United States General Accounting Office

Exposure Draft

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Government Auditing Standards

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GAO

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

Accounting and Information
Management Division

July 26, 1993

TO AUDIT OFFICIALS AND OTHERS INTERESTED IN
GOVERNMENT AUDITING STANDARDS:

The U.S. General Accounting Office (GAO) invites your comments on proposed changes to the Government Auditing Standards, commonly known as the "yellow book." This letter describes the process followed in revising the standards, summarizes proposed major changes, and highlights certain issues for your specific consideration. A crosswalk between the 1988 revision and an exposure draft (ED) of the revised standards accompanies this letter. The crosswalk provides a more detailed means to identify the proposed additions and the deleted material and is fundamental to reviewing the extensive changes.

To help ensure that the standards continue to meet the needs of the audit community and the public it serves, the Comptroller General appointed the Government Auditing Standards Advisory Council 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. The council held seven open meetings from April 1991 through February 1993. The ED reflects the council's recommendations to the Comptroller General.

Major proposed changes to the financial audit standards include:

-- Require auditors to do more work on internal controls. This additional work in financial statement audits would be directed toward (1) assessing whether the control environment contributes to or diminishes the effectiveness of controls and (2) assessing audit risk associated with assets that are vulnerable to loss or misappropriation. Auditors would be required to report weaknesses in the control environment and in controls over safeguarding assets. These new requirements are intended to focus auditors' judgment in areas that are fundamental to the responsibilities of managers entrusted with taxpayers' money and where audit risk could significantly increase if controls are weak. (See exposure draft, 4.22 through 4.36.)

-- Require auditors to explain their responsibilities for testing internal controls and compliance with laws and regulations. In planning the audit, auditors would be required to explain these responsibilities to audit committees or others who oversee financial reporting. They would also be required to explain options, such as agreed-upon procedures or full-scope examination, available for expanding tests of internal controls or compliance beyond what is required in a financial statement audit. These new requirements are intended to help those who arrange for audits determine if it is necessary to arrange for an audit that provides for greater coverage of internal controls and compliance than a financial statement audit does. In reporting on financial statement audits, auditors would be required to state who is responsible for deciding if expanded control and compliance work should be done. This new requirement is intended to establish public accountability for decisions about the extent of testing of internal controls and compliance in financial audits. (See exposure draft, 4.10 and 4.11.)

-- Simplify reporting on internal controls and compliance. The ED illustrates one report format stating what the auditor did and what the auditor found that would satisfy the new requirements for reporting on internal controls and compliance with laws and regulations in financial statement audits. These new requirements would replace requirements to specify the internal control categories tested and to provide positive and negative assurance on compliance. These changes are intended to produce audit reports that more directly address significant findings. (See exposure draft, chapter 5, example 1.)

Major proposed changes to the performance audit standards include:

-- Expand the planning standard to discuss matters auditors should consider in setting audit objectives. The revised standards would emphasize the requirements to consider significance and to understand the program being audited by moving these standards from the general standards to the field work standards. It would supplement these requirements with guidance to help auditors set audit objectives that are more likely to result in reports that meet the needs of decisionmakers.

The revised standards would define significance as an issue's relative importance to audit objectives and potential users of the audit. They would remind auditors that, in determining significance, they should consider quantitative factors, as well as qualitative ones. (See exposure draft, 6.6 through 6.8.) The revised standards would explain that auditors' understanding of a program includes knowledge they already have and knowledge they gain from inquiries and observations made while planning the audit. (See exposure draft, 6.9 and 6.10.) Auditors should use their understanding of the program to be audited to help assess, among other matters, the significance of possible audit objectives and the feasibility of achieving them. (See exposure draft, 6.3 through 6.5.)

-- Recognize program evaluation methods as appropriate in performance audits. The revised standards would expand the concepts "cause" and "effect" so auditors can apply them when their objectives include estimating the effectiveness of a program in causing changes in physical, social, or economic conditions. The ED distinguishes immediate program outputs from ultimate program outcomes and notes that the need to isolate the effects of the program from those of other factors requires using methodological approaches drawn from the field of program evaluation. (See exposure draft, 6.9, 6.59, and 6.60.)

-- Distinguish controls, laws, and regulations that are relevant to a performance audit from those that are significant to the audit's objectives. The revised standards for performance audits would require auditors to understand management controls and laws and regulations that are relevant to the audit. This understanding generally would be part of the information auditors need to plan a performance audit. It includes knowledge the auditors already have and knowledge they gain from specific inquiries and observations. Auditors would be required to test control and compliance issues that are significant to the performance audit's objectives. (See exposure draft, 6.31, 6.33 through 6.39, 6.47, and 6.50 through 6.53.)

The council asked that GAO specifically seek comments on three issues:

-- Should auditors be allowed to depart from "boilerplate" language for reports on financial statement audits? The revised standards would give auditors the flexibility to depart from "boilerplate" language in audit reports. The ED presents an example of a report that departs from the standard report prescribed by the American Institute of Certified Public Accountants (AICPA) and combines the required reports on the financial statements, internal controls, and compliance. This report starts with a summary of the audit results that is written for lay readers of the report. A detailed presentation of the auditors' conclusions and the basis for them follows this summary. This alternative approach to reporting is intended to present audit results so that nonaccountants can understand them. A potential drawback of this change could be confusion among some readers who are already familiar with the AICPA's standard report.

-- Should auditors be allowed to omit references to the "yellow book" standards and to their reports on internal controls and compliance from their opinions on financial statements? The revised standards would require that any stand-alone opinions on financial statements refer to the separately issued reports on internal controls and compliance with laws and regulations, when these reports are separately issued. The standards would also expressly prohibit auditors from issuing opinions on financial statements that do not refer to Government Auditing Standards.

These proposed changes would change the current practice of doing "yellow book" financial statement audits but issuing stand-alone opinions that cite compliance with the AICPA's generally accepted auditing standards (GAAS) but not the "yellow book." This practice is inconsistent with the concept of public accountability that underlies the "yellow book" standards. It also obscures the reality that a "yellow book" audit entails more responsibilities (for example, continuing education, quality review, assessments of control environment and of safeguarding assets) than a GAAS audit. The proposed changes would help ensure that readers of financial audit reports have the opportunity to see the auditors' internal control and compliance findings. Respondents to the ED who support the current practice are asked to describe specific circumstances where omitting reference to the "yellow book" and to reports on controls and compliance serves the needs of users of auditors' reports.

-- Should the performance audit standards on management controls and compliance with laws and regulations remain separate standards, or should they be combined with the standards on planning and evidence? Like the current "yellow book," the ED includes separate performance audit standards on controls and compliance. By retaining separate standards on controls and compliance, the ED continues to emphasize their importance; merging these standards with the planning and evidence standards might imply that auditors no longer need to consider controls and compliance seriously. Alternatively, having separate standards on controls and compliance may overemphasize their importance relative to other performance audit issues, such as program goals, that have not warranted separate standards.

This ED is being sent to 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 analysis of your comments, it would be helpful, if you sent them both in writing and on diskette (in either ASCII or Wordperfect 5.1 for DOS). To ensure that your comments are considered in preparing the final revised standards, please submit them by November 15, 1993, to:

Government Auditing Standards Comments
U.S. General Accounting Office
441 G Street, NW, Room 6025
Washington, DC 20548

When finalized, this revision of the standards will supersede the 1988 revision, and become effective for audits of periods ending on or after December 31, 1994.

If you need additional information, please call Patrick McNamee at (202) 512-9525 or Marcia Buchanan at (202) 512-9321.

Sincerely yours,

Donald H. Chapin

Donald H. Chapin
Assistant Comptroller General

Attachments

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TABLE

FIGURES

ABBREVIATIONS

AICPA	American Institute of Certified Public Accountants
CPA	certified public accountant
ED	Exposure Draft of Government Auditing Standards
FASAB	Federal Accounting Standards Advisory Board
FASB	Financial Accounting Standards Board
GAAS	AICPA's generally accepted auditing standards
GAGAS	generally accepted government auditing standards
GASB	Governmental Accounting Standards Board
GAO	U.S. General Accounting Office
OMB	Office of Management and Budget
SASs	AICPA's statements on auditing standards

CROSSWALK OF PROPOSED REVISIONS TO GOVERNMENT AUDITING STANDARDS

This document is a crosswalk between the 1988 revision of Government Auditing Standards and the proposed changes in the attached exposure draft. Because the exposure draft contains extensive revisions, the crosswalk should help readily identify the proposed additions and the deleted material. The crosswalk groups the proposed changes into eight categories: (1) changes that add requirements, (2) changes that modify the existing standards, (3) changes that add guidance, (4) changes that clarify existing guidance, (5) changes that simplify the standards, (6) changes that update the standards, (7) changes that reorganize the standards, and (8) other changes. The crosswalk refers to specific paragraphs in the 1988 revision and in the exposure draft, with the chapter stated first, then the paragraph number. Thus 4.8 refers to chapter 4, paragraph 8.

CHANGES THAT ADD REQUIREMENTS TO THE STANDARDS

-- Added a requirement for audit organizations that have not met the external quality control review requirement to disclose that fact to those who are responsible for authorizing or arranging for the audit. (See exposure draft, chapter 3 footnote 7.)

-- Added a requirement that nongovernmental audit organizations give their most recent external review report to those who are responsible for authorizing or arranging for the audit when the review report discloses significant deficiencies. (See exposure draft, 3.38.)

-- Added a requirement, as part of planning the audit, for auditors to communicate certain information to individuals responsible for overseeing the financial reporting process. (See exposure draft, 4.7 and 4.10 through 4.11.)

-- Added a requirement for auditors to perform procedures directed toward assessing whether the control environment contributes to or diminishes the effectiveness of controls. (See exposure draft, 4.23 and 4.27 through 4.32.)

-- Added a requirement for auditors to perform procedures directed towards assessing the audit risk associated with assets that are vulnerable to loss or misappropriation. (See exposure draft, 4.23 and 4.33 through 4.36.)

-- Added a requirement for auditors to report who is responsible for deciding whether to supplement the financial statement audit with additional tests of internal controls or compliance and their decision. (See exposure draft, 5.10, 5.12 through 5.13, and example 2.)

-- Added a requirement for auditors to disclose the scope of testing of compliance with laws and regulations. (See exposure draft, 5.10 and 5.23.)

-- Added a requirement for auditors to disclose whether the tests of internal controls provide sufficient evidence to support an opinion on controls. (See exposure draft, 5.18.)

-- Added a requirement for auditors to disclose whether the tests of compliance provide sufficient evidence to support an opinion on compliance. (See exposure draft, 5.23.)

-- Added a requirement for auditors, when other information--including performance measures--is in documents containing audited financial statements, to read that information and report any material inconsistencies or misstatements of facts. (See exposure draft, 5.29 and 5.30.)

-- Added a requirement for auditors to keep a written record of what they communicate in an oral report and the basis for not issuing a written report. (See exposure draft, chapter 7, footnote 1.)

-- Added a requirement for auditors to report abuse in the audit report. (See exposure draft, 7.36.)

CHANGES THAT MODIFIED THE REQUIREMENTS

-- Modified the requirement which incorporates the AICPA standards as part of GAGAS. Instead, the modification incorporates for financial statement audits the AICPA's three generally accepted standards of field work and the four generally accepted standards of reporting. The modification specifies that GAGAS (1) incorporate the SASs that interpret the three standards of field work, (2) provide additional requirements for compliance auditing, and (3) require auditors to add explanatory language to their reports in certain circumstances. These changes would give auditors the flexibility to depart from the standard reports prescribed by AICPA. (See 1988 revision, 1.10, 4.1, 4.2, 5.1, and 5.2; and exposure draft, 1.11, 4.2, 4.3, 5.2, 5.3, and 5.4.)

-- Modified the requirement which discusses the independence of an individual who performs a substantial part of the accounting process or cycle and later performs the audit. Instead, the modification requires the audit organization to establish policies to reasonably ensure the independence of the auditors. (See 1988 revision, chapter 3, footnote 4; and exposure draft, chapter 3, footnote 6.)

-- Modified the requirement for government auditors to have a tracking system on the status of management's actions on significant or material findings and recommendations from prior audits. Instead, the modification adds that government auditors report, as appropriate, on the status of management's actions. It also provides an explanation for tracking past findings and recommendations. (See 1988 revision, 3.41; and exposure draft, 3.31.)

-- Modified the requirement for audit organizations to participate in an external quality control review program. Instead, the modification requires the organization to undergo an external quality control review that meets specified requirements for its conduct and report. (See 1988 revision, 3.43 and 3.48; and exposure draft, 3.32 and 3.36.)

-- Modified the requirement for audit organizations to have an external quality control review within 3 years. Instead, the modification requires the external quality control review to be completed (that is, the report issued) within 3 years of the date the audit organization does its first audit in accordance with Government Auditing Standards. (See 1988 revision, chapter 3, footnote 6; and exposure draft, chapter 3, footnote 7.)

-- Modified the requirement that auditors follow the field work and reporting standards for financial audits when performing a financial related audit. Instead, the modification requires that the standards for financial audits apply to those financial related audits that require an opinion on financial presentations. Other financial related audits should follow the applicable performance audit standards or those of AICPA, as appropriate, and the GAGAS working paper standard. (See 1988 revision, 4.2, 5.26, and 5,27; and exposure draft, 4.5, 5.40, and 5.41.)

-- Modified a requirement for auditors to test compliance with other than direct and material laws and regulations (other relevant laws and regulations) as specified in a contract, law, or regulation governing the audit. This includes performing procedures to obtain knowledge about the design of internal control structure policies and procedures for compliance with relevant laws and regulations and whether the controls are placed in operation. (See 1988 revision, 4.12; and exposure draft, 4.42 through 4.50.)

-- Modified the requirement that working papers contain sufficient information so that supplementary oral explanations are not required. Instead, the modification requires that working papers contain sufficient information to enable an experienced auditor with no previous connection with the audit to ascertain from them what work was done to support the conclusion. (See 1988 revision, 4.19, 4.22c, 6.71, and 6.72e and f; and exposure draft, 4.55 through 4.57 and 6.72.)

-- Modified the requirement that auditors use the report language prescribed by the AICPA's SASs. Instead, auditors may issue a report using language different from that prescribed in the SASs if alternative language will better meet the needs of the report users. (See exposure draft, 5.4.) Provided an example of alternative language. (See exposure draft, chapter 5, example 1.)

-- Modified the practice for auditors to issue financial statement opinions that cite compliance with the AICPA standards without reference to generally accepted government auditing standards. Instead, auditors may issue an opinion that cites both generally accepted government auditing standards and generally accepted auditing standards; however, an opinion citing generally accepted auditing standards but not generally accepted government auditing standards should not be used. (See 1988 revision, 5.3; and exposure draft, 5.7, 5.9; and chapter 5, footnote 4.)

-- Modified the requirement for auditors to report the scope of the internal control work in obtaining an understanding of the internal control structure and in assessing the control risk. Instead, the modification requires auditors to report the scope of internal control testing. (See 1988 revision, 5.17 and 5.18; and exposure draft, 5.18.)

-- Modified the requirement for auditors to report material noncompliance. Instead, the modification requires auditors to report significant instances of noncompliance and added guidance in making judgments on significance. (See 1988 revision, 5.5 and 5.7; and exposure draft, 5.19 and 5.20.)

-- Modified the requirement for auditors to report on illegal acts based on the type of audit organization in which the auditors are employed. Instead, the modification requires auditors, regardless of whether they are government auditors or public accountants, to report directly to outside parties in certain circumstances. (See 1988 revision, 5.10 through 5.16 and 7.36 through 7.42; and exposure draft, 5.24 through 5.28 and 7.35 through 7.37.)

-- Modified the recommendation that if the audit report on the financial statements is not bound with the reports on compliance and internal control, it include a reference to the other reports. Instead, the modification requires auditors to include in the auditors' report a reference to the other reports. (See 1988 revision, 5.36; and proposed revision, 5.37.)

-- Modified the requirement that written reports be prepared on all performance audits. Instead, the modification states that written reports, as a rule, should be prepared, and provides some guidance in determining whether an oral report would be sufficient. (See 1988 revision, 7.2 and 7.3; and exposure draft, 7.2, 7.3, and 7.4.)

-- Modified the requirement that the report include findings developed in response to the audit objective. Instead, the modification requires auditors to report significant findings developed in response to each audit objective. (See 1988 revision, 7.18; and exposure draft, 7.18.)

CHANGES THAT ADD GUIDANCE TO THE STANDARDS

-- Added guidance describing how auditing assists in providing accountability. (See exposure draft, 1.15f.)

-- Added guidance defining performance auditing. (See exposure draft, 2.6.)

-- Added guidance stating that an audit that addresses whether the entity has reported measures of economy and efficiency or program results that are valid and reliable as a type of performance audit. (See exposure draft, 2.8j and 2.9j.)

-- Added guidance providing examples of assignments that do not include findings, conclusions, and/or recommendations, and so, are services other than audits. (See exposure draft, 2.11.)

-- Added guidance on the need for audit organizations that audit the effectiveness of internal controls after having done consulting on the design or implementation of those controls to have policies in place to reasonably ensure the independence of their auditors. (See exposure draft, chapter 3, footnote 3.)

-- Added guidance on the need for an individual required to exercise both the controllership and auditor responsibilities to establish policies to reasonably ensure the independence of the audit function. (See exposure draft, 3.16e and chapter 3, footnote 5.)

-- Added guidance on the enhancement of internal auditors' independence when they report regularly to an audit committee and/or oversight body. (See exposure draft, 3.19.)

-- Added guidance explaining that the standards for financial audits include both financial statement audits and financial related audits. (See exposure draft, 4.1 and 5.1.)

-- Added guidance emphasizing that auditors should understand both the AICPA standards and the additional standards required by the "yellow book" to perform audits in accordance with Government Auditing Standards. (See exposure draft, 4.4.)

-- Added guidance emphasizing that auditors should follow the AICPA standard for planning. (See exposure draft, 4.6.)

-- Added guidance explaining the options for additional testing of internal controls and compliance. (See exposure draft 4.12 through 4.16.)

-- Added guidance emphasizing that AICPA standards and GAGAS require auditors to perform tests of controls if they plan to do less substantive testing. (See exposure draft, 4.22.)

-- Added guidance illustrating how the additional internal control requirements of GAGAS relate to the AICPA standards. (See exposure draft, figure 4-1.)

-- Added guidance illustrating the additional GAGAS requirements for the control environment. (See exposure draft, figure 4-2.)

-- Added guidance illustrating the additional GAGAS requirements for safeguarding of assets. (See exposure draft, figure 4-3.)

-- Added guidance explaining why, under GAGAS, additional internal control work is important. (See exposure draft, 4.25.)

-- Added guidance illustrating how the additional compliance requirements of GAGAS relate to the AICPA standards and what GAGAS requires. (See exposure draft, figure 4-4.)

-- Added guidance delineating the deficiencies to be reported as reportable conditions. (See exposure draft, 5.14.)

-- Added guidance cautioning that auditors need to exercise care not to imply a determination of legality. (See exposure draft, 5.24.)

-- Added guidance describing the field work standards for performance audits as broadly stated. (See exposure draft, 6.1.)

-- Added guidance explaining how to consider the work of auditors from another country. (See exposure draft, chapter 4, footnote 7 and chapter 6, footnote 8.)

-- Added guidance explaining that auditors' awareness of other potential report users can help auditors judge the significance of possible findings. (See exposure draft, 6.8.)

-- Added guidance defining individual elements of a program, including goals and objectives, efforts, program operations, outputs, and outcomes. (See exposure draft, 6.9.)

-- Added guidance providing examples of possible types of criteria. (See exposure draft, 6.11.)

-- Added guidance explaining some possible limitations in establishing objectives, scope, and methodology, and possible ways to overcome such limitations. (See exposure draft, 6.19.)

-- Added guidance specifying the contents of the audit plan and the importance of each item. (See exposure draft, 6.22 and 6.23.)

-- Added guidance recognizing that the nature of supervision will depend on the significance of the work or the experience of the staff doing the work. (See exposure draft, 6.28.)

-- Added guidance defining noncompliance, illegal acts, fraud, and abuse. (See exposure draft, 4.39 and 6.32.)

-- Added guidance referring auditors to the potential need to consult with lawyers in performing work on compliance. (See exposure draft, 6.36.)

-- Added guidance identifying an approach to determine if laws and regulations are significant to audit objectives. (See exposure draft, 6.37.)

-- Added guidance discussing that if auditors intend to rely on controls to reduce tests of compliance, they need to test those controls. (See exposure draft, 6.39.)

-- Added guidance discussing that the determination of abuse is subjective, and, thus, auditors are not expected to provide reasonable assurance of detecting abuse. (See 1988 revision, 4.42 and 6.43; and exposure draft, 6.42.)

-- Added guidance identifying conditions that might indicate a heightened risk of fraud. (See exposure draft, 6.46.)

-- Added guidance explaining procedures which can be used to obtain an understanding of management controls and examples of how the auditors' understanding of management controls can influence the audit plan. (See exposure draft, 6.50.)

-- Added guidance explaining that when the audit objectives include assessing validity and reliability of performance measures, management controls can be significant. (See exposure draft, 6.51b.)

-- Added guidance illustrating how the elements of a finding can vary with the objectives of the audit. (See exposure draft, table 6-1, 6.57.)

-- Added guidance defining "condition." (See exposure draft, 6.58.)

-- Added guidance defining "effect." (See exposure draft, 6.59.)

-- Added guidance explaining that when the auditors' objectives include estimating the impact of a program on changes in physical, social, or economic conditions, auditors need to obtain evidence of the extent to which the program itself is the "cause" of those changes. (See exposure draft, 6.60.)

-- Added guidance cautioning appropriate care in giving pledges of confidentiality. (See exposure draft, chapter 6, footnote 10.)

-- Added guidance explaining the purpose and usefulness of written representations. (See exposure draft, 6.63.)

-- Added guidance explaining that the auditors' approach in determining the sufficiency, relevance, and competence of evidence depends on the source of the evidence. (See exposure draft, 6.64.)

-- Added guidance explaining the methods auditors can use to gather evidence and use to determine if the data meet the tests of evidence. (See exposure draft, 6.65.)

-- Added guidance explaining steps auditors should use to determine if the data gathered by the auditee meet the tests of evidence. (See exposure draft, 6.66 through 6.68.)

-- Added guidance explaining steps auditors should use to determine if the data gathered by third parties meet the tests of evidence. (See exposure draft, 6.69 and 6.70.)

-- Added guidance referring auditors to GAO's guide titled "Assessing the Reliability of Computer-Based Data." (See exposure draft, chapter 6, footnote 13.)

-- Added guidance explaining that auditors should include objectives, scope, methodology, and results in the working papers. (See exposure draft, 6.72.)

-- Added guidance explaining the purposes of working papers. (See exposure draft, 6.73.)

-- Added guidance delineating conditions when an oral report, instead of a written report, is appropriate. (See exposure draft, 7.3.)

-- Added guidance defining "conclusion." (See exposure draft, 7.20.)

-- Added guidance explaining auditors' responsibility for indications of illegal acts. (See exposure draft, 7.33.)

-- Added guidance outlining why auditors may not pursue significant issues needing further study and consideration. (See exposure draft, 7.46.)

CHANGES THAT CLARIFIED GUIDANCE IN THE STANDARDS

-- Clarified guidance describing the applicability of Government Auditing Standards to include audits of other entities entrusted with handling public resources, such as management of a not-for-profit organization that receives federal funds. (Throughout draft.)

-- Clarified guidance describing that audit reports should be publicly available to discuss why audit report information assists in realizing governmental accountability. (See exposure draft, 1.15i.)

-- Clarified guidance explaining that others entrusted with handling public resources have the same responsibilities as public officials. (See exposure draft, 1.15.)

