Relating to an Entity Using a Service Organization
AU-C 450	Evaluation of Misstatements Identified During the Audit
AU-C 500	Audit Evidence
AU-C 501	Audit Evidence—Specific Considerations for Selected Items
AU-C 505	External Confirmations
AU-C 510	Opening Balances—Initial Audit Engagements, Including Reaudit Engagements
AU-C 520	Analytical Procedures
AU-C 530	Audit Sampling
AU-C 540	Auditing Accounting Estimates and Related Disclosures
AU-C 550	Related Parties
AU-C 560	Subsequent Events and Subsequently Discovered Facts
AU-C 570	The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern
AU-C 580	Written Representations
AU-C 585	Consideration of Omitted Procedures After the Report Release Date
AU-C 600	Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)
AU-C 610	Using the Work of Internal Auditors
AU-C 620	Using the Work of an Auditor's Specialist
AU-C 700	Forming an Opinion and Reporting on Financial Statements
AU-C 701	Communicating Key Audit Matters in the Independent Auditor's Report
AU-C 703	Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA

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AU-C 705	Modifications to the Opinion in the Independent Auditor's Report
AU-C 706	Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report
AU-C 708	Consistency of Financial Statements
AU-C 720	The Auditor's Responsibilities Relating to Other Information Included in Annual Reports
AU-C 725	Supplementary Information in Relation to the Financial Statements as a Whole
AU-C 730	Required Supplementary Information
AU-C 800	Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks
AU-C 805	Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement
AU-C 806	Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements
AU-C 810	Engagements to Report on Summary Financial Statements
AU-C 905	Alert That Restricts the Use of the Auditor's Written Communication
AU-C 910	Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country
AU-C 915	Reports on Application of Requirements of an Applicable Financial Reporting Framework
AU-C 920	Letters for Underwriters and Certain Other Requesting Parties
AU-C 925	Filings With the U.S. Securities and Exchange Commission Under the Securities Act of 1933
AU-C 930	Interim Financial Information
AU-C 935	Compliance Audits
AU-C 940	An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements
AU-C 945	Auditor Involvement With Exempt Offering Documents