

21

INTERNAL, OPERATIONAL, AND GOVERNMENTAL AUDITING

UNDERSTANDING THE RISK OF FRAUD IN GOVERNMENTAL AUDITS

Many auditors need to be conversant with both GAAS and generally accepted government auditing standards (GAGAS). GAGAS applies to audits and attestation engagements of government entities, programs, activities, and functions, and to government assistance administered by contractors, nonprofit entities, and other nongovernmental entities. As a result, GAGAS applies to many state and local governments and not-for-profit entities that receive federal awards.

The auditor that audits a small city, or a not-for-profit entity, and that receives a federal award must plan and perform an audit in accordance with GAGAS. GAGAS, like GAAS, requires auditors to consider the risk of fraud. Abraham Akresh, CPA (assistant director in the Financial Management and Assurance Team of the U.S. General Accounting Office), has suggested three important risks that an auditor should consider when assessing the risk of fraud.

1. Risk of management misrepresentation of financial statements
2. Risk of material misappropriation of assets—by employees
3. Risk of material misappropriation of assets—by people outside the organization

Akresh makes the following suggestions regarding the risk of fraud in governmental audits.

- The risk of management misrepresentation of financial statements is usually low, especially in the federal government, since there are no stockholders and financial statements are rarely used for investment decisions. There might be some risk in state and local governments, but it is usually less than for SEC registrants as there are no stock options or bonuses based on financial statements.
- The risk of material misappropriation of assets by employees may range from low to high because of materiality considerations. In a larger city it takes lots of theft to be material. It may not take a lot of theft to be material to a small city or not-for-profit entity. In addition, auditors should consider the qualitative aspects. Nevertheless, entities need strong controls to prevent or detect these misappropriations. Because small entities, such as not-for-profit organizations and some local governments, often lack appropriate controls, fraud risk often increases. For example, auditors should be alert for abuse of travel or purchase cards by employees. Many governments give employees credit cards to be used for the entity's purposes. This increased opportunity for fraud exists because many employees are given credit cards to "reduce red tape" in procurement. However, they may be used for personal purposes by employees who rationalize that their pay is low.

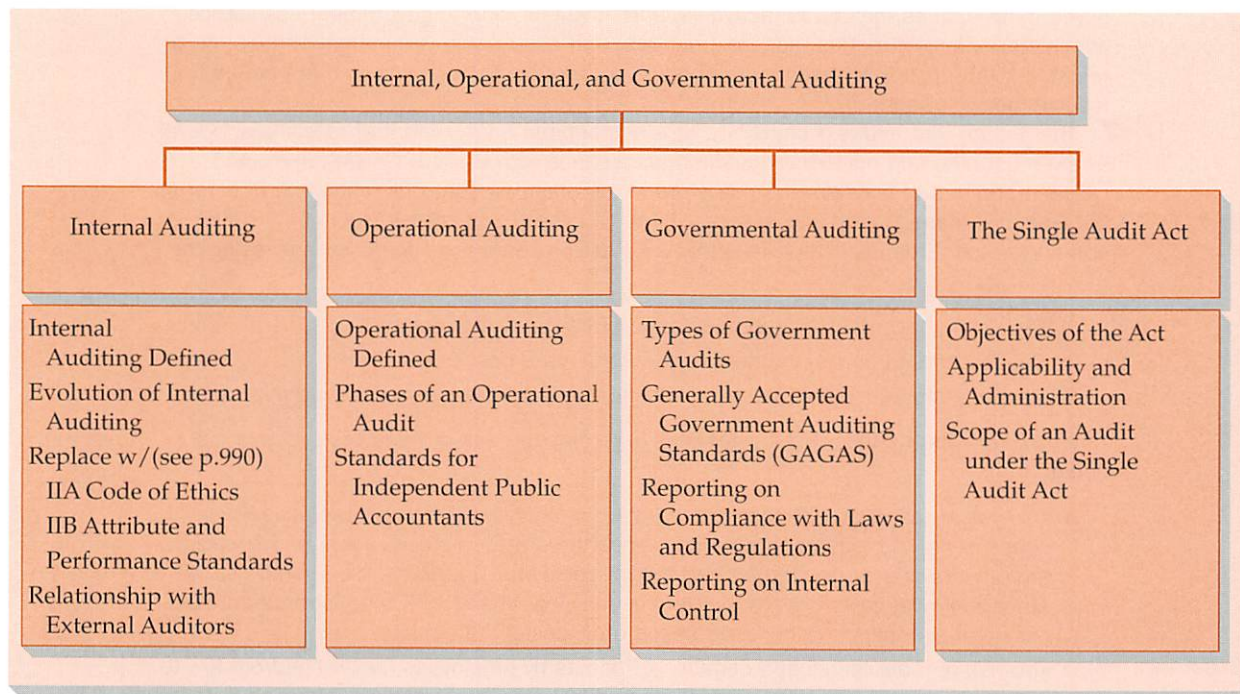
- The risk of material misappropriation of assets by people outside the organization is often a major consideration when the entity makes grants or pays benefits. Entities need strong controls in this area, including specific controls over the existence and occurrence assertion. For example, auditors should be alert to conflicts of interest among procurement officials and to the awarding of contracts based on fraudulent data. Auditors should also be alert to benefit payments made to deceased retirees.