-- Clarified guidance discussing that as part of the procurement of audit services, a factor that should be considered is the results of the bidder's external quality control reviews. (See 1988 revision, 1.17; and exposure draft, 1.18.)

-- Clarified guidance on the purpose of a financial statement audit. (See 1988 revision, 2.3a; and exposure draft, 2.4a.)

-- Clarified guidance describing examples of financial related audits. (See 1988 revision, 2.4; and exposure draft, 2.5.)

-- Clarified guidance on auditors' qualifications to include knowledge of the specific or unique environment in which the audited entity operates. (See 1988 revision, 3.4; and exposure draft, 3.4.)

-- Clarified guidance discussing the effective date of the CPE requirements to reference the CPE Interpretation. (See 1988 revision, chapter 3, footnote 1; and exposure draft, chapter 3, footnote 1.)

-- Clarified guidance referring to the AICPA code of professional conduct. (See 1988 revision, 3.15; and exposure draft, 3.15.)

-- Clarified guidance explaining that the purpose of the external quality control review is to determine that the organization's internal quality control system is in place and operating effectively to provide reasonable assurance that the established policies and procedures and applicable audit standards are being followed in the organization's audit work. (See 1988 revision, 3.46; and exposure draft, 3.35.)

-- Clarified guidance explaining if an audit organization performs only a few audits (instead of a few government audits) it is acceptable to place primary emphasis on a review of the quality of those audits rather than the internal quality control policies and procedures. (See 1988 revision, 3.46; and exposure draft, 3.37.)

-- Clarified guidance explaining that the AICPA SASs that interpret the three standards of field work and provide additional requirements for compliance auditing are incorporated for financial statement audits conducted under Government Auditing Standards. (See 1988 revision, 4.1; and exposure draft, 4.3.)

-- Clarified guidance describing that the standards prescribed by Government Auditing Standards are in addition to instead of supplementing the AICPA standards. (See 1988 revision, 4.1 and 5.1; and exposure draft, 4.3 and 5.5.)

-- Clarified guidance explaining that auditors, in choosing and conducting auditing tests, are responsible for obtaining sufficient, competent, and relevant evidence which will provide a reasonable basis for their opinion on the financial statements. (See 1988 revision, 4.3; and exposure draft, 4.8.)

-- Clarified guidance specifying which are the relevant internal control objectives in a financial statement audit under GAGAS. (See 1988 revision, 4.24 through 4.26; and exposure draft, 4.24.)

-- Clarified guidance explaining what auditors should do when information comes to the auditors' attention that suggests indications of noncompliance. (See 1988 revision, 4.13; and exposure draft, 4.50.)

-- Clarified guidance cautioning exercise of due care when auditors identify instances of noncompliance. (See 1988 revision, 4.15 through 4.18; and exposure draft, 4.51 through 4.54.)

-- Clarified guidance explaining that the AICPA SASs that interpret the four standards of reporting and require auditors to add explanatory language to their reports in certain circumstances are incorporated for financial statement audits conducted under Government Auditing Standards. (See 1988 revision, 5.1; and exposure draft, 5.3.)

-- Clarified guidance explaining that auditors may issue a combined report containing the auditor's opinion, report on internal controls, and report on compliance with laws and regulations. (See 1988 revision, 5.5 and 5.17; and exposure draft, 5.10 and 5.11.)

-- Clarified guidance requiring that auditors identify those reportable conditions which are material weaknesses so as to include those which are individually or cumulatively material. (See 1988 revision, 5.23; and exposure draft, 5.16.)

-- Clarified guidance explaining that the report should reference privileged and confidential information not included. (See 1988 revision, 5.28 and 5.31; and exposure draft, 5.31 and 5.34.)

-- Clarified guidance explaining that planning a performance audit requires auditors to define the audit's objectives, scope, and methodology. (See 1988 revision, 6.9, 6.10 through 6.14; and exposure draft, 6.3 through 6.5.)

-- Clarified guidance explaining consideration of the work of internal auditors. (See exposure draft, 6.15.)

-- Clarified guidance on providing assistance to auditors in developing audit objectives. (See 1988 revision 2.6; and exposure draft 6.10.)

-- Clarified guidance on supervision by deleting the reference that the supervisor may have to perform many details and by including necessary on-the-job training as one of the purposes of supervision. (See 1988 revision, 6.26 and 6.28; and exposure draft 6.27 and 6.29.)

-- Clarified guidance explaining that in planning the audit, auditors need to obtain an understanding of relevant laws and regulations. (See 1988 revision, 6.34 through 6.36; and exposure draft, 6.31 through 6.34.)

-- Clarified guidance explaining that auditors should design the audit to provide reasonable assurance about compliance with laws and regulations that are significant to audit objectives. (See 1988 revision, 6.37 through 6.39; and exposure draft, 6.35.)

-- Clarified guidance explaining the auditors' responsibility for following-up on possible illegal acts and abuse. (See 1988 revisions, 6.40 and 6.41; and exposure draft, 6.40 and 6.41.)

-- Clarified guidance explaining that in planning the audit, auditors need to obtain an understanding of management controls that are relevant to the audit. (See 1988 revision, 6.49; and exposure draft, 6.47.)

-- Clarified guidance classifying management controls to help auditors obtain an understanding of management controls and determine their significance to the audit objectives. (See 1988 revision, 6.51, 6.53 and 6.54; and exposure draft, 6.49.)

-- Clarified guidance discussing the auditors' responsibility for "internal controls" by changing the term to "management controls." (See 1988 revision, 6.49 through 6.56; and exposure draft, 6.47 through 6.53.)

-- Clarified guidance on the tests of evidence, which assist auditors in judging the evidence obtained. (See 1988 revision, 6.59; and exposure draft, 6.56.)

-- Clarified guidance defining "cause" to include two meanings which can be used in a performance audit depending on the audit objectives. (See 1988 revision, 7.22 through 7.24; and exposure draft, 6.60.)

-- Clarified guidance discussing the purpose of performance audit reporting to indicate that the reporting standards may apply to some financial related audits. (See 1988 revision, 7.1; and exposure draft, 7.1.)

-- Clarified guidance explaining that auditors should disclose significant constraints which data limitations or scope impairments impose on the audit approach. (See 1988 revision, 7.14; and exposure draft, 7.14.)

-- Clarified guidance by deleting reliance on controls as a scope limitation. (See 1988 revision, 7.16; and exposure draft, 7.16.)

-- Clarified guidance on the elements that are needed for a finding. (See 1988 revision, 7.19; and exposure draft, 7.19.)

-- Clarified guidance on when including recommendations in the report is appropriate. (See 1988 revision, 7.21 and 7.25; and exposure draft, 7.22 and 7.23.)

-- Clarified guidance explaining that auditors should identify the scope of their work in assessing management controls. (See 1988 revision, 7.29 through 7.32; and exposure draft, 7.26 through 7.29.)

-- Clarified guidance explaining what should be reported on compliance with laws and regulations. (See 1988 revision, 7.33 through 7.34; and exposure draft, 7.30 through 7.37.)

-- Clarified guidance explaining that the report should disclose, when appropriate, other issues warranting further study. (See 1988 revision, 7.51; and exposure draft, 7.46.)

-- Clarified guidance explaining that reports should be sufficient to enable readers to see the benefit of implementing the recommendations. (See 1988 revision, 7.64; and exposure draft, 7.59.)

CHANGES THAT SIMPLIFY THE STANDARDS

-- Simplified guidance on the basic premises that underlie the standards by deleting that audits of financial assistance programs should be designed to satisfy common accountability interest of each contributing government. (See 1988 revision, 1.15h and i.)

-- Simplified the requirement that planning includes consideration of the audit requirements of all levels of government by deleting this requirement. (See 1988 revision, 4.4 through 4.5.)

-- Simplified guidance discussing internal control policies and procedures that are not relevant to an audit and therefore need not be considered. (See 1988 revision, 4.25 and 4.26.)

-- Simplified guidance on working papers by deleting certain specific requirements. (See 1988 revision, 4.22 a, d, and e, and 6.72 a, b, c, g, and h.)

-- Simplified the requirements for reporting on compliance with laws and regulations by not requiring a statement of positive and negative assurance. (See 1988 revision, 5.5 and 5.6.)

-- Simplified guidance on when the GAGAS citation needs to be qualified. (See 1988 revision, 5.4; and exposure draft, 5.8.)

-- Simplified the requirements for reporting on internal controls by not requiring a list of the classification of the internal control structure. (See 1988 revision, 5.17, 5.21, and 5.22.)

-- Simplified guidance detailing the contents of the audit program to delete requiring a definition of terms. (See 1988 revision, 6.23e.)

-- Simplified guidance on the auditors' responsibility for determining the validity and reliability of data from computer-based systems. (See 1988 revision, 6.62 and 6.63; and exposure draft, 6.71.)

-- Simplified guidance discussing review of general and application controls and testing for data reliability. (See 1988 revision, 6.64 through 6.70; and exposure draft, chapter 6, footnote 13.)

-- Simplified guidance defining terms used in Government Auditing Standards by including the pertinent definitions in the chapters. (See 1988 revision, glossary; and throughout exposure draft.)

CHANGES THAT UPDATE THE STANDARDS

-- Updated the applicability of Government Auditing Standards to include auditors auditing federal departments and agencies under the Chief Financial Officers Act of 1990. (See exposure draft, 1.4 and chapter 1, footnote 3.)

-- Updated the applicability of Government Auditing Standards to cite the current federal policies and regulations requiring audits of state and local governments and nonprofit institutions. (See exposure draft, 1.6, and chapter 1, footnotes 4 and 5.)

-- Updated the types of financial statements issued by organizations under current generally accepted accounting standards to delete reference to statement of changes in financial position. (See 1988 revision, 1.9; and exposure draft, 1.10.)

-- Updated the reference to groups which set accounting principles to include the sponsors of the Federal Accounting Standards

Advisory Board. (See 1988 revision, chapter 2, footnote 1; and exposure draft, chapter 2, footnote 1.)

CHANGES THAT REORGANIZED THE STANDARDS

-- Moved to chapter 1 the discussion of the importance of understanding the audit objectives and scope. (See 1988 revision, 2.11; and exposure draft, 1.15f.)

-- Moved to the beginning of chapter 2 the discussion that audits may have a combination of financial and performance audit objectives, or may have objectives limited to only some aspects of one audit type. (See 1988 revision, 2.12; and exposure draft, 2.3.)

-- Moved to chapters 4 and 5 the discussion explaining what standards are applicable to financial statement and financial related audits. (See 1988 revision, 2.5; and exposure draft, 4.6, 5.40, and 5.41.)

-- Moved to chapters 6 and 7 the explanation of what standards are applicable to performance audits. (See 1988 revision, 2.10; and exposure draft, 6.1 and 7.1.)

-- Moved to chapter 1 the discussion explaining the applicability of AICPA standards. (See 1988 revision, 3.2; and exposure draft, 1.11.)

-- Moved to chapter 6 the discussion on determining scope, methodology, and extent of tests and procedures. (See 1988 revision, 3.28; and exposure draft, 6.3, 6.4, 6.5, 6.18, 6.19, and 6.50.)

-- Moved to chapter 6 the explanation of the elements associated with the quality of audit work and related reports. (See 1988 revision, 3.29; and exposure draft, 6.3, 6.4, and 6.54 through 6.74.)

-- Moved to chapter 6 the discussion on the need for sufficient awareness of the body of technical knowledge to select the appropriate methodology, tests, and procedures. (See 1988 revision, 3.30; and exposure draft, 6.3.)

-- Moved to chapter 6 the discussion explaining the need to obtain a mutual understanding of the audit objectives. (See 1988 revision, 3.31; and exposure draft, 6.6 to 6.8.)

-- Moved to chapter 6 the discussion explaining the need for definitive criteria. (See 1988 revision, 3.31; and exposure draft, 6.12.)

-- Moved to chapters 4 and 6 the discussion explaining that in audits under GAGAS, materiality and significance should be considered in the context of providing public accountability and the needs of potential audit report users. (See 1988 revision, 3.33 to 3.34; and exposure draft, 4.7, 4.19, 6.4, and 6.6 through 6.8.)

-- Moved to chapters 4 and 6 the discussion requiring following-up on known material or significant findings and recommendations. (See 1988 revision, 3.41; and exposure draft, 4.7, 4.9, and 6.4f.)

-- Moved to chapters 4 and 6 the discussion requiring auditors to determine whether other auditors or specialists complied with GAGAS before relying on their work. (See 1988 revision, 1.15j, and 3.35 to 3.40; and exposure draft, 4.7, 4.20, 4.21, chapter 4, footnote 7, and 6.13 through 6.17.)

-- Moved to chapters 4 and 6 the discussion explaining audit scope impairments. (See 1988 revision, 3.42; and exposure draft, 4.3 and 6.19.)

-- Moved to chapter 5 the discussion explaining that in judging which internal control deficiencies should be included as reportable conditions, auditors should report control deficiencies that would be important to report users. (See 1988 revision, 3.33; and exposure draft, 5.15.)

-- Moved to chapter 6 the discussion explaining that auditors should attempt to meet the needs of report users. (See 1988 revision, 3.17; and exposure draft, 6.7.)

-- Moved to chapter 6 the discussion explaining the importance of understanding the program. (See 1988 revision, 3.31 and 6.7; and exposure draft, 6.4 and 6.9.)

-- Moved within chapter 4 the discussion specifying the auditors' responsibility for compliance with laws and regulations by separating this responsibility from the planning standard and creating a standard on compliance with laws and regulations. (See 1988 revision, 4.6 through 4.18; and exposure draft, 4.37 through 4.53.)

-- Moved the discussion explaining auditors' responsibility for compliance with laws and regulations by including it in one standard covering the auditors' responsibilities from planning through completion of field work. (See 1988 revision, 6.8c, 6.30, 6.42, and 6.45; and exposure draft, 6.31.)

-- Moved to chapter 6 the definition of "cause." (See 1988 revision, 7.21 through 7.24; and exposure draft, 6.60.)

-- Moved to chapters 4 and 6 the requirement that working papers be available on request. (See 1988 revision, 3.39; and exposure draft, 4.58 and 6.74.)

OTHER CHANGES

-- Deleted guidance discussing value-for-money audits as a type of performance audits. (See 1988 revision, chapter 2, footnote 4.)

-- Deleted guidance on scope impairments, including those circumstances when auditors need to withdraw from, or defer further work on, the audit or a portion of the audit in order not to interfere with an investigation. (See 1988 revision, 4.16 and 6.46.)

-- Deleted guidance on when auditors can limit consideration of the internal control structure. (See 1988 revision, 5.19.)

-- Deleted guidance referring to a publication no longer available on audit survey. (See 1988 revision, chapter 6, footnote 1.)

-- Deleted guidance on coordination within an audit office. (See 1988 revision, 6.16 through 6.18.)

-- Deleted Appendix A, "Summary of Statement on Government Auditing Standards." (See 1988 revision, Appendix A.)

-- Deleted Appendix B, "Overview of Standards." (See 1988 revision, Appendix B.)

CHAPTER 1

INTRODUCTION

PURPOSE

1. This statement contains standards for audits of government organizations, programs, activities, and functions, and of government funds received by contractors, nonprofit organizations, and other nongovernment organizations. The standards are to be followed by auditors and audit organizations when required by law, regulation, agreement, contract, or policy. The standards pertain to auditors' professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports.

APPLICABILITY

2. Federal legislation requires that the federal inspectors general comply with the Comptroller General's audit standards for audits of federal organizations, programs, activities, and functions. The legislation further states that the inspectors general are to ensure that when nonfederal auditors audit federal organizations, programs, activities, and functions they comply with these standards.[1]

3. Other federal auditors must also follow these standards. The Office of Management and Budget (OMB) included these standards in OMB Circular A-73[2] as basic audit criteria for federal executive departments and agencies.

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[1]The Inspector General Act of 1978, as amended, 5 U.S.C. App. (1982).

[2]Section 6 of OMB Circular A-73, "Audit of Federal Operations and Programs."

4. The Chief Financial Officers Act of 1990 requires that these standards be followed by auditors auditing federal departments and agencies.[3]

5. The Single Audit Act of 1984 requires that these standards be followed by auditors auditing state and local governments which receive federal financial assistance.[4]

6. Other federal policies and regulations, such as OMB Circular A-133, require that these standards be followed in audits of institutions of higher education and other nonprofit organizations.[5]

7. Auditors conducting government audits under agreements or contracts also may be required to comply with these audit standards under the terms of the agreement or contract.

8. The audit standards in this document are generally relevant to and recommended for use by state and local government auditors and public accountants in audits of state and local government organizations, programs, activities, and functions. Several

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[3]The Chief Financial Officers Act of 1990 (Public Law 101-576) and OMB Bulletin 93-06, "Audit Requirements for Federal Financial Statements." The act and bulletin require that audits of these entities be made in accordance with these standards.

[4]The Single Audit Act of 1984 (31 U.S.C. 7501-7507) and OMB Circular A-128, "Audits of State and Local Governments." The act and circular establish audit requirements for state and local governments and Indian tribal governments that receive federal financial assistance and require that audits of these entities be made in accordance with these standards. The act also includes specific audit requirements that exceed the minimum audit requirements set forth in these standards, mainly in the areas of internal controls and compliance with laws and regulations.

[5]OMB Circular A-133, "Audits of Institutions of Higher Education and Other Nonprofit Institutions."

state and local audit organizations, as well as several nations, have officially adopted these standards.

9. The Institute of Internal Auditors and the American Evaluation Association (formerly the Evaluation Research Society) have issued related standards.[6]

RELATIONSHIP TO AICPA STANDARDS

10. AICPA has issued standards that are applicable to and generally accepted for audits conducted to express opinions on the fairness with which an organization's financial statements present the financial position, results of operations, and cash flows.

11. For financial statement audits, generally accepted government auditing standards (GAGAS) incorporate the AICPA three generally accepted standards of field work and the four generally accepted standards of reporting. AICPA has issued statements on auditing standards (SAS) that interpret the three standards of field work and provide additional requirements for compliance auditing. GAGAS incorporates these SASs and prescribes additional standards needed to satisfy the unique needs of government financial statement audits. AICPA also has issued SASs that interpret the four standards of reporting and require auditors to add explanatory language to their reports in certain circumstances. In reporting, auditors are required to satisfy the four generally accepted standards of reporting and to include any explanatory language required by the SASs. As additional statements on auditing standards are issued by AICPA, they will be adopted

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[6] Standards for the Professional Practice of Internal Auditing, The Institute of Internal Auditors, Inc., copyright 1978; and New Directions for Program Evaluation: Standards for Evaluation Practice, no. 15. San Francisco: Jossey-Bass, September 1982.

and incorporated into these standards unless GAO excludes them by formal announcement.

ACCOUNTABILITY

12. Our system of managing public programs today rests on an elaborate structure of relationships among all levels of government. Officials and employees who manage these programs must render a full account of their activities to the public. While not always specified by law, this accountability concept is inherent in the governing processes of this nation.

13. The requirement for accountability has caused a demand for more information about government programs and services. Public officials, legislators, and citizens want and need to know whether government funds are handled properly and in compliance with laws and regulations. They also want and need to know whether government organizations, programs, and services are achieving their purposes and whether these organizations, programs, and services are operating economically and efficiently.

14. This statement provides auditing standards to help ensure full accountability and assist government officials and employees in carrying out their responsibilities. The audit standards are more than the codification of current practices. They include concepts and audit areas that are still evolving and are vital to the accountability objectives sought in auditing governments and their programs and services.

BASIC PREMISES

15. The following premises underlie these standards and were considered in their development.

a. The term "audit" includes both financial and performance audits as described in this statement.

b. Public officials and others entrusted with handling public resources (for example, managers of a not-for-profit organization that receives federal funds) are responsible for applying those resources efficiently, economically, and effectively to achieve the purposes for which the resources were furnished. This responsibility applies to all resources, whether entrusted to public officials or others by their own constituencies or by other levels of government.

c. Public officials and others entrusted with public resources are responsible for complying with applicable laws and regulations. That responsibility encompasses identifying the requirements with which the entity and the official must comply and implementing systems designed to achieve that compliance.

d. Public officials and others entrusted with public resources are responsible for establishing and maintaining an effective control system to ensure that appropriate goals and objectives are met; resources are safeguarded; laws and regulations are followed; and reliable data are obtained, maintained, and fairly disclosed.

e. Public officials and others entrusted with public resources are accountable both to the public and to other levels and branches of government for the resources provided to carry out government programs and services. Consequently they should provide appropriate reports to those to whom they are accountable.

f. Independent audit of government reporting is an essential element of control and accountability. Auditing provides credibility to the information reported by or obtained from management through objectively obtaining and evaluating evidence. The importance and comprehensive nature of government auditing places a special responsibility on government officials or others entrusted with public resources who authorize or arrange government audits. This is the responsibility for providing audit coverage that is broad enough to help fulfill the reasonable needs of potential users of the audit report. Auditors can assist government officials and others in understanding the auditors' responsibilities under generally accepted government auditing standards and other audit coverage required by law or regulation. This comprehensive nature of auditing also highlights the importance of auditors clearly understanding the audit objectives, the scope of the work to be conducted, and the reporting requirements.

g. Financial auditing contributes to providing accountability since it provides an independent opinion on whether an entity's financial statements present fairly the results of financial operations and whether other financial information is presented in conformity with established or stated criteria.

h. Performance auditing contributes to providing accountability because it provides an independent view on the extent to which government officials are faithfully, efficiently, and effectively carrying out their responsibilities.

i. To realize governmental accountability, the citizens, their elected representatives, and program managers need information to assess the integrity, performance, and stewardship of the government's activities. Thus, unless legal restrictions or ethical considerations prevent it, audit reports should be available to the public and to other levels of government that have supplied resources.[7]

16. GAO has established a formal system for issuing government auditing standards and related interpretations and guidance to the audit community.

AUDITORS' RESPONSIBILITY

17. The comprehensive nature of government auditing places on the audit organization the responsibility for ensuring (a) that the audit is conducted by personnel who collectively have the necessary skills, (b) that independence is maintained, (c) that applicable standards are followed in conducting audits, (d) that the organization has an appropriate internal quality control system in place, and (e) that the organization undergo an external quality control review.

PROCUREMENT OF AUDIT SERVICES

18. While not an audit standard, it is important that a sound procurement practice be followed when contracting for audit services. Sound contract award and approval procedures, including the monitoring of contract performance, should be in place. The objectives and scope of the audit should be made clear. In addition to price, other factors to be considered include the responsiveness of the bidder to the request for proposal; the experience of the bidder; availability of bidder staff with professional qualifications and technical

[7]The Single Audit Act (31 U.S.C. 7502(f)) requires that the report on single audits be made available for public inspection.

abilities; and the results of the bidder's external quality control reviews.[8]

[8]See How to Avoid a Substandard Audit: Suggestions for Procuring an Audit, National Intergovernmental Audit Forum, May 1988.

CHAPTER 2

TYPES OF GOVERNMENT AUDITS

PURPOSE

1. This chapter describes the types of audits that government and nongovernment audit organizations conduct and that organizations arrange to have conducted, of government organizations, programs, activities, functions, and funds. This description is not intended to limit or require the types of audits that may be conducted or arranged. In conducting these types of audits, auditors should follow the applicable standards included and incorporated in the chapters which follow.

2. All audits begin with objectives and those objectives determine the type of audit to be conducted and the audit standards to be followed. The types of government audits, as defined by their objectives, are classified in this statement as financial audits or performance audits.

3. Audits may have a combination of financial and performance audit objectives, or may have objectives limited to only some aspects of one audit type. For example, auditors conduct audits of government contracts and grants with private sector organizations, as well as government and nonprofit organizations, that often include both financial and performance objectives. These are commonly referred to as "contract audits" or "grant audits." Other examples of such audits include specific audits of internal controls, compliance, and computer-based systems. Auditors should follow the standards in this statement that are applicable to the individual objectives of the audit.

FINANCIAL AUDITS

4. Financial audits include financial statement and financial related audits.

   a. Financial statement audits provide reasonable assurance about whether the financial statements of an audited entity present fairly the financial position, results of operations, and cash flows in accordance with generally accepted accounting principles.[1] As an integral part of performing a financial statement audit under GAGAS, auditors obtain a sufficient understanding of the entity's internal control structure to plan the nature, timing, and extent of tests to be performed; assess the control risk associated with the control environment; and assess the control risk associated with control procedures for safeguarding assets that the auditors conclude are vulnerable to loss or misappropriation. Auditors, in performing a financial statement audit under GAGAS, also design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. They also test compliance with other relevant laws and regulations.

[1]Three authoritative bodies for generally accepted accounting principles are the Governmental Accounting Standards Board (GASB), the Financial Accounting Standards Board (FASB), and the sponsors of the Federal Accounting Standards Advisory Board (FASAB). GASB establishes accounting principles and financial reporting standards for state and local government entities. FASB establishes accounting principles for nongovernment entities. The sponsors of FASAB--the Secretary of Treasury, the Director of the Office of Management and Budget, and the Comptroller General--jointly establish accounting principles and financial reporting standards for the federal government, based on recommendations from FASAB. Some state and local governments and regulatory bodies also have established specific accounting principles.

b. Financial related audits include determining whether (1) financial information is presented in accordance with established or stated criteria, (2) the entity has adhered to specific financial compliance requirements, and (3) the entity's internal control structure or specific areas of risk over financial reporting are suitably designed and implemented to achieve the control objectives.[2]

5. Financial related audits may include audits of the following items:[3]

   a. Segments of financial statements, financial information (for example, statement of revenue and expenses, statement of cash receipts and disbursements, statement of fixed assets), and reports and schedules of financial matters, such as expenditures for specific programs or services, budget requests, and variances between estimated and actual financial performance.

   b. Contracts (for example, bid proposals, contract pricing, amounts billed, amounts due on termination claims, compliance with contract terms).

   c. Grants.

   d. Internal control systems and structure over accounting, financial reporting, and transaction processing and over other financial systems, such as payroll systems, including those using computer-based systems.

   e. Fraud and other noncompliance with laws and regulations.

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[2]The AICPA Statement on Standards for Attestation Engagements may apply to some financial related audits.

[3]Performance audits may also be conducted on these subjects.

PERFORMANCE AUDITS

6. A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of an existing or proposed government organization, program, or activity in order to provide useful information to improve public accountability and decision-making.

7. Performance audits include economy and efficiency and program audits.

   a. Economy and efficiency audits include determining (1) whether the entity is acquiring, protecting, and using its resources (such as personnel, property, and space) economically and efficiently, (2) the causes of inefficiencies or uneconomical practices, and (3) whether the entity has complied with laws and regulations on matters of economy and efficiency.

   b. Program audits include determining (1) the extent to which the desired results or benefits established by the legislature or other authorizing body are being achieved, (2) the effectiveness of organizations, programs, activities, or functions, and (3) whether the entity has complied with significant laws and regulations applicable to the program.

8. Economy and efficiency audits may, for example, consider whether the entity

   a. is following sound procurement practices;

   b. is acquiring the appropriate type, quality, and amount of resources at the lowest cost;

c. is properly protecting and maintaining its resources;

d. is avoiding duplication of effort by employees and work that serves little or no purpose;

e. is avoiding idleness and overstaffing;

f. is using efficient operating procedures;

g. is using the minimum amount of resources (staff, equipment, and facilities) in producing or delivering the appropriate quantity and quality of goods or services promptly;

h. is complying with requirements of laws and regulations that could significantly affect the acquisition, protection, and use of the entity's resources;

i. has an adequate management control system for measuring, reporting, and monitoring performance on economy and efficiency; and

j. has reported measures of economy and efficiency that are valid and reliable.

9. Program audits[4] may, for example

a. assess whether the objectives of a proposed, new, or ongoing program are proper, suitable, or relevant;

b. determine the extent to which a program achieves a desired level of program results;

[4]These audits may apply to services, activities, and functions as well as programs.

c. assess the effectiveness of the program and/or of individual program components;

d. identify factors inhibiting satisfactory performance;

e. determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost;

f. determine whether the program complements, duplicates, overlaps, or conflicts with other related programs;

g. identify ways of making programs work better;

h. assess compliance with laws and regulations applicable to the program;

i. assess the adequacy of the management control system for measuring, reporting, and monitoring performance on effectiveness; and

j. reported measures of program effectiveness that are valid and reliable.

10. Generally, at the completion of a performance audit, auditors do not express an opinion on the overall level of performance. Therefore, it is unlikely that the auditors will be called upon to give such an opinion. Rather, the auditors would report findings and conclusions on the extent and adequacy of performance, and on specific processes, methods, and management controls that can be made more efficient or effective. If potential for improvement is found, the auditors would recommend appropriate corrective actions.

OTHER ACTIVITIES OF AN AUDIT ORGANIZATION

11. Auditors may perform services other than audits. For example, some auditors may perform assignments that do not include findings, conclusions, and/or recommendations. Examples of these other assignments are those that

   a. gather information about a program without verifying it and/or without analysis, conclusions, and recommendations;

   b. assist a legislative body by developing questions for use at hearings;

   c. summarize or synthesize the results of previous work by the audit organization or other organizations on a particular topic without new analysis, conclusions, or recommendations;

   d. develop methods and approaches to be applied in evaluating a new or a proposed program; and

   e. forecast potential program outcomes under various assumptions without evaluating current operations.

12. The head of the audit organization should establish policy on which audit standards from this statement should be followed by the auditors in performing such services. However, as a minimum, auditors should collectively possess adequate professional proficiency and exercise due professional care for the service being performed.

13. An audit organization may be authorized to perform investigative work. The head of the audit organization should establish policy on whether the audit standards in this

statement, or some other appropriate standards, are to be followed by the employees performing this work.

14. Employees of an audit organization may also perform, within the audit organization, nonaudit activities, such as legal, administrative, and computer processing functions. The head of the audit organization should establish policy on what standards in this statement are to be followed, or whether some other appropriate standards are to be followed, by the employees in performing those types of work.

CHAPTER 3

GENERAL STANDARDS

PURPOSE

1. This chapter prescribes general standards for conducting financial and performance audits. These general standards relate to the qualifications of the staff, the audit organization's and the individual auditor's independence, the exercise of due professional care in conducting the audit and in preparing related reports, and the presence of quality controls. General standards are distinct from those standards that relate to conducting field work and preparing related reports.

2. These general standards apply to all audit organizations, both government and nongovernment (for example, public accounting firms and consulting firms), conducting audits of government organizations, programs, activities, and functions and of government funds received by nongovernment organizations.

QUALIFICATIONS

3. The first general standard for auditing is:

    The staff assigned to conduct the audit should collectively possess adequate professional proficiency for the tasks required.

4. This standard places responsibility on the audit organization to ensure that the audit is conducted by staff who collectively have the knowledge and skills necessary for the audit to be conducted. They should also have a thorough knowledge of government auditing and of the specific or

unique environment in which the audited entity operates, relative to the nature of the audit being conducted.

5. The qualifications mentioned herein apply to the knowledge and skills of the audit organization as a whole and not necessarily to every individual auditor. An organization may need to employ personnel, or hire outside consultants, knowledgeable in such areas as accounting, statistics, law, engineering, audit design and methodology, automatic data processing, public administration, economics, social sciences, and actuarial science.

Continuing Education Requirements

6. To meet this standard, the audit organization should have a program to ensure that its staff maintain professional proficiency through continuing education and training. Thus, each auditor responsible for planning, directing, conducting, or reporting on government audits should complete, every 2 years, at least 80 hours of continuing education and training which contributes to the auditor's professional proficiency. At least 20 hours should be completed in any 1 year of the 2-year period. Individuals responsible for planning, directing, conducting substantial portions of the field work, or reporting on the government audit should complete at least 24 of the 80 hours of continuing education and training in subjects directly related to the government environment and to government auditing. If the audited entity operates in a specific or unique environment, auditors should receive training that is related to that environment.

7. The audit organization is responsible for establishing and implementing a program to ensure that auditors meet the continuing education and training requirements just stated.

The organization should maintain documentation of the education and training completed.[1]

8. The continuing education and training may include such topics as current developments in audit methodology, accounting, assessment of internal controls, principles of management and supervision, financial management, statistical sampling, evaluation design, and data analysis. It may also include subjects related to the auditor's field of work, such as public administration, public policy and structure, industrial engineering, economics, social sciences, and computer science.

9. External consultants and internal experts and specialists should be qualified and maintain professional proficiency in their area of expertise and/or specialization but are not required to meet the above continuing education and training requirements. Auditors performing nonaudit activities and services also are not required to meet the above continuing education and training requirements.

<u>Staff Qualifications</u>

10. Qualifications for staff members conducting audits include:

    a. A knowledge of the methods and techniques applicable to government auditing and the education, skills, and

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[1]The qualifications standard and continuing education requirements place responsibilities on both the audit organization and individual auditors. Carrying out these responsibilities requires sound professional judgment. To assist audit organizations and individual auditors in exercising that judgment, GAO issued <u>Interpretation of Continuing Education and Training Requirements</u>. The interpretation guides audit organizations and individual auditors in implementing the requirements in paragraphs 6 and 7 of this chapter.

experience to apply such knowledge to the audit being conducted.

b. A knowledge of government organizations, programs, activities, and functions.

c. The skills to communicate clearly and effectively, both orally and in writing.

d. Skills appropriate for the audit work being conducted. For instance

   (1) if the work requires use of statistical sampling, the staff or consultants to the staff should include persons with statistical sampling skills;

   (2) if the work requires extensive review of computerized systems, the staff or consultants to the staff should include persons with computer audit skills;

   (3) if the work involves review of complex engineering data, the staff or consultants to the staff should include persons with engineering skills; or

   (4) if the work involves the use of nontraditional audit methodologies, the staff or consultants to the staff should include persons with the skills in those methodologies.

e. The following qualifications are needed for financial audits that lead to an expression of an opinion.

   (1) The auditors should be proficient in the appropriate accounting principles and standards and

in government auditing.

(2) The public accountants engaged to conduct audits should be (a) licensed certified public accountants or persons working for a licensed certified public accounting firm or (b) public accountants licensed on or before December 31, 1970, or persons working for a public accounting firm licensed on or before December 31, 1970.[2]

INDEPENDENCE

11. The second general standard for auditing is:

> **In all matters relating to the audit work, the audit organization and the individual auditors, whether government or public, should be free from personal and external impairments to independence, should be organizationally independent, and should maintain an independent attitude and appearance.**

12. This standard places responsibility on each auditor and the audit organization to maintain independence so that opinions, conclusions, judgments, and recommendations will be impartial and will be viewed as impartial by knowledgeable third parties.

13. Auditors should consider not only whether they are independent and their attitudes and beliefs permit them to be independent, but also whether there is anything about

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[2]Accountants and accounting firms meeting these licensing requirements should also comply with the applicable provisions of the public accountancy law and rules of the jurisdiction(s) where the audit is being conducted and the jurisdiction(s) in which the accountants and their firms are licensed.

their situation that might lead others to question their independence. All situations deserve consideration because it is essential not only that auditors are, in fact, independent and impartial, but also that knowledgeable third parties consider them so.

14. Government auditors, including hired consultants and internal experts and specialists, need to consider three general classes of impairments to independence--personal, external, and organizational. If one or more of these impairments affect an auditor's ability to do the work and report findings impartially, that auditor should either decline to perform the audit, or in those situations where that auditor cannot decline to perform the audit, the impairment(s) should be reported in the scope section of the audit report. In addition, in cases when auditors are employees of the audited entity, that fact should be reflected in a prominent place in the audit report.

15. Nongovernmental auditors (for example, private sector internal auditors and public accountants) also need to consider those personal and external impairments that might affect their ability to do their work and report their findings impartially. If their ability is adversely affected, they should decline to perform the audit. Public accountants should also follow the AICPA code of professional conduct, the code of professional conduct of the state board with jurisdiction over the practice of the public accountant and the audit organization, and the guidance on personal and external impairments included in this statement.

Personal Impairments

16. There are circumstances in which auditors may not be

impartial, or may not be perceived to be impartial. The audit organization is responsible for having policies and procedures in place to help determine if auditors have any personal impairments. Managers and supervisors need to be alert for personal impairments of their staff members. Auditors are responsible for notifying the appropriate official within their audit organization if they have any personal impairments. These impairments apply to individual auditors, but they may also apply to the audit organization. Personal impairments may include, but are not limited to, the following.

a. Official, professional,[3] personal, or financial relationships[4] that might cause an auditor to limit the extent of the inquiry, to limit disclosure, or to weaken or slant audit findings in any way.

b. Preconceived ideas toward individuals, groups, organizations, or objectives of a particular program that could bias the audit.

c. Previous responsibility for decision-making or managing an entity that would affect current operations of the entity or program being audited.

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[3]An audit organization that audits the effectiveness of internal controls after having done consulting services involving the design or implementation of those controls should have policies in place to reasonably ensure the independence of its auditors. It should also ensure that the audited entity has assumed full responsibility for activities affected by the consulting work.

[4]When auditing state and local governments, the public accountant should be familiar with AICPA Professional Ethics Interpretation 101-10. This interpretation establishes specific rules on financial relationships that impair the public accountant's independence.

d. Biases, including those induced by political or social convictions, that result from employment in, or loyalty to, a particular group, organization, or level of government.

e. Performance of an audit by an individual required by law to exercise both the controllership responsibilities and to audit organizations, programs, activities, and functions that are within the controller's responsibilities.[5]

f. Subsequent performance of an audit by the same individual who, for example, had previously approved invoices, payrolls, claims, and other proposed payments of the entity or program being audited.

g. Concurrent or subsequent performance of an audit by the same individual who maintained the official accounting records.[6]

h. Financial interest that is direct, or is substantial though indirect, in the audited entity or program.

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[5]Auditors who are required by law to exercise controllership responsibilities should establish organizational and other policies to reasonably ensure the independence of the audit function.

[6]For example, an individual performs a substantial part of the accounting process or cycle, such as analyzing, journalizing, posting, preparing adjusting and closing entries, and preparing the financial statements, and later the same individual performs an audit. In instances in which the audit organization acts as the main processor for transactions initiated by the audited entity, the audit organization should establish policies to reasonably ensure the independence of its auditors and to ensure that the audited entity has assumed full responsibility for the processed transactions and acknowledges responsibility for the financial records and financial statements.

External Impairments

17. Factors external to the audit organization may restrict the audit or interfere with an auditor's ability to form independent and objective opinions and conclusions. For example, under the following conditions, an audit may be adversely affected and an auditor may not have complete freedom to make an independent and objective judgment:

    a. external interference or influence that improperly or imprudently limits or modifies the scope of an audit;

    b. external interference with the selection or application of audit procedures or in the selection of transactions to be examined;

    c. unreasonable restrictions on the time allowed to competently complete an audit;

    d. interference external to the audit organization in the assignment, appointment, and promotion of audit personnel;

    e. restrictions on funds or other resources provided to the audit organization that would adversely affect the audit organization's ability to carry out its responsibilities;

    f. authority to overrule or to influence the auditor's judgment as to the appropriate content of an audit report; and

    g. influences that jeopardize the auditor's continued employment for reasons other than competency or the need for audit services.

Organizational Independence

18. Government auditors' independence can be affected by their place within the structure of the government entity to which they are assigned and also by whether they are auditing internally or auditing other entities.

Internal Auditors

19. A federal, state, or local government audit organization, or an audit organization within other government entities, such as a government college, university, or hospital, may be subject to administrative direction from persons involved in the government management process. To help achieve organizational independence, audit organizations should report the results of their audits and be accountable to the head or deputy head of the government entity and should be organizationally located outside the staff or line management function of the unit under audit. The audit organization's independence is enhanced when it also reports regularly to the entity's independent audit committee and/or the appropriate government oversight body.

20. Auditors should also be sufficiently removed from political pressures to ensure that they can conduct their audits objectively and can report their findings, opinions, and conclusions objectively without fear of political repercussion. Whenever feasible, they should be under a personnel system in which compensation, training, job tenure, and advancement are based on merit.

21. If the above conditions are met, and no personal or external impairments exist, the audit staff should be considered organizationally independent to audit internally and free to report objectively to top management.

22. When organizationally independent internal auditors conduct audits external to the government entity to which they are directly assigned, they may be considered independent of the audited entity and free to report objectively to the head or deputy head of the government entity to which assigned.

External Auditors

23. Government auditors employed by audit organizations whose heads are elected and legislative auditors auditing executive entities may be considered free of organizational impairments when auditing outside the government entity to which they are assigned.

24. Government auditors may be presumed to be independent of the audited entity, assuming no personal or external impairments exist, if the entity is

    a. a level of government other than the one to which they are assigned (federal, state, or local) or

    b. a different branch of government within the level of government to which they are assigned (legislative, executive, or judicial).

25. Government auditors may also be presumed to be independent, assuming no personal or external impairments exist, if the audit organization's head is

    a. elected by the citizens of the organization's jurisdiction,

    b. elected or appointed by a legislative body of the level of government to which he/she is assigned and report the results of the audits to and are accountable to the legislative body, or

c. appointed by the chief executive but confirmed by, report the results of the audits to, and is accountable to a legislative body of the level of government to which he/she is assigned.

DUE PROFESSIONAL CARE

26. The third general standard for auditing is:

Due professional care should be used in conducting the audit and in preparing related reports.

27. This standard requires auditors to work with due care. Due care imposes a responsibility upon each auditor within the audit organization to observe generally accepted government auditing standards. Exercise of due care requires all levels of supervisors critically reviewing the work and the judgment of those assisting in the audit.

28. Exercising due professional care means using sound judgment in establishing the scope, selecting the methodology, and choosing tests and procedures for the audit. The same sound judgment should be applied in conducting the tests and procedures and in evaluating and reporting on the audit results.

29. Auditors should use sound professional judgment in determining the standards that are applicable to the work to be conducted, and therefore should be followed. Situations may occur in which government auditors are not able to follow an applicable standard and are not able to withdraw from the audit. In those situations, the auditors should disclose in the scope section of their report, the fact that

an applicable standard was not followed, the reasons therefore, and the known effect not following the standard had on the results of the audit. The auditors' determination that certain standards do not apply to the audit should be documented in the working papers.

30. While this standard places responsibility on each auditor and audit organization to exercise due professional care in the performance of the audit assignment undertaken, it does not imply unlimited responsibility; neither does it imply infallibility on the part of either the individual auditor or the audit organization.

31. For government auditors, due professional care also includes having a process that enables them to track and report, as appropriate, the status of management's actions on significant or material findings and recommendations from their prior audits. The benefit from audit work is not in the findings reported or the recommendations made, but in their effective resolution. Important measures of an audit organization's effectiveness are the type of issues it tackles and the changes/improvements it is able to effect. The audit organization's continued attention to past findings and recommendations through a tracking system helps auditors get better results from their audit work.

QUALITY CONTROL

32. The fourth general standard for auditing is:

> **Audit organizations conducting audits in accordance with these standards should have an appropriate internal quality control system in place and undergo an external quality control review.**

33. This standard makes government and nongovernment audit organizations conducting audits in accordance with these standards responsible for having an appropriate internal quality control system in place and undergoing an external quality control review.

34. The internal quality control system established by the organization should provide reasonable assurance that it (1) has established, and is following, adequate audit policies and procedures and (2) has adopted, and is following, applicable auditing standards. The nature and extent of an organization's internal quality control system depends on a number of factors, such as its size, the degree of operating autonomy allowed its personnel and its audit offices, the nature of its work, its organizational structure, and appropriate cost-benefit considerations. Thus, the systems established by individual organizations will vary, as will the extent of their documentation.

35. Organizations conducting audits in accordance with these standards should have an external quality control review at least once every 3 years by an organization not affiliated with the organization being reviewed.[7] The external quality control review should determine that the organization's internal quality control system is in place and operating effectively to provide reasonable assurance that established policies and procedures and applicable auditing standards are being followed.

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[7]Audit organizations should have an external quality control review completed (that is, report issued) within 3 years from the date they start their first audit in accordance with these standards. An audit organization that has not met this requirement should disclose that fact to those who are responsible for authorizing or arranging for the audit.

36. An external quality control review under this standard should meet the following requirements for conducting and reporting on the review.

a. Reviewers should be qualified and have current knowledge of the type of work to be reviewed and the applicable audit standards. For example, individuals reviewing government audits should have a thorough knowledge of the government environment and government auditing relative to the work being reviewed.

b. Reviewers should be independent (as defined in these standards) of the audit organization being reviewed, its staff, and its auditees whose audits are selected for review. Reciprocal reviews are not permitted.

c. Reviewers should use sound professional judgment in conducting and reporting on the quality review.

d. Audits selected for review should represent the organization's audits, and should include one or more audits conducted in accordance with these standards.

e. This review should include a review of the audit reports, working papers, and other necessary documents (for example, correspondence, continuing education and training requirements documentation) as well as interviews with the reviewed organization's professional staff.

f. A written report should be prepared communicating the results of the external quality control review.

37. External quality control review procedures should be tailored to the size and nature of an organization's audit

work. For example, an organization that performs only a few audits may be more effectively reviewed by primarily emphasizing a review of the quality of those audits rather than the organization's internal quality control policies and procedures.

38. Audit organizations should make the report on external quality control reviews available to auditors using their work and to appropriate oversight bodies. It is recommended that the report be made available to the public. Before starting a GAGAS audit, nongovernment audit organizations subject to the external quality control review requirement should, when their most recent quality control review report discloses significant deficiencies, give this report to those responsible for authorizing or arranging the audit. Information about those deficiencies generally would be relevant to decisions on procuring audit services.

CHAPTER 4

FIELD WORK STANDARDS FOR FINANCIAL AUDITS

PURPOSE

1. This chapter prescribes standards of field work for financial audits, which include financial statement audits and financial related audits.

RELATION TO AICPA STANDARDS

2. For financial statement audits, generally accepted government auditing standards (GAGAS) incorporate AICPA's three generally accepted standards of field work, which are:

   a. The work is to be adequately planned and assistants, if any, are to be properly supervised.

   b. A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

   c. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

3. The AICPA has issued statements on auditing standards (SAS) that interpret the three standards of field work and provide additional requirements for compliance auditing. GAGAS

incorporate these SASs[1] and prescribes additional standards needed to satisfy the unique needs of government financial statement audits. These additional standards further define the nature and extent of auditors' responsibilities in the areas of

a. planning,

b. internal controls,

c. compliance with laws and regulations, and

d. working papers.

4. Some provisions of the AICPA standards are reiterated in this chapter to emphasize their importance or help explain the additional field work standards. Auditors should understand both the AICPA standards and these additional standards in order to perform financial statement audits in accordance with GAGAS.

FINANCIAL RELATED AUDITS

5. The field work standards and compliance auditing standards of the AICPA and the additional standards in this chapter apply to those financial related audits that require the expression of an opinion on financial presentations. Other financial related audits should follow the applicable field work standards in chapter 6 or those of AICPA (including Statement on Standards for Attestation Engagements), as appropriate, and the working paper standard in this chapter.

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[1]Future AICPA statements on field work and compliance auditing will be adopted and incorporated unless GAO excludes them by formal announcement.

PLANNING

6. The AICPA standards and GAGAS require the following:

> **The work is to be properly planned.**

7. The additional standard for planning is:

> **Planning a financial statement audit requires (1) following up on known material findings, including reportable conditions and significant noncompliance and recommendations from previous audits, (2) communicating certain information to individuals responsible for overseeing the financial reporting process, (3) considering materiality level and audit risk in the context of providing public accountability, and (4) determining if other external auditors whose work is relied on, if any, complied with GAGAS.**

8. For all financial statement audits, the auditors have sole responsibility for choosing and conducting auditing tests that, in their judgment, are appropriate in the circumstances to achieve the audit objectives. Such tests and procedures should be designed to obtain sufficient, competent, and relevant evidence that will provide a reasonable basis for their opinions on the financial statements (that is, reasonable assurance that the financial statements are not misstated because of material errors or irregularities).

Audit Follow-up

9. Auditors should follow up on known material findings, including reportable conditions and significant noncompliance, and recommendations from previous audits that could affect the

financial statement audit. They should do this to determine whether prompt and appropriate corrective actions have been taken by entity officials. The audit report should disclose the status of known but uncorrected material findings and recommendations from prior audits that affect the financial statement audit.

Auditors' Communications to Individuals Responsible for Overseeing Financial Reporting

10. Auditors should determine that certain information is communicated to those responsible for the oversight of the financial reporting process.[2] That information includes the matters discussed in AICPA's SAS no. 61, Communications with Audit Committees[3] and information about the following as related to the scope of internal control and compliance work:

a. the auditors' responsibilities for testing internal controls and compliance with laws and regulations in a

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[2]Whom the auditor communicates with depends on who contracted for or otherwise arranged for the audit. If the audited entity contracted for the audit, it would be the audit committee or others with equivalent authority and responsibility. If another entity that oversees the audit contracted or arranged for the audit, then the auditor should communicate with responsible individuals in the oversight entity. If a government auditor initiates the audit under his or her own authority, then the auditor should communicate to the entity to whom the audited entity is accountable (for example, a legislative oversight committee), if any.

[3]Matters to be communicated include the auditor's responsibility under generally accepted auditing standards; significant accounting policies; management judgments and accounting estimates; significant audit adjustments; other information in documents containing audited financial statements; disagreements with management; consultation with other accountants; major issues discussed with management prior to retention; and difficulties encountered in performing the audit. Some of this information may be more appropriately communicated later in the audit.

financial statement audit, as discussed in the AICPA's SASs and in generally accepted government auditing standards;

b. the nature of any additional testing of internal controls and compliance required by laws and regulations, as stated in laws;

c. the options for additional testing of internal controls and compliance through agreed-upon procedures or examination (as discussed in paragraphs 12 though 16);

d. the individuals who are responsible for deciding if additional testing of controls and compliance should be performed (as discussed in paragraphs 17 and 18);

e. possible weaknesses in internal controls that auditors may be aware of prior to undertaking the specific audit engagement, which will vary among audits; and

f. the effect that possible weaknesses in internal controls, as just discussed in "e," could have on (1) accuracy and sufficiency of financial information used for management decision-making, (2) safeguarding of assets, or (3) compliance with laws and regulations.

11. Individuals responsible for overseeing the financial reporting process vary in their knowledge of auditing, internal controls, and compliance with laws and regulations. Thus, it is not practical to prescribe a standard format for communicating the matters just described. The information presented in paragraphs 12 through 18 provides guidance to help auditors prepare the required communications. The communications may be oral or written. If the information is communicated orally, the auditors should document the

communication by appropriate memoranda or notations in the working papers.

Options for Additional Testing of Internal Controls and Compliance

12. Tests of internal controls and compliance with laws and regulations in a financial statement audit contribute to the evidence supporting the auditor's opinion on the financial statements. However, they do not provide a basis for opining on internal controls or compliance. The limited purpose of these tests may prevent them from meeting the needs of some users who require information on internal controls and compliance with laws and regulations.

13. To meet certain audit report users' needs, laws and regulations often prescribe testing and reporting on internal controls and compliance to supplement the financial statement audit's coverage of these areas.[4] Nevertheless, even after auditors perform, and report the results of, internal control and compliance tests required by laws and regulations, and support the opinion on the financial statements, some reasonable needs of report users still may be unmet. Auditors may meet these needs by further supplementing tests of

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[4]For example, when auditing state and local governmental entities that receive federal financial assistance, the auditor should be familiar with the Single Audit Act of 1984 (31 U.S.C. 7501-7507) and OMB Circular A-128, "Audits of State and Local Governments." The act and circular include specific audit requirements, mainly in the areas of internal controls and compliance with laws and regulations, that exceed the minimum audit requirements in the standards in chapters 4 and 5 of this document. Audits of nonprofit organizations under OMB Circular A-133, "Audits of Institutions of Higher Education and Other Nonprofit Institutions," and audits conducted under the Chief Financial Officers Act of 1990, also have specific audit requirements in the areas of internal controls and compliance. Many state and local governments have similar requirements.

internal controls and compliance with laws and regulations in either of two ways:

a. supplemental (or agreed-upon) procedures or

b. examination, resulting in an opinion.

14. Supplemental, or agreed-upon, procedures can be applied to specific areas of risk or areas where more accountability is needed than can be provided in a financial statement audit. However, if auditors perform only agreed-upon procedures, they should not express an opinion about the entity's internal control structure or its compliance with laws and regulations.[5]

15. To provide an opinion on internal controls or compliance, auditors perform an examination. This requires obtaining sufficient evidence to provide reasonable assurance about the effectiveness of internal controls or about compliance with specific laws and regulations.[6]

16. Auditors may perform an examination of only the design of control policies and procedures. This requires obtaining sufficient information to permit the auditors to reach a conclusion about whether the entity's relevant control procedures are suitably designed to achieve the control objectives.

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[5]This additional work should be classified as a financial-related audit. As such, the auditor should follow the guidance in paragraph 5 of this chapter in determining the appropriate standards to follow.

[6]See footnote 5.

Who Decides If Further Testing of Controls and Compliance Should Be Performed?

17. Which individuals are responsible for deciding whether to supplement the financial statement audit with additional tests of internal controls or compliance depends on who performs the audit. When government auditors (for example, federal inspectors general, many state and local auditors) perform the audit, they often have the authority to unilaterally decide to supplement the financial statement audit with additional tests of internal controls or compliance. When the audit is performed by public accountants, expanded testing must first be authorized by those individuals who contract for the financial statement audit.

18. When a government auditor has the authority to supplement the financial statement audit with additional tests, that auditor should consider the matters relevant to the scope of internal control and compliance work discussed in paragraphs 11 e and f, his or her knowledge of audit report users' needs for information, and the costs associated with devoting audit resources to these areas rather than to others. If the financial statement audit is likely to result in an adverse opinion or a disclaimer of an opinion, that auditor is encouraged to perform additional control work as a basis for constructive recommendations that could help remedy the conditions expected to result in the adverse opinion or disclaimer.

Establishing Materiality and Considering Audit Risk

19. AICPA's SAS no. 47, Audit Risk and Materiality in Conducting an Audit, provides the basic guidance on establishing materiality and considering audit risk in financial statement audits. In audits conducted under generally accepted government auditing standards, auditors should consider the materiality level and threshold of acceptable audit risk in the context of providing public accountability. As discussed in paragraph 15 of chapter 1, auditing and financial reporting play significant roles in establishing public accountability for the use of taxpayer funds. Accordingly, in a GAGAS audit, auditors may set lower materiality levels and lower thresholds of acceptable audit risk for certain account balances, classes of transactions, and related assertions than in audits in the private sector.

Considering Others' Work

20. One factor underlying government auditing is that federal, state, and local governments cooperate in auditing programs of common interest so that auditors may use others' work and avoid duplicate audit efforts. In conducting an audit, auditors may consider the work of others once they are satisfied with the other auditors' qualifications[7] and independence, as well as with the quality of the others' work as measured by appropriate tests or other acceptable methods.

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[7]Auditors from another country engaged to conduct audits in their country should meet the professional qualifications to practice under that country's laws and regulations or other acceptable standards, such as those issued by the International Organizational of Supreme Audit Institutions (INTOSAI). Also see the International Federation of Accountants International Auditing Guidelines 3.

21. When the auditors consider using the work of others, they should follow the applicable AICPA's SASs.[8] In deciding the level of responsibility to assume for the work of external auditors, auditors should consider the extent the other auditors' work complies with the additional field work standards on internal controls and compliance prescribed by GAGAS.

INTERNAL CONTROL

22. The AICPA standards and GAGAS require the following:

> **A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed. When auditors plan to reduce for certain financial statement assertions the assessed level of control risk, this could result in less audit effort for their substantive tests of those assertions. In these circumstances, they are required to test controls for sufficient evidence to support that assessed level of control risk.**

23. The additional standard for internal controls is:

> **Auditors should perform procedures directed toward assessing the control risk associated with the control**

[8] SAS no. 1, Codification of Auditing Standards and Procedures, (section 543) provides guidance in deciding the responsibility to assume for the work performed by other independent auditors; SAS no. 65, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements, provides guidance in considering and using the work on the internal auditor; and SAS no. 11, Using the Work of a Specialist, provides guidance on that particular matter.

environment and with control procedures for safeguarding assets.

24. Establishing and maintaining an internal control structure is an important management responsibility. Effective internal controls are essential to achieving the proper conduct of government business with full accountability for the resources made available. In financial statement audits done in accordance with GAGAS, auditors are generally concerned with internal control structure policies and procedures relevant in the following areas:

    a. transaction recording, processing, and reporting (controls that provide reasonable assurance that an entity identifies, assembles, classifies, records, analyzes, and reports its transactions, in conformity with generally accepted accounting principles or appropriate regulatory requirements for preparing financial statements),

    b. safeguarding assets (controls that provide reasonable assurance that losses or misappropriations of assets due to errors or irregularities in processing transactions and handling the related assets are prevented or detected), and

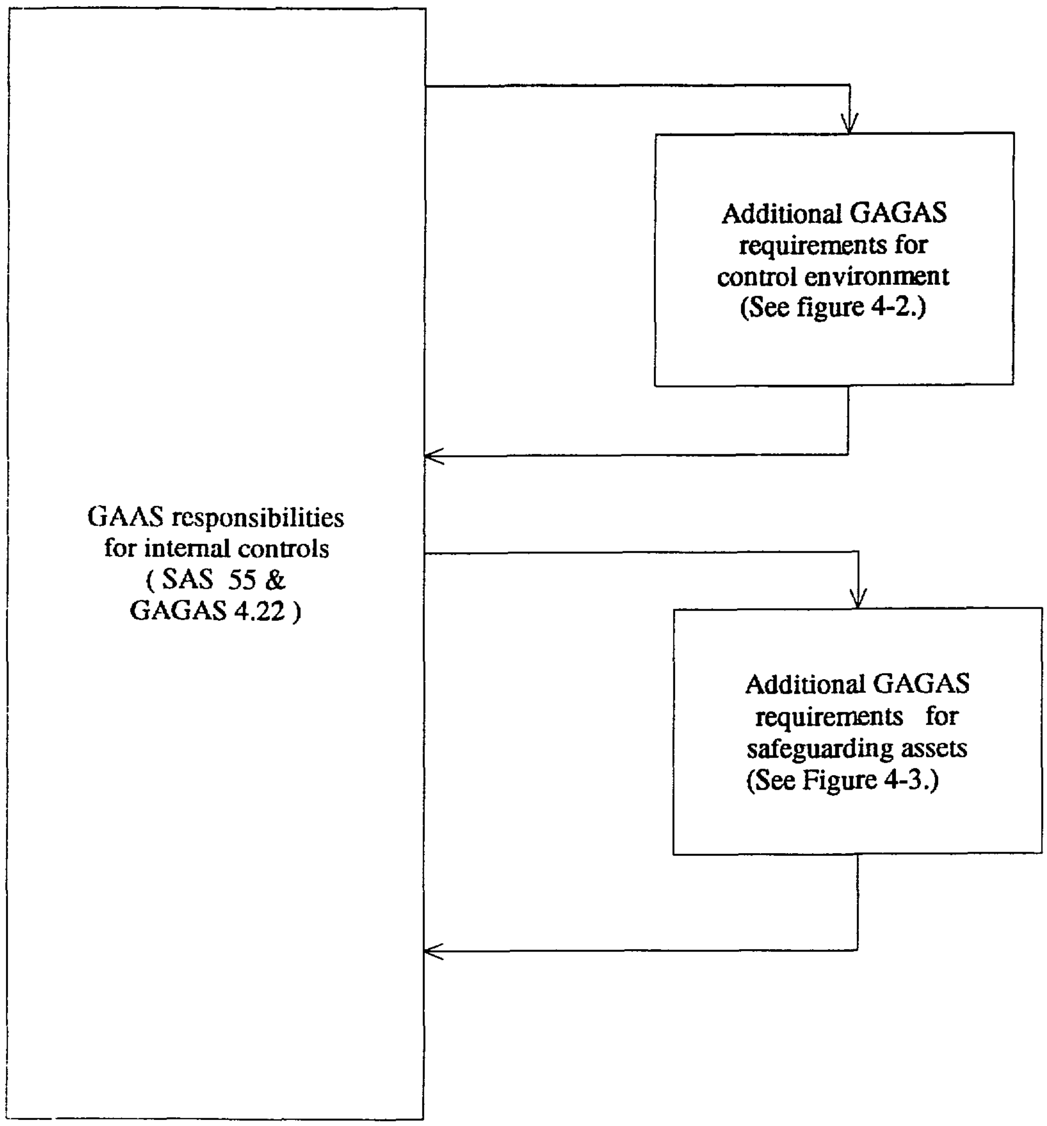
    c. compliance (controls that provide reasonable assurance of preventing or detecting noncompliance with laws and regulations that are relevant to a financial statement audit).

25. The nature and extent of procedures auditors select to perform to satisfy the AICPA standards can vary depending on the size and complexity of the entity, previous experience with the entity, the nature of the particular policy or procedure

involved, and the nature of the entity's documentation of specific policies and procedures. In audits done in accordance with GAGAS, auditors should perform procedures directed toward assessing control risk associated with the internal control structure in two areas--the control environment and safeguarding assets. The AICPA standards do not require separate assessment of any individual elements of the internal control structure. Under GAGAS, however, auditors should assess control risk associated with two specific areas: control environment and control procedures for safeguarding assets that auditors conclude are vulnerable to loss or misappropriation. Knowledge about the control environment is essential to assessing the audit risk; a weak control environment often indicates heightened risk of fraud. Knowledge about controls over safeguarding assets is essential to assessing the risk that management has not recognized material losses or misappropriations of assets. Also, auditors' performance of the procedures required by GAGAS may disclose reportable conditions in areas that are fundamental to the responsibilities of those entrusted with taxpayer funds. Communicating such reportable conditions is important to establishing the public accountability for the management of the audited entity.

26. Figure 4-1 shows how the additional requirements of GAGAS for these areas of the internal control structure relate to the AICPA's SASs. Additional figures show the procedures required to assess the control risk associated with (1) the control environment (as shown in figure 4-2) and (2) the control procedures for safeguarding of assets (as shown in figure 4-3).

Figure 4.1: Consideration of the Internal Control Structure in a Financial Statement Audit Under GAGAS



Note: The figure refers to specific paragraphs in the exposure draft, with the chapter stated first, then the paragraph number.

The Control Environment

27. Generally accepted auditing standards require auditors to obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment.[9] In addition to the work done to meet this requirement of GAAS, auditors should perform the procedures discussed in paragraphs 28 through 31. Using information obtained from all relevant audit procedures, auditors should form a judgment about whether the control environment contributes to or diminishes from the effectiveness of specific internal control structure policies and procedures. If auditors judge that deficiencies in the control environment diminish the effectiveness of specific control policies or procedures, they should report those deficiencies as reportable conditions.

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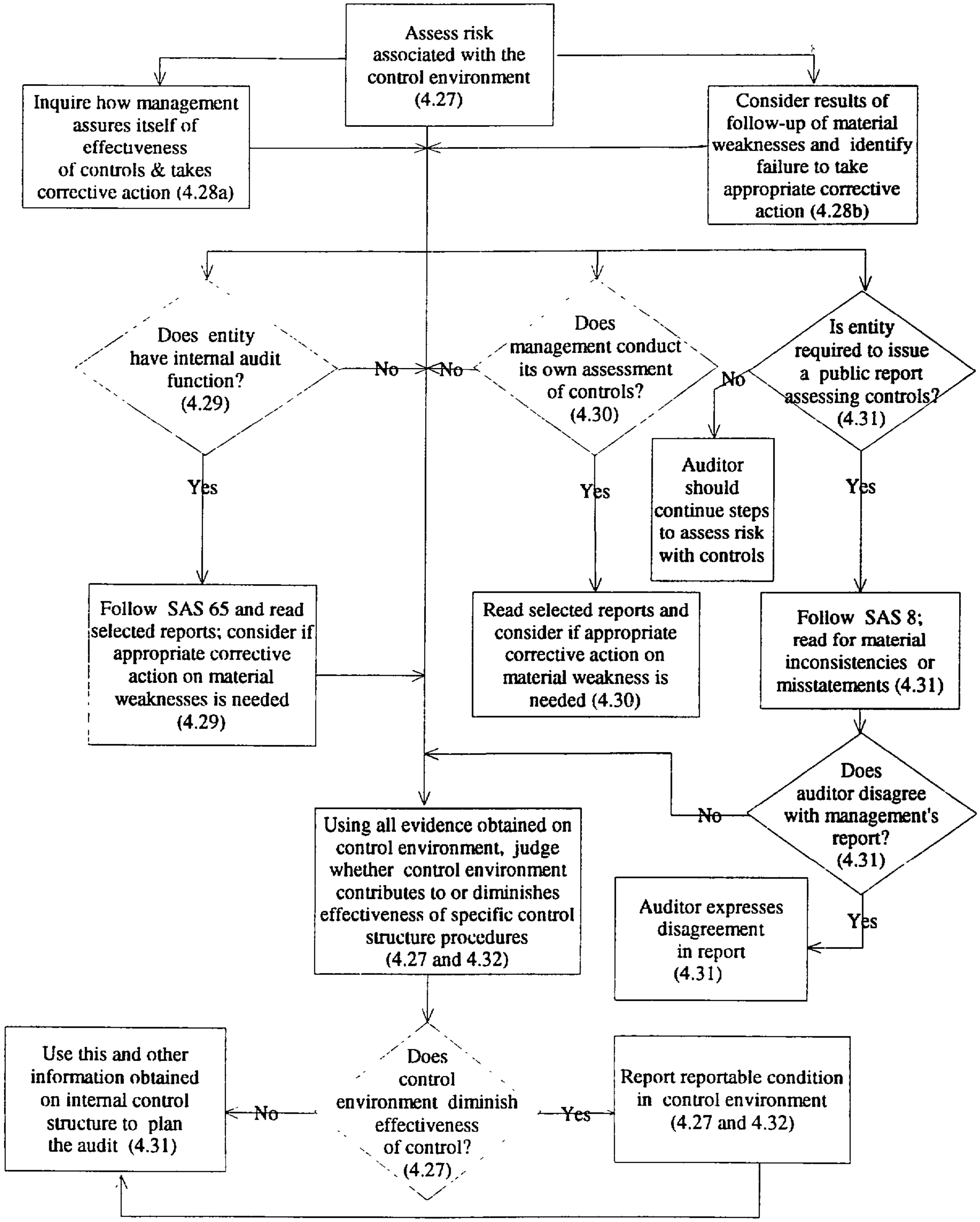
[9]For additional guidance on obtaining an understanding of the control environment, see the AICPA Audit Guide Consideration of the Internal Control Structure in a Financial Statement Audit.

Figure 4.2: Additional GAGAS Requirements for the Control Environment



NOTE: The figure refers to specific paragraphs in the exposure draft, with the chapter stated first, then paragraph number.

Audit Procedures

28. In all financial statement audits, auditors should:

    a. Inquire as to how management assures itself of the effectiveness of internal controls relevant to the areas discussed in paragraph 24 and takes corrective action on identified deficiencies in those controls.

    b. Consider whether the results of auditors' follow-up of known material findings and recommendations, as discussed in paragraph 9, identified failure by management to take appropriate corrective action on material weaknesses in internal controls.

29. When the entity has an internal audit function, auditors should follow the guidance in AICPA's SAS no. 65, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements, to obtain an understanding of the internal audit function sufficient to identify those internal audit activities that are relevant to planning the audit. In addition, auditors should read selected internal audit reports; and by (a) inquiries of appropriate managerial, supervisory, and staff personnel, (b) inspection of entity documents and records, and (c) observation of entity activities and operations, consider if management takes appropriate corrective action on material weaknesses identified by internal audit.

30. When management conducts its own assessments of the effectiveness of internal controls, auditors should apply procedures similar to those discussed in paragraph 29 above.

31. When the audited entity is required by law or regulation to issue to the public a comprehensive[10] report on management's assessment of internal controls, auditors should read the report and consider whether that report, or the manner of its presentation, is materially inconsistent with the auditors' knowledge about the internal controls. In doing so, auditors should follow the guidance in SAS no. 8, Other Information in Documents Containing Audited Financial Statements, regardless of whether management's report on internal controls is included with the audited financial statements or presented in a separate document. Auditors should express disagreement with management's report if the financial statement audit identified material weaknesses in internal controls that management did not disclose in its report.[11]

Judgments About the Control Environment

32. Evidence obtained from relevant audit procedures, including information obtained on the entity's internal audit function and management's assessment of the internal control structure, should be considered in forming the judgment about the control environment. Given the variety of entities for which financial statements are audited in accordance with GAGAS, it is not practical to prescribe specific criteria for judging whether the control environment contributes to or diminishes the effectiveness of specific internal control structure policies and procedures, or whether a reportable condition

[10]A comprehensive report on internal controls is management's assessment on an entitywide basis of the effectiveness of its internal controls in one or more of the areas discussed in paragraph 24. It may also include information with respect to internal controls relevant to other areas, but the auditor is not required to report on that information.

[11]The expression of disagreement can be included in the auditor's opinion on the financial statements or the report on internal controls, if separate documents.

exists with respect to the control environment. However, the following guidelines may be helpful to auditors in forming those judgments:

a. The nature of effective control environment policies and procedures varies with the size of an entity. For example, in smaller entities, effective monitoring of internal controls may be achieved through a combination of regular management and supervisory activities, and other actions personnel take in performing their duties. As the size of an entity and the complexity of its operations increase, so too should the extent of its monitoring processes. Ongoing monitoring should be organized to evaluate achievement of the entity's control objectives over time.

b. Failure to correct a material weakness in internal controls would be a reportable condition in the control environment. However, a decision not to correct a reportable condition in internal controls might not itself, be a reportable condition. SAS no. 60, Communication of Internal Control Structure Related Matters Noted in an Audit, states: "The existence of reportable conditions . . . may represent a conscious decision by management--a decision of which the audit committee is aware--to accept that degree of risk because of cost or other considerations. It is the responsibility of management to make the decisions of costs to be incurred and related benefits."

c. The collective effect on the control environment of strengths and weaknesses in various control environment factors may be overridden by strengths or weaknesses at high levels of management. For example, an active governing board or audit committee often mitigates concerns relative to risks associated with management's philosophy and operating style by overseeing both operating activities and financial reporting. An effective audit committee takes an active role in overseeing an entity's accounting and financial reporting policies and practices.

Safeguarding Assets

33. Auditors should perform procedures to obtain knowledge about whether management has placed in operation control procedures for the safeguarding of assets.[12] The auditors' purpose in performing these tests is to form a basis for judging the risk that the financial statements could be materially misstated because of understatement of losses or misappropriations arising from errors or irregularities in processing transactions and handling the related assets. If the auditors' procedures disclose inadequate provisions for the safeguarding of assets, then the auditors should report those inadequate provisions as reportable conditions in their report on internal controls.

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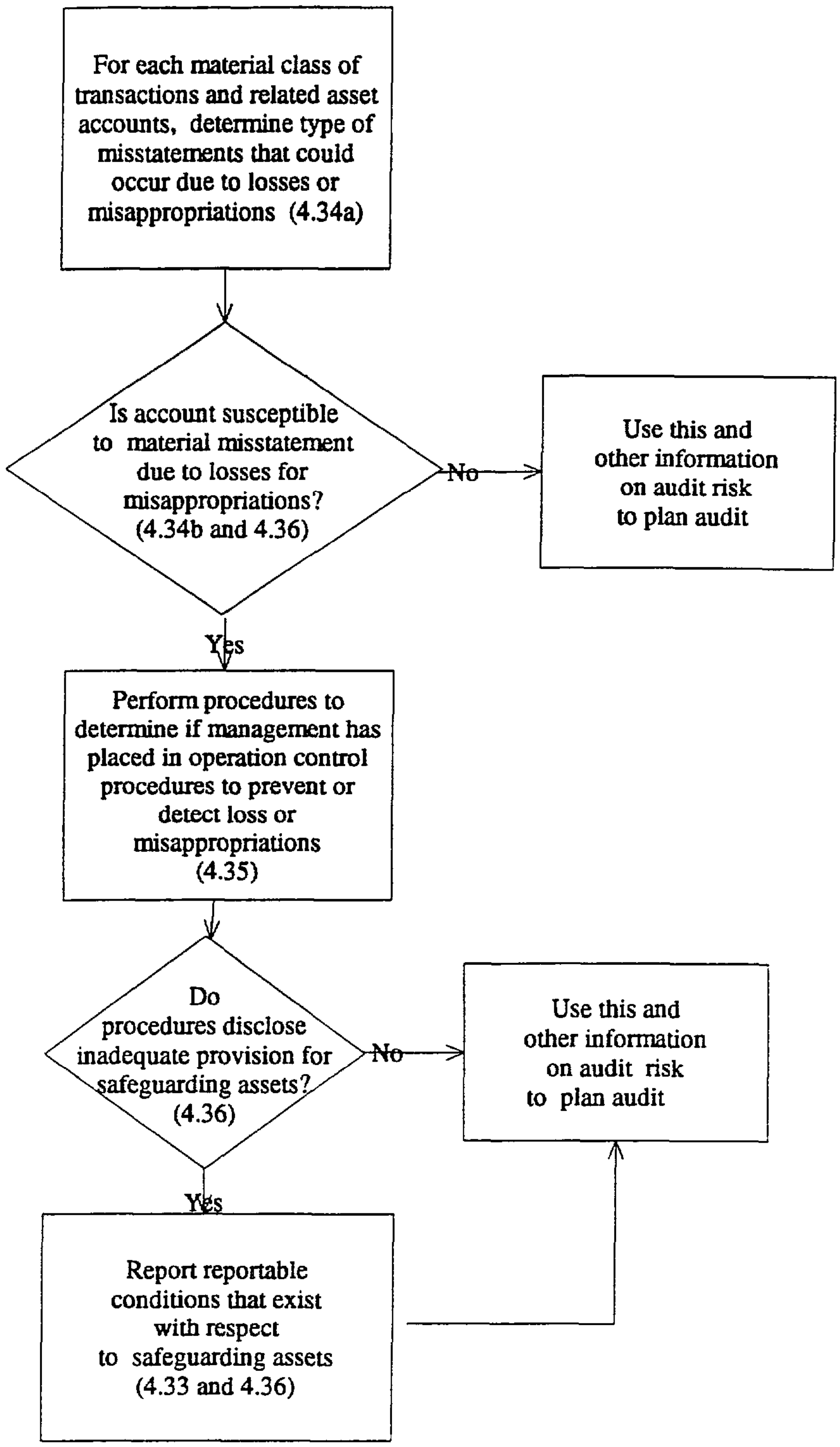
[12]In the context of these standards, safeguarding of assets refers only to protection against loss or misappropriation arising from errors and irregularities in processing transactions and handling the related assets. It does not include the loss of assets arising from management's operating decisions in the normal course of business.

Figure 4.3: Additional GAGAS Requirements for Safeguarding Assets



Note: The figure refers to specific paragraphs in the exposure draft, with the chapter stated first, then the paragraph number.

34. The extent of the auditors' procedures to obtain knowledge about whether management has placed in operation internal control procedures for the safeguarding of assets may vary among different types of assets depending on their materiality and susceptibility to misstatement due to loss or misappropriation. At a minimum, auditors should

  a. determine the types of misstatements due to losses or misappropriations that could occur for each material related asset account and transaction class and

  b. assess the susceptibility of the various asset accounts to these type of misstatements, losses, or misappropriations.

35. When auditors conclude that an account is susceptible to material misstatements due to losses or misappropriations of assets, then they should perform procedures to determine if management has placed in operation control procedures that should prevent or detect those losses or misappropriations. This may be accomplished by procedures such as inquiries of appropriate management, supervisory, and staff personnel; inspection of entity documents and records; and observation of entity activities and operations, as appropriate.

36. It is not practical to prescribe specific criteria for judging whether an account is susceptible to material misstatement arising from losses or misappropriations of assets, how an entity's control procedures for safeguarding assets affect audit risk, or whether a reportable condition exists with respect to those control procedures. However, the following guidelines may be helpful to auditors in forming those judgments.

  a. Control procedures for the safeguarding of assets include controls designed to achieve these broad objectives: (1)

executing transactions in accordance with management's general or specific authorization, (2) recording transactions as necessary to maintain accountability for assets, (3) permitting access to assets only in accordance with management's authorization, and (4) comparing the recorded accountability for assets with the existing assets at reasonable intervals, and act appropriately on any differences.

b. A lack of control procedures for the safeguarding of assets could allow repeated errors or irregularities in processing transactions and handling the related assets, and the repetition could accumulate in a material amount.

c. Deficiencies in control procedures for the safeguarding of assets could constitute a scope limitation, preventing auditors from obtaining sufficient evidence about the absence of material errors or irregularities in the financial statements. For example, inadequate controls over the collection of cash contributions in a not-for-profit organization may preclude auditors from obtaining sufficient evidence about the completeness of recorded revenues and would be a reportable condition.

d. The absence of financial information used to manage, as well as errors in this information, could increase the risk that the financial statements may be materially misstated. For example, the failure to obtain adequate information about borrowers before making loans could increase the risk of material credit losses, as well as the risk that management's estimate of the allowance for such losses will be understated. Because of its effect on audit risk, the inadequate information system would be a reportable condition, even if the auditors are able to perform sufficient substantive tests of the allowance for credit losses.

COMPLIANCE WITH LAWS AND REGULATIONS

37. The AICPA standards and GAGAS require the following:

> **Auditors should design the audit to provide reasonable assurance that the financial statements are free of material misstatement resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. Auditors should perform procedures to obtain knowledge about the design of internal control structure policies and procedures for compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts and about whether those policies and procedures have been placed in operation.**

38. The additional standard for compliance with laws and regulations is:

> **In a financial statement audit, tests should be made of compliance with other relevant laws and regulations as specified in a contract, law, or regulation governing the audit. In testing compliance with relevant laws and regulations, auditors should (1) perform procedures to obtain knowledge about the design of internal control structure policies and procedures for compliance with relevant laws and regulations and about whether the controls are placed in operation and (2) exercise due professional care in pursuing indication of possible fraud or other illegal acts that could result in criminal prosecution.**

39. The following terms are used in describing auditors' responsibilities under this standard:

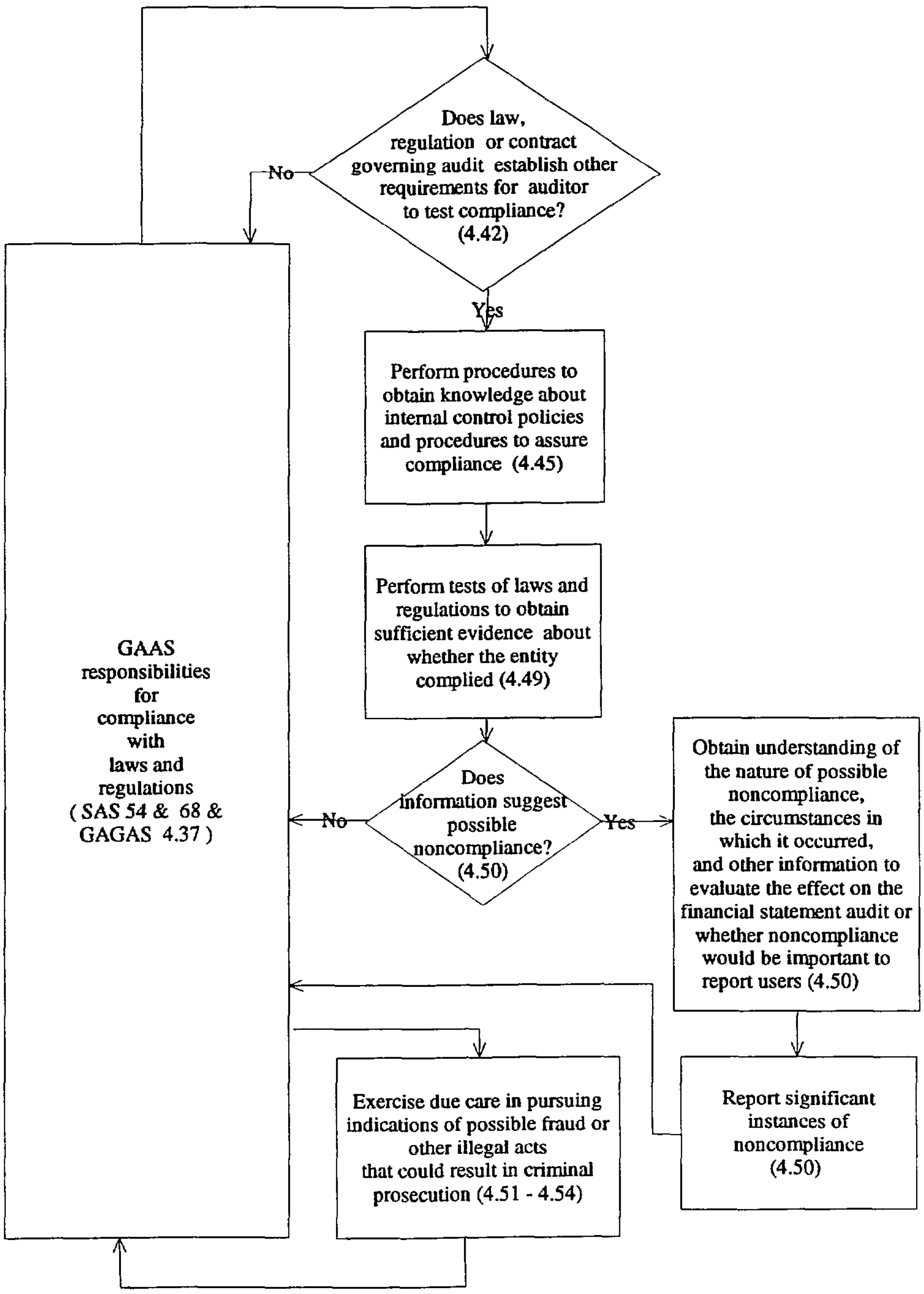
a. Noncompliance is a failure to follow requirements, or a violation of prohibitions, contained in laws, regulations, contracts, grants, or agency policies and procedures.

b. Illegal acts are a type of noncompliance; specifically, an illegal act is a violation of a law or regulation.

c. Fraud is the obtaining of something of value, unlawfully, through willful misrepresentation. Thus, fraud is a type of illegal act.

40. Figure 4-4 shows how the additional requirements of GAGAS for compliance with laws and regulations relate to the AICPA's SASs. This flowchart and the subsequent guidance are intended to help auditors (1) determine the relevant laws and regulations, (2) perform procedures to obtain knowledge about the internal control structure policies and procedures to reasonably assure compliance with laws and regulations relevant to the audit, (3) assess the risk of noncompliance, and (4) design and perform tests of compliance with relevant laws and regulations.

Figure 4.4: Consideration of Compliance With Laws and Regulations in a Financial Statement Audit Under GAGAS



Note: The figure refers to specific paragraphs in the exposure draft, with the chapter stated first, then paragraph number.

41. Auditors may find it necessary to consult with legal counsel in (1) determining which laws and regulations might have a significant impact on the financial statement assertions, (2) designing tests of compliance with laws and regulations, and (3) evaluating the results of those tests. Expert advice may also be necessary when an audit requires testing of compliance with contract provisions, grant agreements, or agency policies and procedures. Depending on the circumstances of the audit, it may be appropriate to consult other sources of expert advice on compliance matters, such as investigative staff, audit officials of other government entities whose funds are involved, and/or the applicable law enforcement organization.

Determining Relevant Laws and Regulations

42. The AICPA's SAS no. 68, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance, establishes the auditors' basic responsibilities for testing compliance with laws and regulations that could have a direct and material effect on financial statement amounts.[13] Under GAGAS, other laws and regulations are relevant to a financial statement audit if law, regulation, grant agreement, or the contract governing the audit has established a requirement for auditors to test compliance with them. For example, the implementing regulations for audits conducted under the Chief Financial Officers Act of 1990, provides a listing of laws for which compliance should be tested in audits of federal agencies' financial statements. While an auditor may not view the

[13]Following are some types of laws and regulations that may have a direct and material effect on the determination of amounts in a state or local government entity's financial statements: (1) budgetary reporting, (2) the establishment of funds, (3) matching and eligibility requirements and other mandates that are conditions for receiving funds, (4) restrictions on expenditures, and (5) taxing and debt limitations.

specified laws as having a direct and material effect on the financial statements, the government auditor or the independent public accountant contracted to audit a federal agency's financial statements assumes the responsibility--under generally accepted government auditing standards--for testing compliance with these laws.

43. Auditors can obtain information about relevant laws and regulations from the audited entity, legal counsel, state or local auditors or other applicable audit oversight organizations, state societies of CPAs, or associations of governments. When funding from another level of government is involved and the source of funding is known, auditors can obtain or corroborate information about the applicable laws and regulations from that source.

Internal Controls Over Compliance With Relevant Laws and Regulations

44. Compliance with laws and regulations is important to governmental organizations, programs, activities, and functions because public officials have a responsibility to comply with the specific laws and regulations which created these organizations and govern their operations. An entity's management is responsible for establishing an internal control structure to reasonably assure compliance with laws and regulations.

45. Auditors should perform procedures to obtain knowledge about internal control structure policies and procedures to assure compliance with laws and regulations relevant to the audit, including the laws and regulations addressed in SAS no. 68 and other relevant laws and regulations. The auditors' procedures should include inquiries of appropriate managerial, supervisory, and staff personnel; inspection of entity

documents and records; and observation of entity activities and operations. These procedures should provide the auditors knowledge about the design of internal control structure policies and procedures and about whether they have been placed in operation. The auditors' knowledge should be sufficient to identify types of potential misstatements and noncompliance, to consider factors that affect the risk of misstatement and noncompliance, and to design substantive tests of compliance with laws and regulations. Budget and related funds controls, which assure that transactions are executed in accordance with budgetary authorizations, are an essential part of governments' internal control structures and often require special attention from the auditor.[14]

46. Performing tests of controls to reduce the assessed level of control risk would result in less audit effort for the substantive tests of compliance with laws and regulations; however, it cannot eliminate the need to perform any substantive tests. Consequently, regardless of the effectiveness of internal control structure policies and procedures, auditors should perform substantive tests of compliance with laws and regulations.

47. If the auditors' procedures disclose inadequate provisions for compliance with laws and regulations, then the auditors should, after consultation with legal counsel, as appropriate, report those inadequate provisions as reportable conditions in their report on internal controls.

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[14]Auditors are not required to determine whether the controls are placed in operation if they determined that the controls are likely to be ineffective in preventing or detecting noncompliance that is relevant to the financial statement audit.

Performing Tests of Compliance

48. SAS no. 68 requires auditors to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

49. GAGAS requires auditors to assess, for other relevant laws and regulations, the risks that noncompliance could occur. Because these other relevant laws and regulations do not have a direct and material effect on financial statement amounts, the assessment of risk and design of tests of compliance will likely differ from the work performed to meet the requirements of SAS no. 68. The nature and extent of these tests, if not specified in law, regulation, or contract, will be a matter of auditor judgment. Auditors should consider the control policies and procedures and the significance of the area of compliance to the program, and may consult with legal counsel, investigative staff and/or audit officials of other government entities who fund the audited entity.

50. When information comes to auditors' attention that suggests noncompliance with these or any other laws and regulations, the auditors, in consultation with attorneys, should obtain an understanding of the nature of the indication of noncompliance, the circumstances in which it occurred, and sufficient other information to evaluate both the effect on the financial statements and the implication for other aspects of the audit. The auditors should also consider whether the indication of noncompliance would be important to users of the audit report. If the auditors determine that the sensitivity of the indication of noncompliance would cause it to be perceived as significant by decisionmakers, the auditors should report those significant indications in the report on

compliance. The implications of a particular indication of noncompliance will depend on the relationship of the perpetration and concealment, if any, of the noncompliance to specific control procedures and the level of management or employees involved.

Due Care Concerning Possible Illegal Acts

51. Auditors should exercise due professional care in pursuing indications of possible fraud or other illegal acts that could result in criminal prosecution so as not to interfere with potential future investigations, legal proceedings, or both. Due care would include consulting legal counsel, investigative staff, and/or audit officials of other government entities whose funds were involved, as appropriate, before proceeding.

52. Under some circumstances laws, regulations, or policies may require that auditors promptly report to law enforcement or investigatory authorities, before extending audit steps and procedures, indications of fraud or other illegal acts that could result in criminal prosecution. Auditors may also be required to withdraw from or defer further work on the audit or a portion of the audit in order not to interfere with an investigation.

53. Most auditors are not trained to conduct investigations of fraud or other illegal acts, which are the responsibility of law enforcement authorities or investigative staff. However, auditors are responsible for being aware of the characteristics and types of vulnerabilities and potential illegal acts associated with the area being audited so that they can identify indications that these acts may have occurred.

54. An audit made in accordance with generally accepted government auditing standards will not guarantee the discovery of all illegal acts or contingent liabilities resulting from noncompliance. Nor does the subsequent discovery of illegal acts committed during the audit period necessarily mean that the auditors' performance was inadequate, provided the audit was made in accordance with these standards.

WORKING PAPERS

55. The AICPA standards and GAGAS require the following:

> **A record of the auditors' work should be retained in the form of working papers.**

56. The additional standard for working papers is:

> **Working papers document the basis for findings, conclusions, and auditors' recommendations and should contain sufficient information to enable an experienced auditor having no previous connection with the audit subsequently to ascertain from them what work was performed to support the conclusions.**

57. This standard is more stringent than the AICPA standards, which permit auditors to support their work by other means in addition to working papers. Audits done in accordance with generally accepted government auditing standards are subject to review by other auditors and by oversight officials more frequently than audits done in accordance with the AICPA standards. Thus, whereas the AICPA standards cite two main purposes of working papers--providing the principal support for the audit report and aiding auditors in the conduct and supervision of the audit--working papers serve an additional purpose in audits performed in accordance with generally

accepted government auditing standards. Working papers allow for the review of audit quality by providing the reviewer a written explanation of the basis for the auditors' significant conclusions and judgments.

58. Arrangements need to be made to ensure that working papers will be made available, upon request, to other government audit staff and individual auditors. Contractual arrangements for government audits should provide for access to working papers.

59. Working papers for financial audits should contain

   a. the objective, scope, and methodology, including any sampling criteria used, and results of the audit;

   b. evidence of the work performed to support findings, judgments, and conclusions; and

   c. evidence of supervisory reviews of the work conducted.

CHAPTER 5

REPORTING STANDARDS FOR FINANCIAL AUDITS

PURPOSE

1. This chapter prescribes standards of reporting for financial audits, which include financial statement audits and financial related audits.

2. For financial statement audits, Government Auditing Standards incorporate the AICPA's four generally accepted standards of reporting, which are:

    a. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

    b. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

    c. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

    d. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

3. The AICPA has issued statements on auditing standards (SAS) that interpret the four standards of reporting and require auditors to add explanatory language to their reports in certain circumstances.[1] Preparing audit reports in accordance with the AICPA's SASs is the most common way to implement the four standards of reporting and other reporting requirements.

4. Under generally accepted government auditing standards, auditors may issue their report using language different from that prescribed in the SASs if the alternative language will better meet the needs of the users of the audit report. For example, alternative language may be appropriate when the report users are primarily government officials who are able to discuss the audit report with the auditors. However, other users, particularly those who are already familiar with reports in accordance with the SASs and who are unable to discuss the report with the auditors, may not readily understand alternative report language. Thus, before deciding to use alternative report language, auditors should be satisfied that the users of their report are likely to find it clearer than reports in accordance with the SASs. Whenever auditors choose to depart from the SASs on reporting, they remain responsible for determining that the alternative reporting language satisfies the four generally accepted standards of reporting and includes any explanatory language required by the SASs.[2] Regardless of

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[1]For example, the SASs require auditors to add explanatory language to their reports when the chance of a material loss resulting from resolution of a matter involving an uncertainty is reasonably possible. GAGAS incorporates the AICPA's reporting requirements for additional explanatory language. Future AICPA statements on reporting will be adopted and incorporated unless GAO excludes them by formal announcement.

[2]Example 1 to this chapter provides an example of an alternative report.

whether auditors report in accordance with the SASs or an alternative, such as in example 1, they are encouraged to provide additional details on the audit or the entity through explanatory paragraphs in their report.

5. This chapter prescribes additional standards needed to satisfy the unique needs of government financial audits. These standards further define the nature and extent of auditors' responsibilities in the areas of

   a. compliance with generally accepted government auditing standards,

   b. internal controls and compliance with laws and regulations,

   c. other information in documents containing audited financial statements,

   d. privileged and confidential information, and

   e. report distribution.

6. This chapter also addresses the standards that apply to reporting the results of financial related audits.

<u>COMPLIANCE WITH GOVERNMENT AUDITING STANDARDS</u>

7. The first additional reporting standard for financial audits is:

   The audit report should include a statement that the audit was made in accordance with generally accepted

government auditing standards.[3]

8. The above statement refers to all the applicable standards that the auditors should have followed during their audit. The statement should be qualified in situations where the auditors did not follow an applicable standard. In these situations, the auditors should disclose in the scope section of their report the applicable standard that was not followed, the reasons therefor, and how not following the standard affected the results of the audit.

9. Auditors may issue an opinion that cites both generally accepted auditing standards and generally accepted government auditing standards. However, an opinion citing generally accepted auditing standards, but not generally accepted government auditing standards, should not be used.[4]

REPORTING ON INTERNAL CONTROLS AND COMPLIANCE WITH LAWS AND REGULATIONS

10. The second additional reporting standard for financial audits is:

Auditors should report on internal controls and compliance with laws and regulations by

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[3]Generally accepted government auditing standards (GAGAS) include the audit standards set forth in this publication, Government Auditing Standards, and subsequent revisions and interpretations.

[4]It has been a common practice to issue opinions on the financial statements that cite compliance with the AICPA standards without reference to generally accepted government auditing standards. This practice is no longer acceptable because of the significant differences between the standards.

a. identifying who is responsible for deciding whether to supplement the financial statement audit with additional tests of internal controls or compliance, and their decision;

b. reporting internal control and compliance findings; and

c. disclosing the scope of the auditors' testing of internal controls and compliance with laws and regulations.

11. Auditors may address internal controls and compliance with laws and regulations in separate reports or in the report on the financial statements.

Decisions About Internal Control and Compliance Work

12. Auditors should disclose in the report:[5]

    a. who is responsible for deciding whether to supplement the financial statement audit with additional tests of controls and compliance and

    b. the decision on whether and, if so, to what extent internal control and compliance work was expanded beyond what is required in a financial statement audit.

[5]This information can be included in either the auditor's opinion on the financial statements or in the separate reports on internal controls and compliance with laws and regulations. To help auditors comply with this requirement, example 2 to this chapter illustrates an explanatory paragraph that could be included in a financial statement audit report prepared in accordance with AICPA standards.

13. As discussed in chapter 4, who is responsible for deciding whether to supplement the financial statement audit with additional tests of internal controls or compliance depends on who performs the audit. Disclosure of who is responsible for this decision and what decision was made assists in providing a context for report users to understand the extent of internal control and compliance coverage.

Reporting on Internal Controls

14. The audit report should present "reportable conditions" as defined in AICPA's SAS no. 60, Communication of Internal Control Structure Related Matters Noted in an Audit, including:

    a. deficiencies in the control environment that diminish the effectiveness of specific control policies or procedures,

    b. inadequate provisions for the safeguarding of assets,

    c. inadequate provisions for compliance with laws and regulations that are perceived as significant, and

    d. the status of known but uncorrected reportable conditions and recommendations from prior audits that affect the financial statement audit.

15. In making the judgment as to which deficiencies in internal controls should be included as reportable conditions, auditors should consider not only their materiality in relation to the financial statements, but also how audit report users could perceive the control deficiency. Auditors should report control deficiencies that, in their judgment, would be important to the users of the audit

report.

16. In reporting reportable conditions (audit findings), the auditors should identify those that are individually or cumulatively material weaknesses.[6] In presenting the findings, auditors should follow the report contents standards as appropriate for objectives, scope and methodology, audit results, and views of responsible officials, and the report presentation standards, discussed in chapter 7.

17. Reporting matters that in the auditors' judgment are not reportable conditions in an audited entity's internal control structure should be separately communicated to the audited entity, preferably in writing. Such control structure matters when communicated in a management letter should be referred to in the audit report. All communications should be documented in the working papers.

18. The audit report should also describe the scope of the auditors' testing of internal controls and should indicate whether those tests provide sufficient evidence to support an opinion on internal controls.

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[6]Audit findings have often been regarded as containing the elements of criteria, condition, and effect, plus cause when problems are found. However, the elements needed for a finding depend entirely on the objectives of the audit. It is recognized that reportable conditions and noncompliance found by the auditor may not always have all of these elements fully developed, given the scope and objectives of the specific financial audit. But at least the auditor should identify the condition, criteria, and possible asserted effect to provide sufficient information to federal, state, and local officials to permit them to determine the effect and cause in order to take prompt and proper corrective action.

Reporting on Compliance

19. The audit report should include all instances of noncompliance that auditors determine are significant. All instances of fraud or other illegal acts that could result in the entity, or an official or employee of the entity, being subject to criminal prosecution should also be reported. As discussed in chapter 4, the term "noncompliance" comprises illegal acts (violations of laws and regulations) and violations of contractual provisions, grant agreements, and agency policies and procedures.

20. In judging the significance of instances of noncompliance, auditors should consider not only their materiality in relation to the financial statements but also how audit report users could perceive the noncompliance. Auditors should report instances of noncompliance that, in their judgment, would be important to the users of the audit report. For that reason, auditors and those individuals who contract for the financial statement audit, to the extent practical, should agree in advance on the auditors' responsibilities for reporting significant instances of noncompliance. These individuals' expectations may well exceed the auditors' responsibility to report noncompliance that may materially affect on the financial statements.

21. In reporting significant instances of noncompliance, the auditors should place their findings in proper perspective. To give the reader a basis for judging the prevalence of noncompliance, the instances of noncompliance should be related to the universe or the number of cases examined and be quantified in terms of dollar value, if appropriate. In presenting instances of noncompliance, auditors should follow the report content standards as appropriate, for objectives, scope and methodology, audit results, and views

of responsible officials, and the report presentation standards, discussed in chapter 7.

22. Other nonsignificant instances of noncompliance need not be disclosed in the auditors' reporting on compliance but should be reported in a separate communication to the audited entity, preferably in writing. Such instances of noncompliance, when communicated in a management letter, should be referred to in the audit report. All communications should be documented in the working papers.

23. The audit report should also describe the scope of the auditors' testing of compliance with laws and regulations. The report should indicate whether or not those tests provide sufficient evidence to support an opinion on compliance.

Illegal Acts

24. AICPA's SAS no. 54, Illegal Acts by Clients, notes that: "the determination of whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law." Auditors' training, experience, and understanding of the program being audited may provide a basis for recognition that some acts coming to their attention may be illegal. However, whether an act is, in fact, illegal is a determination that is normally beyond the auditors' professional capacity. In some circumstances, it will not be practicable for auditors to await a legal determination before issuing their report. Even so, information that auditors obtain about an act appearing to be a significant illegal act may be significant to the users of the audit report. Auditors, after consultation with legal counsel, as appropriate, should report such

information as an indication of an illegal act as discussed in paragraphs 25 through 28. In reporting indications of illegal acts, auditors should not imply that they have made a determination of legality.

25. Illegal acts that auditors become aware of should be covered in a written report and submitted in accordance with the following paragraphs. Such acts may be covered in a separate report if including them in the overall report would compromise investigative or legal proceedings or otherwise preclude the report from being released to the public. Auditors should be aware that reports containing information on fraud or other illegal acts that could result in criminal prosecution, or reports with references that such acts were omitted, could interfere with legal processes or subject the implicated individuals to undue publicity. They also might subject auditors to potential legal action. Thus, auditors generally should not release such reports without consulting with legal counsel, investigative staff, and/or audit officials of other government entities whose funds were involved.

26. If auditors become aware of illegal acts that could affect the audited entity, they should promptly report to the top officials of that entity (unless, as discussed in "a," below, those officials are implicated in the illegal acts). In the following circumstances, the auditors[7] should promptly report the illegal acts to appropriate parties outside the audited entity (as discussed in paragraph 27):

   a. Top management of the audited entity is implicated in the illegal acts.

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[7]Internal auditors auditing within the entity that employs them do not have a duty to report outside that entity.

b. The auditors identify fraud or other illegal acts that could result in criminal prosecution.

c. The audited entity fails to report certain illegal acts as required by law or regulation.

27. Depending on whom the audited entity is accountable to, auditors may be required to report illegal acts to one or more of the following parties:

a. A senior level of government; for example, a local government may be accountable to a state government.

b. Another branch of government; for example, an agency in the executive branch of a state government may be accountable to the state legislature or one of its committees.

c. An entity providing government funds to the audited entity; for example, an entity receiving federal funds is accountable to the federal agency providing those funds. If federal funds were received indirectly from a nonfederal entity (that is, a state or local government or nonprofit organization) the audited entity is also accountable to that entity.

d. Law enforcement agencies; law or regulation may require auditors to report certain illegal acts to law enforcement agencies.

28. Auditors should exercise judgment in determining if they should promptly report illegal acts to outside parties in other circumstances. Generally, the more significant an illegal act is, the greater will be outside parties' need for prompt information about that act.

REPORTING ON OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

29. The third additional reporting standard for financial audits is:

    Auditors should report disagreements with management's reporting on performance measures or other information that is included in a document containing the auditors' opinion on the financial statements.

30. An entity may publish various documents that contain other information, such as performance measures, in addition to the audited financial statements and the auditors' opinion. Auditors should read that information and report any material inconsistencies or misstatements of facts. Auditors should follow the guidance in AICPA's SAS no. 8, Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents, when carrying out this responsibility.

PRIVILEGED AND CONFIDENTIAL INFORMATION

31. The fourth additional reporting standard for financial audits is:

    If certain information is prohibited from general disclosure, the audit report should state the nature of the information omitted and the requirement that makes the omission necessary.

32. Certain information may be prohibited from general disclosure by federal, state, or local laws or regulations. Such information may be provided on a need-to-know basis only to persons authorized by law or regulation to receive

it.

33. If such requirements prohibit auditors from including pertinent data in the report, they should state the nature of the information omitted and the requirement that makes the omission necessary. The auditors should obtain assurance that a valid requirement for the omission exists and, where appropriate, consult with legal counsel.

34. Paragraph 25 provides guidance on the auditors' considerations before releasing reports which refer to the fact that illegal acts or indications of such acts were omitted from reports.

REPORT DISTRIBUTION

35. The fifth additional reporting standard for financial audits is:

> **Written audit reports are to be submitted by the audit organization to the appropriate officials of the organization audited and to the appropriate officials of the organizations requiring or arranging for the audits, including external funding organizations, unless legal restrictions prevent it. Copies of the reports should also be sent to other officials who have legal oversight authority or who may be responsible for acting and to others authorized to receive such reports. Unless restricted by law or regulation, copies should be made available for public inspection.**[8]

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[8]See the Single Audit Act of 1984 (31 U.S.C. 7502(f)) and section 13(f) of OMB Circular A-128 for the distribution of reports on single audits of state and local governments.

36. Audit reports should be distributed promptly to officials interested in the results. Such officials include those designated by law or regulation to receive such reports, those responsible for acting, those of other levels of government that have provided funds to the audited entity, and legislators.

37. The audit report on the financial audit, the report on compliance, and the report on internal control, if separate reports, should be bound together so that the three reports are issued together in one bound document. If the three reports are not issued together in one bound document, the audit report on the financial audit must include a statement that reports on compliance and internal control were also issued.

38. When public accountants are engaged, the engaging organization should ensure that the audit report is distributed appropriately. If the public accountants are to make the distribution, the engagement agreement should indicate what officials or organizations should receive the report.

39. Internal auditors should follow their entity's own arrangements and statutory requirements for distribution. Usually, they report to their entity's top managers and the entity's managers are responsible for distribution of the report.

REPORTING ON FINANCIAL RELATED AUDITS

40. The sixth additional reporting standard for financial audits is:

The reporting standards and compliance auditing

standards of AICPA and the supplemental standards of this chapter apply to those financial related audits that require an expression of an opinion on financial presentations. Other financial related audits should follow the applicable reporting standards in chapter 7 of this statement or those of the AICPA (including Statement on Standards for Attestation Engagements), as appropriate.

41. The additional standards in this chapter on compliance with generally accepted government auditing standards, privileged and confidential information, and report distribution apply to all financial related audits where the AICPA auditing or attestation standards apply. Auditors should exercise professional judgment in determining if the provisions of the additional standard on reporting on internal controls and compliance are relevant to the objectives of the financial related audit.

EXAMPLE 1:

Alternative Report Language

This example provides an alternative report format to the language prescribed by the AICPA. The example combines in one report, the auditor's opinion, the opinion on internal control, and the report on compliance with laws and regulations for the U.S. General Accounting Office's financial statements for the period ending September 30, 1992. This report summarizes up-front the auditors' conclusions on GAO's principal statements, internal controls, and compliance with laws and regulations. While this example presents an opinion on internal controls, these standards do not require such an expression of opinion. For suggested language to use when disclosing who made audit coverage decisions under these standards, see chapter 5, example 2.

INDEPENDENT AUDITORS' REPORT

Comptroller General of the United States:

We audited the General Accounting Office's Principal Statements as of and for the year ended September 30, 1992, and performed a related study and evaluation of its system of internal control.

In our opinion:

- The 1992 Principal Statements are presented fairly, in all material respects; and
- The system of internal control in effect at September 30, 1992, was sufficient to meet the control objectives identified below.

We found:

- No material conflicts with management's report on internal controls voluntarily prepared under the Federal Managers' Financial Integrity Act of 1982; and
- No material noncompliance with the selected provisions of applicable laws and regulations tested.

Each of these conclusions is discussed in more detail below. This report also discusses the scope of our work.

OPINION ON PRINCIPAL STATEMENTS

In our opinion, the 1992 Principal Statements including the accompanying notes, on pages 23 through 31, present fairly, in all material respects, the General Accounting Office's:

- financial position as of September 30, 1992;
- results of operations and changes in net position;
- cash flows; and
- budget and actual expenses for the year then ended

on the basis of accounting described in Note 1 to the Principal Statements, which is a comprehensive basis of accounting other than generally accepted accounting principles. The Principal Statements of the General Accounting Office as of September 30, 1991, were audited by other auditors whose report thereon dated December 18, 1991, expressed an unqualified opinion on those statements.

As described in Note 1, in 1992 the General Accounting Office adopted the provisions of Office of Management and Budget (OMB) Bulletin 93-02, "Form and Content of Federal Financial Statements", which require the presentation of a Statement of Cash Flows, a Statement of Budget and Actual Expenses, and certain other disclosures.

OPINION ON INTERNAL CONTROLS

We have made a study and evaluation of the General Accounting Office's system of internal control designed by management to provide reasonable, but not absolute, assurance that the following objectives are met:

- obligations and costs are in compliance with applicable laws and regulations;

- funds, property and other assets are safeguarded against loss from unauthorized use or disposition; and

- revenue and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial reports and to maintain accountability over assets.

In our opinion, the system of internal control in effect at September 30, 1992, taken as a whole, was sufficient to meet the objectives stated above insofar as those objectives pertain to the prevention or detection of errors and irregularities in amounts that would be material to the Principal Statements. In addition, nothing came to our attention to indicate that the General Accounting Office's report on internal controls dated June 25, 1992, voluntarily prepared under the Federal Managers' Financial Integrity Act of 1982 (FMFIA), conflicts materially with the results of our study and evaluation of the system of internal control.

Internal Controls at the National Finance Center. Recent examinations of the National Finance Center (NFC), a federal information processing center that performs substantial payroll processing functions for the General Accounting Office, identified certain weaknesses in NFC's internal controls:

- An independent accountant's report dated September 30, 1991 found that "Program changes (at NFC) are not adequately documented and controlled."

- An audit report by NFC's Inspector General dated September 30, 1992 found that "Improvements are needed in the security controls over IDMS." The report further stated that "security vulnerabilities existed (in IDMS) that would allow unauthorized access and modification to payroll/personnel data." IDMS is a database management system software package which NFC uses to manage and maintain federal agency employee payroll and personnel information.

These conditions were considered in determining the nature, timing, and extent of audit tests to be applied in our audit of the 1992 Principal Statements, and these conditions do not affect our opinions on these Principal Statements and the system of internal control.

COMPLIANCE WITH LAWS AND REGULATIONS

The objective of our audit of the Principal Statements, including our tests of compliance with selected provisions of applicable laws and regulations, was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

However, our tests of compliance with selected provisions of applicable laws and regulations disclosed no material instances of noncompliance. Also, with respect to items not tested, nothing came to our attention that caused us to believe that material noncompliance with such provisions occurred. These conclusions with respect to our tests of compliance with selected provisions of applicable laws and regulations are intended solely for the information of Congress and the General Accounting Office's management.

RESPONSIBILITIES AND METHODOLOGY

Management has the responsibility for:

- preparing the Principal Statements in conformity with the comprehensive basis of accounting described in Note 1 to the Principal Statements;

- establishing and maintaining a system of internal control; and

- complying with applicable laws and regulations.

Further, management has elected to comply with substantially all of the provisions of FMFIA.

Our responsibility is to express opinions on the Principal Statements and system of internal control based on our audit and study and evaluation, respectively. Accordingly, we planned and performed the audit to obtain reasonable assurance about whether (1) the Principal Statements are free of material misstatement and presented fairly in accordance with the basis of accounting described in Note 1 to the Principal Statements, and (2) the system of internal control is sufficient to meet the control objectives stated previously insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the Principal Statements. We are also responsible for testing compliance with provisions of applicable laws and regulations.

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the Principal Statements;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the Principal Statements;
- evaluated and tested relevant internal controls over the following significant cycles, classes of transactions, and account balances,

  - Payroll,
  - Travel Disbursements,
  - Operating Disbursements,
  - Budget Monitoring and Appropriations,
  - Fund Balances With Treasury, and
  - Accounts Payable;

- tested compliance with selected provisions of the following laws and regulations that may materially affect the Principal Statements,

  - Anti-deficiency Act,
  - Fair Labor Standards Act,
  - Civil Service Retirement Act,
  - GAO Personnel Act of 1980,
  - Federal Employees' Compensation Act,
  - Federal Employees' Health Benefits Act of 1959, and
  - Federal Employees' Group Life Insurance Act of 1980; and

- at management's request, compared the General Accounting Office's most recent FMFIA report on internal controls dated June 25, 1992 with our study and evaluation of the system of internal control.

We did not evaluate the internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to ensuring efficient operations. We limited our work to accounting and other controls necessary to achieve the objectives outlined in our opinion on the system of internal control. Because of inherent limitations in any system of internal control, losses, noncompliance or misstatements may nevertheless occur and not be detected. We also caution that projecting our evaluations to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate.

Our audit was conducted in accordance with generally accepted auditing standards, Government Auditing Standards, as issued by the Comptroller General of the United States, and OMB Bulletin 91-14, "Audit Requirements for Federal Financial Statements." Our study and evaluation of the system of internal control in effect at September 30, 1992, was conducted in accordance with standards established by the American Institute of Certified Public Accountants. We believe that our audit and our study and evaluation provide a reasonable basis for our opinions.

Consistency of Other Information. The "Overview of Operations and Financial Management" and other supplemental information in "A Message from the Comptroller General" contain a wide range of data, some of which is not directly related to the Principal Statements. Professional standards require the auditor to read this information and consider whether such information, or the manner of its presentation, is materially inconsistent with the information, or the manner of its presentation, appearing in the Principal Statements. If based on such reading the auditor concludes that there is a material inconsistency, the auditor should determine whether the Principal Statements, his report, or the other information require revision.

KPMG Peat Marwick

December 18, 1992
Washington, DC

EXAMPLE 2

Suggested Language for Disclosing Who Made Audit Coverage Decisions

This example addresses internal controls and compliance with laws and regulations when auditors have not been engaged to expand the testing required as part of an audit of the financial statements. The example is in the form of an explanatory paragraph that could be included in either a financial statement audit report prepared in accordance with the AICPA's standards or in the alternative reporting language shown in example 1.

> Management is responsible for obtaining audit coverage that is broad enough to help fulfill the reasonable needs of potential users of the audit report. With respect to audit coverage of internal controls and compliance with laws and regulations, management engaged us to perform those procedures required in a financial statement audit conducted in accordance with generally accepted government auditing standards. Those procedures were not sufficient to provide a basis for expressing an opinion on internal controls or compliance. Had we been engaged to apply additional agreed-upon procedures or perform an examination of controls or compliance with laws and regulations, we might have discovered and reported deficiencies in internal controls or instances of noncompliance in addition to those that follow:
>
> [Present internal control and compliance findings.]

CHAPTER 6

FIELD WORK STANDARDS FOR PERFORMANCE AUDITS

PURPOSE

1. This chapter presents field work standards for government performance audits. Because of the variety of objectives that can be undertaken in performance audits and the range of methodologies available to achieve those objectives, these standards are stated broadly. Each standard is accompanied by guidance on how to apply it. This guidance is intended to help auditors implement the standards, not to constrain their judgment in doing so.

PLANNING

2. The first field work standard for performance audits is:

   Work is to be adequately planned.

3. In planning, auditors define the audit's objectives, scope, and methodology. The objectives should clearly state what the audit is to accomplish. They should identify the audit subjects and performance aspects to be included, as well as the potential finding and reporting elements that the auditors expect to develop.[1] Audit objectives, including potential finding and reporting elements, can be thought of as questions about the program[2] that auditors seek to

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[1]See discussion of the elements of a finding in paragraphs 57 through 60.

[2]Government Auditing Standards are standards for audit of governmental organizations, programs, activities, and functions. For the sake of brevity, this standard uses only the term "program." However, the concepts presented are equally applicable to audits of organizations, activities, and functions.

answer. Scope is the boundary of the audit. It addresses such things as the period and number of locations to be covered. The methodology comprises the work auditors will do to achieve the objectives. Auditors should design the methodology to provide sufficient, competent, and relevant evidence to achieve the objectives of the audit. Methodology includes not only the nature of the auditors' procedures, but also their extent (for example, sample size).

4. Planning a performance audit ordinarily includes the following:

   a. Considering significance and the needs of potential users of the audit report. (See paragraphs 6 through 8.)

   b. Obtaining an understanding of the "program" to be audited. (See paragraphs 9 and 10.)

   c. Considering legal and regulatory requirements. (See paragraphs 31 through 46.)

   d. Considering management controls. (See paragraphs 47 through 53.)

   e. Identifying criteria needed to evaluate matters subject to audit. (See paragraphs 11 and 12.)

   f. Identifying significant findings and recommendations from previous audits that could affect the current audit objectives. Auditors should determine if management has corrected the conditions causing those findings and implemented those recommendations.

g. Identifying potential sources of data that could be used as audit evidence and the reliability of this data, including data collected by the audited entity, data generated by the auditors, or data provided by third parties.

h. Considering whether the work of other auditors or of experts may be used to satisfy some of the auditors' objectives. (See paragraphs 13 through 17.)

i. Providing sufficient staff and other resources to do the audit. (See paragraphs 18 and 19.)

5. Neither objectives nor scope nor methodology is determined in isolation. Auditors determine these three elements of the audit plan together, as the considerations in determining each often overlap. Planning continues throughout the audit, and auditors should document their plan and changes to it as discussed in paragraphs 20 through 24.

Significance and User Needs

6. Auditors should consider significance in planning, performing, and reporting on performance audits. The significance of a matter is its relative importance to the audit objectives and potential users of the audit report. In determining significance, auditors should consider not only the quantitative factors, but also the qualitative ones, such as

a. visibility and sensitivity of the program under audit,

b. newness of the program or changes in its conditions,

c. role of the audit in providing information that can improve public accountability and decision-making, and

d. level and extent of review or other forms of independent oversight.

7. One group of users of the auditors' report is government officials who may have authorized or requested the audit. In attempting to meet the needs of these users, auditors should maintain their independence. In making decisions about planning, performing, and reporting on the audit, auditors should judge based on the evidence developed, not on the wishes of those who may have authorized or requested the audit.

8. Another important user of the auditors' report is the audited entity, which is responsible for acting on the auditors' recommendations. Other potential users of the auditors' report include government officials (other than those who may have authorized or requested the audit), the media, interest groups, and individual citizens. These other potential users may have, in addition to an interest in the program, an ability to influence the conduct of the program. Thus, an awareness of these potential users' interests and influence can help auditors understand why the program operates the way it does. This awareness can also help auditors judge whether possible findings could be significant to these other users.

Understanding the Program

9. Auditors should obtain an understanding of the program to be audited to help assess, among other matters, the significance of possible audit objectives and the feasibility of achieving them. The auditors' understanding

includes knowledge the auditors already have about the program and knowledge they gain from inquiries and observations they make in planning the audit. The extent and breadth of those inquiries and observations will vary among audits, as will the need to understand the following individual elements of the program.

a. Goals and objectives: Goals and objectives are statements about what the program is supposed to achieve. Management may set goals and objectives for program outputs, processes, or efforts; however, legislatures often set program goals and objectives when they establish a program. Auditors may use these goals and objectives to develop criteria for assessing program performance.

b. Efforts: Efforts are the amount of financial and nonfinancial resources that are put into a program.[3] These resources may come from within or outside the entity operating the program. Examples of measures of efforts are dollars, employee-hours, and square feet of building space.

c. Program operations: Program operations are the strategies, processes, and activities the audited entity uses to convert efforts into outputs. Program operations are subject to management controls, which are discussed later in this chapter.

d. Outputs: Outputs are the quantity of services provided

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[3]This definition is from the Governmental Accounting Standards Board's Preliminary Views on Concepts Related to Service Efforts and Accomplishments Reporting, December 18, 1992.

or work conducted.[4] Examples of measures of output are tons of solid waste processed, number of students graduated, and number of unemployed persons placed in jobs.

e. Outcomes: Outcomes are accomplishments or results that occur (at least partially) because of services provided.[5] Outcomes differ from outputs. For example, while the number of unemployed persons placed in jobs may be established as a measure of a job training program's immediate output, the program's ultimate outcome (and test of its effectiveness) depends on whether persons in the job training program are more likely to remain employed than similar persons not in the program.[6] Surveys of public perceptions of the quality of services is another outcome measure. Outcomes may be intended or unintended. For example, the intention of the 55-mile per-hour speed limit was to conserve gasoline, but it has also been credited with reducing traffic deaths. The need to isolate the effects of the program from those of other influences requires using methodological approaches drawn from the field of program evaluation. Possible external influences on program outcomes may include cultural, economic, physical, or technological factors.

10. One approach to setting audit objectives is to relate the elements of a program to the types of performance audits discussed in chapter 2. For example, audits concerned with

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[4]See footnote 3.

[5]See footnote 3.

[6]Auditors should consider these differences when their report discusses program outputs (for example, immediate performance indicators).

economy would focus on efforts: Were they obtained at the least possible cost? Audits concerned with efficiency would look at the relationship between efforts and either outputs or outcomes to determine the cost per unit of output or outcome. Audits concerned with effectiveness could be concerned with determining whether program outcomes met specified goals and objectives or whether outcomes were better than they would have been without the program. Any type of performance audit may encompass program operations if auditors are looking for reasons why the program was successful or not.

Criteria

11. Criteria are the standards used to determine whether a program meets or exceeds expectations. Criteria provide a context for understanding the results of the audit. The audit plan, where possible, should state the criteria to be used. In selecting criteria, auditors have a responsibility to use only criteria that are reasonable, attainable, and relevant to the matters being audited. The following are some examples of different types of criteria:

    a. targets or goals set by management or prescribed by law or regulation,

    b. technically developed standards or norms,

    c. expert opinions,

    d. prior years' performance,

    e. performance of similar entities,

    f. performance in the private sector, and

g. expected direction of change in outcomes.

12. When the criteria are vague, the auditors should seek interpretation. If interpretation is not available, auditors should strive to agree on the appropriateness of these measures with the interested parties, or if applicable, indicate that they were unable to report on performance because of the lack of definitive criteria.

Considering the Work of Other Auditors and Experts

13. Auditors should determine if other auditors have previously done, or are doing, audits of the program or the entity that operates it. If auditors intend to rely on the work of others because it appears to be relevant to their own audit objectives, they should perform procedures that provide a sufficient basis for that reliance. When auditors decide to rely on the work of others, they should indicate in the scope section of their report the magnitude of the audit work completed by others and their basis for relying on that work.[7]

14. Whether other auditors have done performance audits or financial audits, other auditors may be useful sources of information for planning and performing the audit. If other auditors have identified areas that warrant further study, their work may influence the auditors' selection of audit objectives. The availability of other auditors' work, or of

[7]If the work of others is used only for background or informational purposes and is not material or significant to the auditors' report, this guidance does not preclude auditors from referring to such work in their audit report even if the auditors did not verify it. In these situations, the auditors may just cite the information and its source in their audit report.

the work of other experts, may also influence the selection of audit methodology, as the auditors may be able to rely on that work to limit the extent of their own testing.

15. To rely on the work of another external auditor or of an internal auditor, auditors should satisfy themselves as to the other auditor's qualifications and independence. Auditors should satisfy themselves that the other auditor's evidence is relevant to the auditors' own audit objectives and is sufficient and competent. Evidence of another external auditor's qualifications[8] and independence can be obtained through prior experience, inquiry of others in the audit community and/or review of the other auditor's external quality control review report. Evidence of an internal auditor's qualifications and independence can be obtained through discussion with managers and internal auditors, review of hiring and training policies, review of organization charts, and/or review of the internal auditor's external quality control review report.

16. Auditors may determine the sufficiency, relevance, and competence of another auditor's evidence by reviewing the other auditor's report, audit program, and/or working papers. Depending on the significance of the other auditor's work to the body of evidence supporting the auditors' findings and their conclusions or recommendations, if any, the auditors may find it necessary to make supplemental tests of the other auditor's work. Because generally accepted government auditing standards do not

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[8]Auditors from another country engaged to conduct audits in their country should meet the professional qualifications to practice under that country's laws and regulations or other acceptable standards, such as those issued by the International Organization of Supreme Audit Institutions (INTOSAI). Also see the International Federation of Accountants <u>International Auditing Guideline 3</u>.

recognize internal auditors as being independent for purposes of reporting the results of their audits externally, auditors' tests of their evidence generally should be more rigorous than they would be if the same evidence had been provided by other external auditors.

17. When relying upon the work of nonauditors (consultants, experts, specialists, and so forth, other than those hired to assist in the audit), the auditors should obtain an understanding of the methods or assumptions used. They should also satisfy themselves as to the nonauditors' professional reputation, qualifications, and independence from the organization, program, activity, or function under audit. The auditors should also consider whether to review the work program, review the working papers, or make supplemental tests of the work conducted.

Staff and Other Resources

18. Staff planning should include:

    a. Assigning staff with the appropriate skills and knowledge for the job.

    b. Assigning an adequate number of experienced staff and supervisors to the audit. Consultants should be used when necessary.

    c. Providing for on-the-job training of staff.

19. The availability of staff and other resources is an important consideration in establishing the objectives, scope, and methodology of an audit. For example, limitations on travel funds may preclude auditors from visiting certain locations, or lack of a expertise in a

particular methodology may preclude auditors from undertaking certain objectives. Auditors may be able to overcome such limitations by use of staff from local offices or by engaging consultants with the necessary expertise.

Written Audit Plan

20. A written audit plan should be prepared for each audit and is essential to conducting audits efficiently and effectively. The form and content of the written audit plan will vary among audits. The plan generally should include an audit program and a memorandum or other appropriate documentation of key decisions about the objectives, scope, and methodology of the audit and of auditors' basis for those decisions.

21. Documenting the audit plan is an opportunity for the auditors to review the work done in planning the audit to determine whether

    a. the proposed audit objectives are likely to result in a useful report,

    b. the proposed audit scope and methodology are adequate to satisfy the audit objectives promptly, and

    c. sufficient staff and other resources have been made available to perform the audit.

22. Written audit plans should generally include the following information.

    a. Introduction and background: To the extent necessary, information should be provided about the legal authority for the audited organization, program, activity, or function; its history and current objectives; its principal locations; and similar information needed by auditors to understand and carry out the audit plan.

b. Clearly stated objectives.

c. Clearly described scope.

d. Audit methods: The methodology should be clearly described, and for most audits, should present suggested steps, procedures, and sampling plans, as discussed in paragraphs 23 and 24, below. For coordinated audits, the audit organization planning the work should ensure that comparable audit methods and procedures are followed to ensure that the data obtained from participating locations will be comparable.

e. Special instructions: The auditors should clearly understand and reach early agreement on the responsibilities in each audit. This agreement is especially important when the work is to be directed by a central audit organization with work to be conducted at several different locations. This section of the plan may be used to list the responsibilities of each audit organization, such as preparing audit programs, conducting audit work, supervising audit work, drafting reports, handling auditee comments, and processing the final report.

f. Report: The audit plan, to the extent possible, should set forth the general format of the audit report and cite the types of information to be included.

23. Audit programs provide

a. a description of the methodology and suggested steps and procedures to accomplish the audit objectives,

b. a systematic basis for assigning work to supervisors and staff, and

c. the basis for a summary record of work.

24. Written audit programs should not be used merely as a checklist of steps to be conducted. Effective work on performance audits requires that the staff understand the objectives of the audit and use initiative in applying the audit program and in assessing the results of the work.

SUPERVISION

25. The second field work standard for performance audits is:

Staff are to be properly supervised.

26. This standard makes auditors and their audit organization responsible for seeing that staff who are involved in accomplishing the objectives of the audit receive appropriate guidance and supervision to ensure that the audit work is properly conducted, the audit objectives are accomplished, and staff are provided effective on-the-job training. External consultants and specialists also should be given appropriate guidance.

27. The most effective way to ensure the quality and expedite the progress of an assignment is by exercising proper supervision from the start of the planning to the completion of audit work and reporting. Supervision adds seasoned judgment to the work performed by less experienced staff and provides necessary on-the-job training for them.

28. Assigning and using staff is important to satisfying objectives. Since skills and knowledge vary among auditors, work assignments must be commensurate with abilities.

29. Supervisors should satisfy themselves that staff members clearly understand their assigned tasks before starting the work. Staff should be informed of not only what work they are to do and how they are to proceed but also why the work is to be conducted and what it is expected to accomplish. With experienced staff, the supervisors' role may be more general. They may outline the scope of the work and leave details to assistants. With a less experienced staff, a supervisor may have to specify not only how to gather data but also techniques for analyzing it.

30. Audit organizations should establish policies to ensure that reviews of audit work are prompt and to determine whether the (1) work complies with audit standards, (2) audit programs are followed, unless deviation is justified and authorized, (3) audit work has been conducted with due professional care, (4) working papers adequately support findings and any conclusions or recommendations, and (5) audit objectives are met. These policies may recognize that the nature of the review may vary depending on the significance of the work or the experience of the staff. For example, it may be appropriate to have experienced staff auditors review much of the work of other staff with similar experience. Reviews of the work should be documented in the working papers.

LEGAL AND REGULATORY REQUIREMENTS

31. The third field work standard for performance audits is:

In planning the audit, auditors should obtain an

understanding of laws and regulations that are relevant to the audit. When laws and regulations are significant to audit objectives, auditors should design the audit to provide reasonable assurance about compliance with them. In all performance audits, auditors should be alert to situations or transactions that could be indicative of illegal acts or abuse. Auditors should exercise due professional care and caution in pursuing indications of possible fraud or other illegal acts that could result in criminal prosecution so as not to interfere with potential future investigations and/or legal proceedings.

32. The following terms are used in describing auditors' responsibilities under this standard:

    a. Noncompliance is a failure to follow requirements, or a violation of prohibitions, contained in laws, regulations, contracts, grants, or agency policies and procedures.

    b. Illegal acts are a type of noncompliance; specifically, they are violations of laws or regulations.

    c. Fraud is the obtaining of something of value, illegally, through willful misrepresentation. Thus, fraud is a type of illegal act.

    d. Abuse occurs when the conduct of a government organization, program, activity, or function falls short of societal expectations for prudent behavior. Abuse is distinct from illegal acts in that when abuse occurs, no law or regulation is violated.

Understanding Relevant Laws and Regulations

33. In planning the audit, auditors should obtain an understanding of laws and regulations that are relevant to the audit. Auditors may obtain an understanding of laws and regulations through review of relevant documents and inquiry of attorneys, either their own or the audited entity's.

34. Understanding relevant laws and regulations can be important to planning a performance audit because government programs are usually created by law and are subject to more specific rules and regulations than the private sector. For example, what is to be done, who is to do it, the goals and objectives to be achieved, the population to be served, and how much can be spent on what are usually set forth in laws and regulations. Thus, understanding the laws establishing a program can be essential to understanding the program itself. Obtaining that understanding may also be a necessary step in identifying laws and regulations that are significant to audit objectives.

Testing Compliance With Significant Laws and Regulations

35. Auditors should design the audit to provide reasonable assurance about compliance with laws and regulations that are significant to audit objectives. This requires determining if laws and regulations are significant to the audit objectives and, if they are, assessing the risk that significant illegal acts could occur. Based on that risk assessment, the auditors design and perform procedures to provide reasonable assurance of detecting significant illegal acts.

36. Auditors may find it necessary to consult with attorneys in determining those laws and regulations that are significant

to the audit objectives, assessing the risk that illegal acts occurred, designing tests of compliance with laws and regulations, and evaluating the results of those tests. Expert advice may also be necessary when audit objectives require testing of compliance with contract provisions, grant agreements, or agency policies and procedures. Depending on the circumstances of the audit, it may be appropriate to consult other sources of expert advice on compliance matters, such as investigative staff, audit officials of other government entities whose funds are involved, and/or the applicable law enforcement organization.

37. It is not practical to set precise standards for determining if laws and regulations are significant to audit objectives because government programs are subject to so many laws and regulations, and audit objectives can vary widely. However, auditors may find the following approach helpful in making that determination:

  a. Reduce each audit objective to questions about specific elements of the program being audited (that is, goals and objectives, efforts, program operations, outputs, and outcomes, as discussed in paragraph 9).
  b. Identify laws and regulations that directly address specific elements of the program included in the audit objectives' questions.
  c. Determine if violations of those laws and regulations could significantly affect the auditors' answers to the questions encompassed in the audit objectives. If they could, then those laws and regulations are likely to be significant to the audit objectives.

38. The following are examples of types of laws and regulations that can be significant to the objectives of economy and

efficiency audits and of program audits.

a. Economy and efficiency: Laws and regulations that could significantly affect the acquisition, protection, and use of the entity's resources, and the quantity, quality, timeliness, and cost of the products and services it produces and delivers.

b. Program: Laws and regulations pertaining to the objectives of the entity's programs, activities, and functions; the manner in which programs and services are to be delivered; and the population a program or service is to serve.

39. In planning tests of compliance with significant laws and regulations, auditors assess the risk that illegal acts could occur. That risk may be affected by such factors as the complexity of the laws and regulations or their newness. The auditors' assessment of risk includes consideration of whether or not the entity has controls that are effective in preventing or detecting illegal acts. Management is responsible for establishing effective controls to ensure compliance with laws and regulations. In designing steps and procedures to test compliance, auditors should consider the effectiveness of an entity's controls to ensure compliance. If auditors intend to rely on those controls to reduce the extent of their tests of compliance, they should test those controls for sufficient evidence of their effectiveness.

Following Up on Possible Illegal Acts and Abuse

40. Auditors should be alert to situations or transactions that could be indicative of illegal acts or abuse. When information comes to the auditors' attention (through audit

procedures, tips, or other means) indicating that illegal acts or abuse may have occurred, auditors should consider whether the possible illegal acts or abuse could significantly affect the audit results. If they could, then the auditors should extend the audit steps and procedures, as necessary (a) to determine if the illegal acts or abuse occurred and (b) if so, to determine their effect on the audit results.

41. Auditors' training, experience, and understanding of the program being audited may provide a basis for recognition that some acts coming to their attention may be illegal. However, whether an act, in fact, is illegal is a determination normally beyond auditors' professional capacity. That determination would generally be based on the advice of an attorney or may have to await final determination by a court. In some circumstances, it will not be practical for auditors to await a legal determination before issuing their report, for example, the information auditors obtain about an act that appears to be a significant illegal act may actually be significant to the users of the auditors' report; and the users may need to act on it quickly. Auditors, after consultation with attorneys, as appropriate, should report such information as an indication of an illegal act as discussed in paragraph 33 of chapter 7.

42. Abuse is distinct from illegal acts. When abuse occurs no law or regulation is violated. Rather, the conduct of a government organization, program, activity, or function does not meet societal expectations for prudent behavior. To recognize abuse, auditors should be sensitive to these expectations. Because, however, the determination of abuse is so subjective, auditors are not expected to provide reasonable assurance of detecting abuse.

43. An audit made in accordance with these standards provides reasonable assurance that its objectives will be achieved; it does not guarantee the discovery of all illegal acts or abuse. Nor does the subsequent discovery of illegal acts or abuse committed during the audit period necessarily mean that the auditors' performance was inadequate, provided the audit was made in accordance with these standards.

Due Care Concerning Possible Fraud

44. Auditors should exercise due professional care and caution in pursuing indications of possible fraud or other illegal acts that could result in criminal prosecution so as not to interfere with potential investigations and/or legal proceedings. Due care would include consulting with legal counsel, investigative staff, audit officials of other government entities whose funds were involved, and/or the applicable law enforcement organization, as appropriate, before proceeding.

45. Circumstances may exist in which laws, regulations, or policies require auditors to promptly report to law enforcement or investigatory authorities before extending audit steps and procedures, indications of fraud or other illegal acts that could result in criminal prosecution. Auditors may also be required to withdraw from, or defer further work on, the audit or a portion of the audit in order not to interfere with an investigation.

46. Most auditors are not trained to investigate fraud or other illegal acts, as these matters are the responsibility of investigators or law enforcement authorities. However, auditors are responsible for being aware of vulnerabilities to fraud associated with the area being audited in order to be able to identify indications that fraud may have

occurred. In some circumstances, conditions such as the following might indicate a heightened risk of fraud:

a. Auditees offer unreasonable explanations to the auditors' inquiries.

b. Auditees are annoyed at reasonable questions by auditors.

c. Auditees refuse to provide records.

d. Auditees refuse to take vacations or accept promotions.

MANAGEMENT CONTROLS

47. The fourth field work standard for performance audits is:

> **Auditors should obtain an understanding of management controls that are relevant to the audit. When management controls are significant to audit objectives, auditors should obtain sufficient evidence to support their judgments about those controls.**

48. Management is responsible for establishing effective management controls. The lack of administrative continuity in government units because of continuing changes in elected legislative bodies and in administrative organizations increases the need for effective management controls.

49. Management controls, in the broadest sense, include the plan of organization, methods, and procedures adopted by management to ensure that its goals and objectives are met. Management controls include the process for planning, organizing, directing, and controlling program operations. It includes the management control systems for measuring,

reporting, and monitoring program performances. The following classification of management controls is intended to help auditors focus on understanding management controls and in determining their significance to the audit objectives.

a. Program operations: Controls over program operations include policies and procedures management has implemented to reasonably ensure that the program meets its objectives. Understanding these controls can help auditors understand the program processes that convert program efforts to program outputs.

b. Validity and reliability of data: Controls over the validity and reliability of data include policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports. These controls help assure management that it is getting valid and reliable information about whether programs are operating properly. Understanding these controls can help auditors assess the risk that the data gathered by the entity may not be valid and reliable and then design appropriate tests of the data.

c. Compliance with laws and regulations: Controls over compliance with laws and regulations include policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws, regulations, and policies. Understanding the management controls relevant to compliance with those laws and regulations that the auditors have determined are significant can help them assess the risk of illegal acts.

d. <u>Safeguarding resources</u>: Controls over the safeguarding of resources include policies and procedures management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse. Understanding these controls can help auditors plan economy and efficiency audits.

50. Auditors can obtain an understanding of management controls through inquiries, observations, and review of other auditors' reports. The procedures auditors perform to obtain an understanding of management controls will vary among audits. One factor influencing the breadth and extent of these procedures is the auditors' knowledge about management controls gained in prior audits. Also, the need to understand management controls will depend on the particular aspects of the program the auditors consider in setting objectives, scope, and methodology. The following are examples of how the auditors' understanding of management controls can influence the audit plan:

a. <u>Objectives</u>: Poorly controlled aspects of a program have higher risk of failure, and thus may be more significant than others in terms of where auditors would want to focus their efforts.

b. <u>Scope</u>: Poor or no controls in a certain location may lead auditors to target their efforts there.

c. <u>Methodology</u>: Effective controls over collecting, summarizing, and reporting data may enable auditors to limit the extent of their direct testing of data validity and reliability. In contrast, poor controls may lead auditors to perform more direct testing of the data, look for data from outside the entity, or develop their own data.

51. Auditors should consider the significance of management controls to audit objectives in determining whether and to what extent it is necessary to test those controls. The following are examples of circumstances where management controls can be significant to audit objectives:

a. Management controls can be significant to audit objectives that include determining the cause of unsatisfactory performance. If the unsatisfactory performance could occur from weaknesses in specific management controls, auditors should perform steps and procedures to assess the adequacy of those controls.

b. Management controls can be significant to audit objectives when those objectives include assessing the validity and reliability of performance measures developed by the audited entity. Effective management controls over collecting, summarizing, and reporting data will help ensure valid and reliable performance measures. If auditors judge that management controls over data validity and reliability are effective and, therefore, decide to limit direct testing of performance measures, they should test those controls to provide a sufficient basis for that judgment.

52. Internal auditing is an important part of management control, and the auditors should consider this in conducting the audit. Where an assessment of management controls is called for, external auditors should consider the extent to which the work of the internal auditors can be used to help provide reasonable assurance that management controls are functioning properly and to prevent duplication of effort. (See paragraph 15.)

53. In view of the wide range in the size and nature of

government organizations, programs, activities, and functions and in view of their organizational structures and operating methods, no single pattern for internal audit activities can be specified. Many government entities have these activities identified by other names, such as inspection, appraisal, investigation, organization and methods, or management analysis. These activities assist management by reviewing selected functions.

EVIDENCE

54. The fifth field work standard for performance audits is:

Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditors' findings and conclusions. A record of the auditors' work is to be retained in the form of working papers.

55. Evidence may be categorized as physical, documentary, testimonial, and analytical. Physical evidence is obtained by direct inspection or observation of people, property, or events. Such evidence may be documented in the form of memoranda summarizing the matters inspected or observed, photographs, charts, maps, or actual samples. Documentary evidence consists of created information such as letters, contracts, accounting records, invoices, and management information on performance. Testimonial evidence is obtained from others through statements received in response to inquiries, through interviews, or through responses to questionnaires. Testimonial evidence needs to be evaluated from the standpoint of whether the individual may be biased or only have partial knowledge about the area. Analytical evidence includes computations, comparisons, reasoning, and separation of information into components.

56. The guidance in the following paragraphs is intended to help auditors judge the quality and quantity of evidence needed to satisfy audit objectives. Paragraphs 57 through 60 describe the elements of an audit finding. Paragraphs 61 through 71 provide guidance to help auditors determine what constitutes sufficient, competent, and relevant evidence to support their findings and conclusions. Finally, paragraphs 72 through 74 provide guidance on how to document that evidence.

Audit Findings

57. Audit findings have often been regarded as containing the elements of criteria, condition, and effect, plus cause when problems are found. However, the elements needed for a finding depend entirely on the objectives of the audit.[9] Thus, a finding or set of findings is complete to the extent that the audit objectives are satisfied and the report clearly relates those objectives to the finding's elements. Criteria are discussed in paragraphs 11 and 12; the other elements of a finding--condition, effect, and cause--are discussed below.

[9] The table in figure 6-1 illustrates how the elements of a finding can vary with the objectives of the audit.

Table 6.1: Finding Elements Called for by Various Objectives

Type of objective	Elements of a Finding: Criteria	Condition	Cause	Effect
Retrospective				
Economy/ efficiency	What should be	What is	Why condition occurred	Result of any difference between what should be and what is
Descriptive	N/A	What is	N/A	N/A
Compliance	What should be	What is	Optional*	Optional*
Program impact	Direction or size of intended change	What is, what would have been without program	Assert program as cause	Difference between what is and what would have been
Prospective--options analysis	Direction or size of intended change, future program, policy, etc.	What will be if no change and what will be if one or more option is selected	Assert one or more options as cause	Future result with or without options

*Depends on assignment objective.

58. Condition is a situation that exists. It has been observed and documented during the audit.

59. Effect has two meanings, which depend on the audit objectives. When the auditors' objectives include identifying the actual or potential consequences of a condition that varies (either positively or negatively) from the criteria identified in the audit, "effect" is a measure of those consequences. Auditors often use effect in this sense to demonstrate the need for corrective action in response to identified problems. When the auditors'

objectives include estimating the effectiveness of a program in causing changes in physical, social, or economic conditions, "effect" is a measure of the impact achieved by the program. Here, effect is the extent to which positive or negative changes in actual physical, social, or economic conditions can be identified and attributed to program operations.

60. Like effect, cause also has two meanings, which depend on the audit objectives. When the auditors' objective is to explain why the poor (or good) performance observed in the audit happened, the reasons for the observed performance are referred to as "cause." Identifying the cause of problems is necessary before making constructive recommendations for correction. Because problems can result from a number of plausible factors, auditors need to clearly demonstrate and explain with evidence and reasoning the link between the problems and the factor or factors they identified as the cause. When the auditors' objectives include estimating the impact of a program on changes in physical, social, or economic conditions, they seek evidence of the extent to which the program itself is the "cause" of those changes.

Tests of Evidence

61. Evidence should be sufficient, competent, and relevant. Evidence is sufficient if there is enough of it to support the auditors' findings. In determining the sufficiency of evidence it may be helpful to ask such questions as: Is there enough evidence to persuade a reasonable person of the validity of the findings? When appropriate, statistical methods may be used to establish sufficiency. Evidence used to support a finding is relevant if it has a logical, sensible relationship to that finding. Evidence is competent to the extent that it is consistent with fact

(that is, evidence is competent if it is valid).

62. The following presumptions are useful in judging the competence of evidence. However, these presumptions are not to be considered sufficient in themselves to determine competence.

a. Evidence obtained from a credible independent source is more competent than that secured from the audited organization.

b. Evidence developed under an effective system of management controls is more competent than that obtained where such control is weak or nonexistent.

c. Evidence obtained through the auditors' direct physical examination, observation, computation, and inspection is more competent than evidence obtained indirectly.

d. Original documents provide more competent evidence than do copies.

e. Testimonial evidence obtained under conditions where persons may speak freely is more credible than testimonial evidence obtained under compromising conditions (for example, where the persons may be intimidated).[10]

63. Auditors should, when they deem it useful, obtain from

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[10]Auditors should exercise appropriate care in pledging confidentiality in order to enhance the quality of testimonial evidence. If a pledge is given, auditors should act to minimize the risk of a breach of confidentiality. Pledges of confidentiality should not be given when the auditor is legally empowered to compel people to respond to requests for testimonial evidence.

officials of the audited entity written representations concerning the competence of the evidence they obtain. Written representations ordinarily confirm oral representations given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations.

64. The auditors' approach to determining the sufficiency, relevance, and competence of evidence depends on the source of the information that constitutes the evidence. Information sources include original data gathered by auditors and existing data gathered by either the auditee or a third party. Data from any of these sources may be obtained from computer-based systems.

65. Data Gathered by the Auditors. Data gathered by the auditors includes the auditors' own observations and measurements. Among the methods for gathering this type of data are questionnaires, structured interviews, and direct observations. The design of these methods and the skill of the auditors applying them are the keys to ensuring that these data constitute sufficient, competent, and relevant evidence. When these methods are applied to determine cause, auditors are concerned with eliminating rival explanations of cause. This involves considering three types of validity:

a. Internal validity means that A (the program as defined for the particular audit) caused B (the effect measured in the audit).

b. Construct validity refers to whether the auditors are measuring or observing what they intend to.

c. External validity refers to the ability to generalize the auditors' findings to a broader universe.

66. Data Gathered by the Auditee. Auditors can use data gathered by the auditee as part of their evidence. If those data are significant to the overall body of evidence supporting their findings, auditors should obtain additional evidence of the reliability of those data. Statements by program management or personnel about the reliability of program data should be corroborated with other evidence. Auditors can obtain the necessary evidence by testing the effectiveness of the entity's controls over the reliability of the data, by direct tests of the data, or by a combination of the two.

67. When the auditors' tests of data disclose errors in that data, the auditors should consider the significance of those errors in relation to the audit objectives. If the auditors conclude that these errors are so significant that the data are not valid or reliable, they should consider whether to

a. seek evidence from other sources,

b. redefine the audit's objectives to eliminate the need to use the invalid or unreliable data, or

c. use the data, but clearly indicate in their report the data's limitations and refrain from making unwarranted conclusions or recommendations.

68. Similar considerations apply when the auditors are unable to obtain sufficient, competent, and relevant evidence about the validity and reliability of the auditee's data.

69. Data Gathered by Third Parties. The auditors' evidence may

also include data gathered by third parties. In some cases, these data may already have been audited, or the auditors may be able to audit this evidence themselves. Often, however, it will not be practical to obtain evidence of the data's validity and reliability.

70. How the use of unaudited third-party data affects the auditors' report depends on the data's significance to the overall body of evidence supporting the auditors' findings. If it is significant, the auditors should clearly indicate in their report the data's limitations and refrain from making unwarranted conclusions or recommendations based on that data.

71. Validity and Reliability of Data From Computer-Based Systems. Auditors should obtain sufficient evidence that computer-processed data are valid and reliable when those data are significant to the overall body of evidence supporting the auditors' findings, and any conclusions or recommendations.[11] This is necessary regardless of whether the data are provided to auditors or auditors independently extract them.[12] Auditors should determine if other auditors have worked to establish the validity and reliability of the data or the effectiveness of the controls over the system that produced it. If they have, auditors may be able to use that work. If not, auditors can obtain evidence about the validity and reliability of computer-

[11]When the reliability of a computer-based system is the primary objective of the audit, the auditors should conduct a review of the system's general and application controls.

[12]When computer-processed data are used by the auditor, or included in the report, for background or informational purposes and are not significant to the audit results, citing the source of the data and stating that they were not verified will satisfy the reporting standards for accuracy and completeness set forth in this statement.

processed data from tests of general and application controls, direct tests of the data, or a combination of both.[13]

Working Papers

72. Working papers are the link between field work and the audit report.[14] They should contain sufficient information to enable an experienced auditor previously not connected with the audit to ascertain from them what work the auditors performed to support the findings and any conclusions or recommendations. That information would ordinarily include the audit's objectives, scope, methodology (including any sampling criteria used), and results (including evidence of supervisory reviews of the work conducted).

73. Working papers serve three purposes. They provide the principal support for the auditors' report, aid the auditors in conducting and supervising the audit, and allow others to review the audit's quality. This third purpose is important because audits done in accordance with generally accepted government auditing standards are often subject to review by other auditors and by oversight officials. These reviewers need a written explanation of the basis for the auditors' significant judgments. Audit organizations should establish policies and procedures to ensure that working papers achieve these purposes. Audit organizations should tailor these policies and procedures to the nature of the work they perform.

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[13]GAO has published a guide titled Assessing the Reliability of Computer-Based Data, (GAO/OP-8.1.3, September 1990).

[14]The requirement to prepare working papers may be satisfied with documentation maintained on disks, tapes, or film.

74. Audit organizations should also establish policies and procedures to ensure the safe custody and retention of working papers for a time sufficient to satisfy legal and administrative requirements. Arrangements need to be made to ensure that working papers will be made available upon request to other government audit staff and individual auditors. To facilitate reviews of audit quality and reliance by other auditors on the auditors' work, contractual arrangements for government audits should provide for access to working papers.

CHAPTER 7

REPORTING STANDARDS FOR PERFORMANCE AUDITS

PURPOSE

1. This chapter prescribes standards of reporting for government performance audits. The report "Contents" and "Presentation" standards may also apply to some financial related audits.

FORM

2. The first reporting standard for government performance audits is:

   Written audit reports generally should be prepared communicating the results of each government audit.

3. Written reports (a) communicate the results of audits to officials at all levels of government, (b) make the results less susceptible to misunderstanding, (c) make the results available for public inspection, and (d) facilitate follow-up to determine whether appropriate corrective actions have been taken. The need to maintain public accountability for government programs demands that, as a general rule, audit reports be written. In some circumstances, however, it might be appropriate for auditors to issue oral reports.[1] Before issuing an oral report, auditors should determine that both of the following conditions exist:

   a. An oral report would effectively meet decisionmakers' needs for information about the results of the audit.

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[1]If they issue an oral report, the auditors should keep a written record of what they communicated and the basis for not issuing a written report.

b. It is unlikely that parties other than those who would receive the oral report would have a significant interest in the results of the audit.

4. This standard is not intended to limit or prevent discussion of findings, judgments, conclusions, and recommendations with persons who have responsibilities involving the area being audited. On the contrary, such discussions are encouraged. However, a written report generally should be prepared whether or not such discussions are held.

5. When an audit is terminated prior to completion, auditors should communicate the termination to the auditee and other appropriate officials, preferably in writing. Auditors should also write a memorandum for the record, summarizing the results of the work and explaining why the audit was terminated.

TIMELINESS

6. The second reporting standard for government performance audits is:

   Reports are to be issued promptly so as to make the information available for timely use by management, legislative officials, and other interested parties.

7. To be of maximum use, the report must be timely. A carefully prepared report may be of little value to decisionmakers if it arrives too late. Therefore, the audit organization should plan for the prompt issuance of the audit report and conduct the audit with this goal in mind.

8. The auditors should consider interim reporting, during the audit, of significant matters to appropriate officials. Such

communication, which may be oral or written, is not a substitute for a final written report, but it does alert officials to matters needing immediate attention and permits them to correct them before the final report is completed.

REPORT CONTENTS

9. The third reporting standard for government performance audits covers the report contents.

Objectives, Scope, and Methodology

10. **The report should include a statement of the audit objectives and a description of the audit scope and methodology.**

11. Knowledge of the objectives of the audit, as well as the audit scope and methodology for achieving the objectives, is needed by readers to understand the purpose of the audit, judge the merits of the audit work and what is reported, and understand any significant limitations.

Objectives

12. The statement of objectives being reported on should explain why the audit was made and state what the report is to accomplish. Articulating what the report is to accomplish normally involves identifying the audit subject and the aspect of performance examined, and because what is reported depends on the objectives, communicating what finding elements are discussed and whether conclusions and recommendations are given.

13. The statement of objectives tells the reader the boundaries of the audit. To preclude misunderstanding in cases where the objectives are particularly limited and broader objectives can

be inferred, it may be necessary to clearly define the audit boundaries by stating objectives that were not pursued.

Scope and Methodology

14. The statement of scope should describe the depth and coverage of audit work conducted to accomplish the audit's objectives. It, as applicable, should explain the relationship between the universe and what was audited, identify organizations and geographic locations at which audit work was conducted and the period covered, cite the kinds and sources of evidence used and the techniques used to verify it, and explain any quality or other problems with the evidence. Significant constraints imposed on the audit approach by data limitations or scope impairments are to be disclosed.

15. The statement on methodology should clearly explain the evidence gathering and analysis techniques used to accomplish the audit's objectives. The explanation should identify any assumptions made in conducting the audit, describe any comparative techniques applied and measures and criteria used to assess performance, and if sampling is involved, describe the sample design and state why it was chosen.

16. Every effort should be made to avoid any misunderstanding by the reader concerning the work that was and was not done to achieve the audit objectives, particularly when the work was limited because of constraints on time or resources.

Audit Findings and Conclusions

17. **The report should include a full discussion of the significant audit findings, and where applicable, auditors' conclusions.**

Findings

18. The report should present the significant findings developed in response to each audit objective.[2] Sufficient, competent and relevant information about findings should be included to promote adequate understanding of the matters reported and to provide convincing, but fair presentations in proper perspective. Appropriate background information that readers need to understand the findings should also be included.

19. Audit findings have often been regarded as containing the elements of criteria, condition, and effect, plus cause when problems are found.[3] However, the elements needed for a finding depend entirely on the objectives of the audit. Thus, a finding or set of findings is complete to the extent that the audit objectives are satisfied and the report clearly relates those objectives to the finding's elements.

Conclusions

20. The report should contain conclusions when called for by the audit objectives. Conclusions are logical inferences about the program based on the auditors' findings. Conclusions should be specified and not left to be inferred by readers. The report should not be written on the basis that a bare recital of facts makes the conclusions inescapable. The strength of the auditors' conclusions depends on the persuasiveness of the evidence supporting the findings.

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[2]Any audit finding not included in the audit report, because of insignificance, should be separately communicated to management, preferably in writing. The audit report should reference findings communicated in a management letter. All communications should be documented in the working papers.

[3]See description of the elements of a finding in paragraphs 57 through 60 of chapter 6.

Recommendations

21. **The report should include recommendations for actions to correct problem areas and to improve operations.**

22. The report should contain recommendations when the potential for significant improvement in operations and performance is substantiated by the reported findings. Recommendations to effect compliance with laws and regulations and improve management controls should also be made when significant instances of noncompliance are noted or significant weaknesses in controls are found. The audit report should also disclose the status of known uncorrected significant findings and recommendations from prior audits that affect the objectives and findings of the current audit.

23. Reports which contain constructive recommendations can encourage improvements in the conduct of government programs and activities. Recommendations are most constructive when they are directed at resolving the cause of identified problems, are action oriented and specific, are addressed to parties that have the authority to act, and are feasible and, to the extent practical, cost-effective.

Statement on Auditing Standards

24. **The report should include a statement that the audit was made in accordance with generally accepted government auditing standards and disclose when applicable standards were not followed.**

25. The statement of conformity refers to the applicable standards that the auditors should have followed during the audit. The statement need not be qualified when standards that were not applicable were not followed. When applicable standards were

not followed, the auditors should modify the statement to disclose in the scope section of their report the required standard that was not followed, why, and the known effect of not following the standard had on the results of the audit.

Management Controls

26. **The report should identify the scope of the auditors' assessment work and any significant weaknesses found during the audit.**

27. Reporting on management controls will vary depending on the significance of any weaknesses found and the relationship of those weaknesses to the audit objectives.

28. In audits where the sole objective is to audit the management controls, weaknesses found of significance to warrant reporting would be considered deficiencies and be so identified in the audit report. The management controls that were assessed should be identified to the extent necessary to clearly present the objectives, scope, and methodology of the audit.

29. In a performance audit, auditors may identify significant weaknesses in management controls as a cause of deficient performance. In reporting this type of finding, the control weaknesses would be described as the "cause."

Compliance With Laws and Regulations

30. **The report should include (a) all significant instances or indications of noncompliance, (b) all instances or indications of fraud or other illegal acts that could result in criminal prosecution, and (c) all significant instances of abuse that were found during or in connection with the audit.**

Noncompliance

31. The auditors' report should include all instances of noncompliance and abuse that auditors determine are significant. All instances of fraud or other illegal acts that could result in the entity, or an official or employee of the entity, being subject to criminal prosecution should also be reported. As discussed in chapter 6, the term "noncompliance" comprises illegal acts (violations of laws and regulations) and violations of contractual provisions, grant agreements, and agency policies and procedures. Abuse occurs when the conduct of a government organization, program, activity, or function does not meet societal expectations for prudent behavior.

32. In reporting significant instances of noncompliance identified in response to the audit objectives, the auditors should place their findings in proper perspective. To give the reader a basis for judging the prevalence and consequences of noncompliance, the instances of noncompliance should be related to the universe or the number of cases examined and be quantified in terms of dollar value, if appropriate.

Indications of Illegal Acts

33. As discussed in chapter 6, any determination by auditors of whether a particular act is illegal would generally be based on the advice of an attorney or may have to await final determination by a court. When auditors are unable to determine the legality of an act that appears to be a significant illegal act, fraud, or other illegal act that could result in criminal prosecution, they should report that act as an indication of an illegal act. Auditors should report indications of illegal acts in accordance with the guidance for reporting illegal acts contained in paragraphs 34

through 37. In reporting indications of illegal acts, auditors should try not to imply that they have determined legality.

Illegal Acts

34. Illegal acts that auditors become aware of should be covered in a written report and submitted in accord with the following paragraphs. Such acts may be covered in a separate report if including them in the overall report would compromise investigative or legal proceedings or otherwise preclude the report from being released to the public. Auditors should be aware that reports containing information on fraud or other illegal acts that could result in criminal prosecution, or reports with references that such acts were omitted from other reports, could interfere with legal processes or subject the implicated individuals to undue publicity. Such reports also might subject auditors to legal action. Thus, auditors generally should not release such reports without consulting an attorney, investigative staff, audit officials of other government entities whose funds were involved, and/or the applicable law enforcement organization, as appropriate.

35. If auditors become aware of illegal acts that could affect the audited entity, they should promptly report to the top officials of that entity (unless, as discussed in 35a, those officials are implicated in the illegal acts). In the following circumstances, the auditors[4] should promptly report the illegal acts to appropriate parties outside the audited entity (as discussed in paragraph 36):

[4]Internal auditors auditing within the entity that employs them do not have a duty to report outside that entity.

a. Top management of the audited entity is implicated in the illegal acts.

b. The auditors identify fraud or other illegal acts that could result in criminal prosecution.

c. The audited entity fails to carry out a responsibility established by law or regulation to report certain illegal acts.

36. Depending on whom the audited entity is accountable to, auditors may be required to report illegal acts to one or more of the following parties:

a. <u>A senior level of government</u>. For example, a local government may be accountable to a state government.

b. <u>Another branch of government</u>. For example, an agency in the executive branch of a state government may be accountable to the state legislature or one of its committees.

c. <u>An entity providing government funds to the audited entity</u>. For example, an entity receiving federal funds is accountable to the federal agency providing those funds. If federal funds were received indirectly from a nonfederal entity (that is, a state or local government or nonprofit organization) the audited entity is also accountable to that entity.

d. <u>Law enforcement agencies</u>. Laws or regulations may require auditors to report certain illegal acts to law enforcement agencies.

37. Auditors should use judgment in determining if they should promptly report illegal acts to outside parties in other circumstances. Generally, the more significant an illegal act, the greater the outside parties' need for prompt information about that act.

<u>Views of Responsible Officials</u>

38. **The report should include the views of responsible officials of the audited organization, program, activity, or function concerning both auditors' findings, conclusions, and recommendations, and corrections planned.**

39. One of the most effective ways to ensure that a report is fair, complete, and objective is to obtain advance review and comments by responsible auditee officials and others, as may be appropriate. Including the views of responsible officials produces a report that shows not only what was found and what the auditors think about it, but also what the responsible persons think about it and what they plan to do about it.

40. Auditors should normally request that the responsible officials' views on significant findings, conclusions, and recommendations adversely affecting the audited entity be submitted in writing. When, in these cases, written comments are not obtained, oral comments should be requested.

41. Advance comments should be objectively evaluated and recognized, as appropriate, in the report. A promise or plan for corrective action should be noted but should not be accepted as justification for dropping a significant finding or a related recommendation.

42. When the comments oppose the report's findings, conclusions, or recommendations, and are not, in the auditors' opinion,

valid, the auditors may choose to state their reasons for rejecting them. Conversely, the auditors should modify their report if they find the comments valid.

Noteworthy Accomplishments

43. **The report should include a description of any noteworthy accomplishments, particularly when management improvements in one area may be applicable elsewhere.**

44. Significant management accomplishments identified during the audit, which were within the scope of the audit, should be included in the audit report, along with deficiencies. Such information is necessary to fairly present the situation the auditors found and to provide appropriate balance to the report. In addition, inclusion of such accomplishments may lead to improved performance by other government organizations that read the report.

Issues Needing Further Study

45. **The report should include a listing of any significant issues needing further study and consideration.**

46. If, during the audit, auditors identify significant issues that warrant further work, but the issues are not directly related to the audit objectives or the auditors do not have the time or resources to expand the audit to pursue them, they should refer the issues to the auditors within the audit organization who are responsible for planning future audit work. When appropriate, auditors should also disclose the issues in the report and the reasons the issues need further study.

Privileged and Confidential Information

47. **The report should include a statement about any pertinent information that was omitted because it is deemed privileged or confidential. The nature of such information should be described, and the basis under which it is withheld should be stated.**

48. Certain information may be prohibited from general disclosure by federal, state, or local laws or regulations. Such information may be provided on a need-to-know basis only to persons authorized by law or regulation to receive it. Before omitting pertinent data from the report, the auditors should obtain assurance that a valid requirement for the omission exists, and where appropriate, consult with an attorney.

49. Auditors should generally consult with an attorney before releasing reports with references that illegal acts or indications of such acts were omitted from reports.[5]

REPORT PRESENTATION

50. The fourth reporting standard for government performance audits is:

> **The report should be complete, accurate, objective, and convincing, and be as clear and concise as the subject permits.**

Complete

51. Being complete requires that the report contain all information needed to satisfy the audit objectives, promote an

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[5]See paragraph 34.

adequate and correct understanding of the matters reported, and meet the applicable report content requirements. It also means including appropriate background information.

52. Giving readers an adequate and correct understanding means providing perspective on the extent and significance of reported findings, such as the frequency of occurrence relative to the number of cases or transactions tested and the relationship of the findings to the entity's operations.

53. Except as necessary to make convincing presentations, detailed supporting data need not be included. In most cases, a single example of a deficiency is not sufficient to support a broad conclusion or a related recommendation. All that it supports is that there was a deviation, an error, or a weakness.

Accurate

54. Accuracy requires that the evidence presented be true and that findings be correctly portrayed. The need for accuracy is based on the need to assure readers that what is reported is credible and reliable. One inaccuracy in a report can cast doubt on the validity of an entire report and can divert attention from the substance of the report. Also, inaccurate reports can damage the credibility of the issuing audit organization and reduce the effectiveness of reports it issues.

55. The report should include only information, findings, and conclusions that are supported by competent and relevant evidence in the auditors' working papers. That evidence should demonstrate the correctness and reasonableness of the matters reported. Correct portrayal means describing accurately the audit scope and methodology, and presenting

findings and conclusions in a manner consistent with the scope of audit work.

Objective

56. Objectivity requires that the presentation of the entire report be balanced in content and tone. A report's credibility is significantly enhanced when it presents evidence in an unbiased manner so that readers can be persuaded by the facts.

57. The audit report should be fair and not be misleading, and should place the audit results in proper perspective. This means presenting the audit results impartially and guarding against the tendency to exaggerate or overemphasize deficient performance. In describing shortcomings in performance, auditors should present the explanation of responsible officials including the consideration of any unusual difficulties or circumstances they faced.

58. The tone of reports should encourage favorable reaction to findings and recommendations. Titles, captions, and the text of reports should be stated constructively. Although findings should be presented clearly and forthrightly, the auditors should keep in mind that one of their objectives is to persuade, and that this can best be done by avoiding language that generates defensiveness and opposition. Although criticism of past performance is often necessary, the report should emphasize needed improvements.

Convincing

59. Being convincing requires that the audit results be responsive to the audit objectives, the findings be presented persuasively, and the conclusions and recommendations follow

logically from the facts presented. The information presented should be sufficient to enable the readers of the validity of the findings, the reasonableness of the conclusions, and the desirability of implementing the recommendations. Reports designed in this way can help focus the attention of responsible officials on the matters that warrant attention and can help stimulate correction.

Clear

60. Clarity requires that the report be easy to read and understand. Reports should be written in language as clear and simple as the subject permits.

61. Use of straightforward, nontechnical language is essential to simplicity of presentation. If technical terms and unfamiliar abbreviations and acronyms are used, they should be clearly defined. Acronyms should be used sparingly.

62. Both logical organization of material, and accuracy and precision in stating facts and in drawing conclusions, are essential to clarity and understanding. Effective use of titles and captions and topic sentences make the report easier to read and understand. Visual aids (such as pictures, charts, graphs, and maps) should be used when appropriate to clarify and summarize complex material.

Concise

63. Being concise requires that the report be no longer than necessary to convey the message. Too much detail detracts from a report, may even conceal the real message, and may confuse or discourage readers. Also avoid needless repetition.

64. Although room exists for considerable judgment in determining the content of reports, those that are complete, but still concise, are likely to receive greater attention.

REPORT DISTRIBUTION

65. The fifth reporting standard for government performance audits is:

> **The audit organization should submit written audit reports to the appropriate officials of the organization audited and to the appropriate officials of the organizations requiring or arranging for the audits, including external funding organizations, unless legal restrictions prevent it. Copies of the reports should also be sent to other officials who may be responsible for acting on audit findings and recommendations and to others authorized to receive such reports. Unless restricted by law or regulation, copies should be made available for public inspection.**

66. Audit reports should be distributed to as many interested officials as practical. In some cases, the subject of the audit may involve material that is classified for security purposes or is not releasable to particular parties or the public for other valid reasons. Generally, however, the report should be distributed to officials directly interested in the results. Such officials include those designated by law or regulation to receive such reports; those responsible for acting on the findings and recommendations; legislators; and those of other levels of government that have provided funds to the audited entity.

67. Internal auditors auditing within their entity should follow their entity's own arrangements and statutory requirements.

Usually, they report to their entity's top managers and the entity is responsible for distribution of the report.

68. When nongovernment audit organizations are engaged, the engaging government organization is responsible for distributing the reports and for making reports available to the public, as appropriate. If the nongovernment audit organization is to make the distribution, the engagement agreement should indicate what officials or organizations should receive the report.

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