These types of risks should regularly be considered as part of the auditor's brainstorming session. Auditors might also brainstorm on how to use generalized audit software to scan an entire population of expenditure to identify items likely to represent fraud.

Source: Abraham Akresh, *AICPA Pre-Certification Education Executive Committee Fraud Education Task Force*, American Institute of Certified Public Accountants, Inc., New York, New York, 2004.

[PREVIEW OF CHAPTER 21]

Thus far in this textbook, the focus has been primarily on financial statement audits for nongovernmental entities made by independent auditors. In this chapter, attention is directed to other types of auditing. For each type of auditing, consideration is given to its objectives, scope, and applicable standards. The following diagram provides an overview of the chapter organization and content.



focus on auditor knowledge

After studying this chapter you should understand the following aspects of an auditor's knowledge base:

- K1.** Know the definition of internal auditing and the IIA professional practices framework.
- K2.** Know the IIA code of ethics, attribute standards, and performance standards.

- K3.** Know the definition of operational auditing and describe the phases of an operational audit.
- K4.** Know the standards that independent public accountants should follow in performing operational audits.
- K5.** Know the three types of governmental audits.
- K6.** Know the general standards, additional fieldwork standards, and additional reporting standards associated with generally accepted governmental auditing standards (GAGAS) for financial audits and performance audits.
- K7.** Know the objectives and applicability of the Single Audit Act.
- K8.** Know the components of a single audit and the procedures and reports associated with each.

[INTERNAL AUDITING]

Chapter 1 introduced internal auditing, and Chapter 10 explained how internal auditing is an important part of the monitoring component of an entity's system of internal control. As explained in the following sections, internal auditing also provides other valuable services to an entity.

INTERNAL AUDITING DEFINED

The Institute of Internal Auditors (IIA) defines internal auditing as:

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Auditor Knowledge 1

■ Know the definition of internal auditing and the IIA professional practices framework.

The essential parts of this definition are as follows:

- *Internal* indicates that auditing activities are carried on within organizations. Today employees of the organization may conduct internal audit activities, or they may be outsourced to other professionals outside the organization who serve the entity.
- *Independent and objective* makes it clear that the auditor's judgment has value when it is free of bias.
- *Systematic, disciplined approach* implies that the internal auditor follows professional standards that guide internal audit work.
- *Helps an organization accomplish its objectives* indicates that internal auditing exists to aid or benefit the entire organization and is guided by the organization's goals and objectives. Some specific ways in which internal auditors add value include a focus on the improvement of *the organization's operations and the effectiveness of risk management, control, and governance processes*.

Internal auditing is part of the monitoring function of internal control that examines and evaluates the adequacy and effectiveness of other controls.

EVOLUTION OF INTERNAL AUDITING

Internal auditing has evolved into a highly professional activity that extends to the appraisal of the efficiency and effectiveness of all phases of a company's operations, both financial and nonfinancial. Internal auditors were primarily responsible for finding the financial fraud at WorldCom. Today many companies have an internal auditing department, the director/manager of the internal audit function may have senior management status, and internal audit has a reporting responsibility directly to the board of directors or its audit committee.

Passage of the Foreign Corrupt Practices Act in 1977 added emphasis to internal auditing. This Act requires companies to maintain effective internal control systems. Companies subject to this Act quickly realized that an expanded internal auditing function provided the best assurance of compliance. Accordingly, budgets for internal auditing were dramatically enlarged, and the size and quality of internal auditing departments were significantly increased.

The growth and importance of internal auditing to a company has been accompanied by increased professional recognition for the internal auditor. The Institute of Internal Auditors (IIA) was formed in 1941, and its current membership is approximately 70,000 internal auditors in 120 countries. In 1972, the IIA administered its first Certificate of Internal Auditors' Examination. The examination takes two days and consists of four parts:

- The internal auditor's role in governance, risk, and control
- Conducting an internal audit engagement
- Business analysis and information technology
- Business management skills

To become a certified internal auditor (CIA), an individual must pass the examination and have a minimum of two years of experience as an internal auditor or the equivalent. The criteria for internal auditing experience include auditing experience in public accounting. To retain the CIA certificate, the individual must comply with the IIA's practice standards and code of ethics and meet continuing professional education requirements. Certified internal auditors are not licensed by any governmental agency.

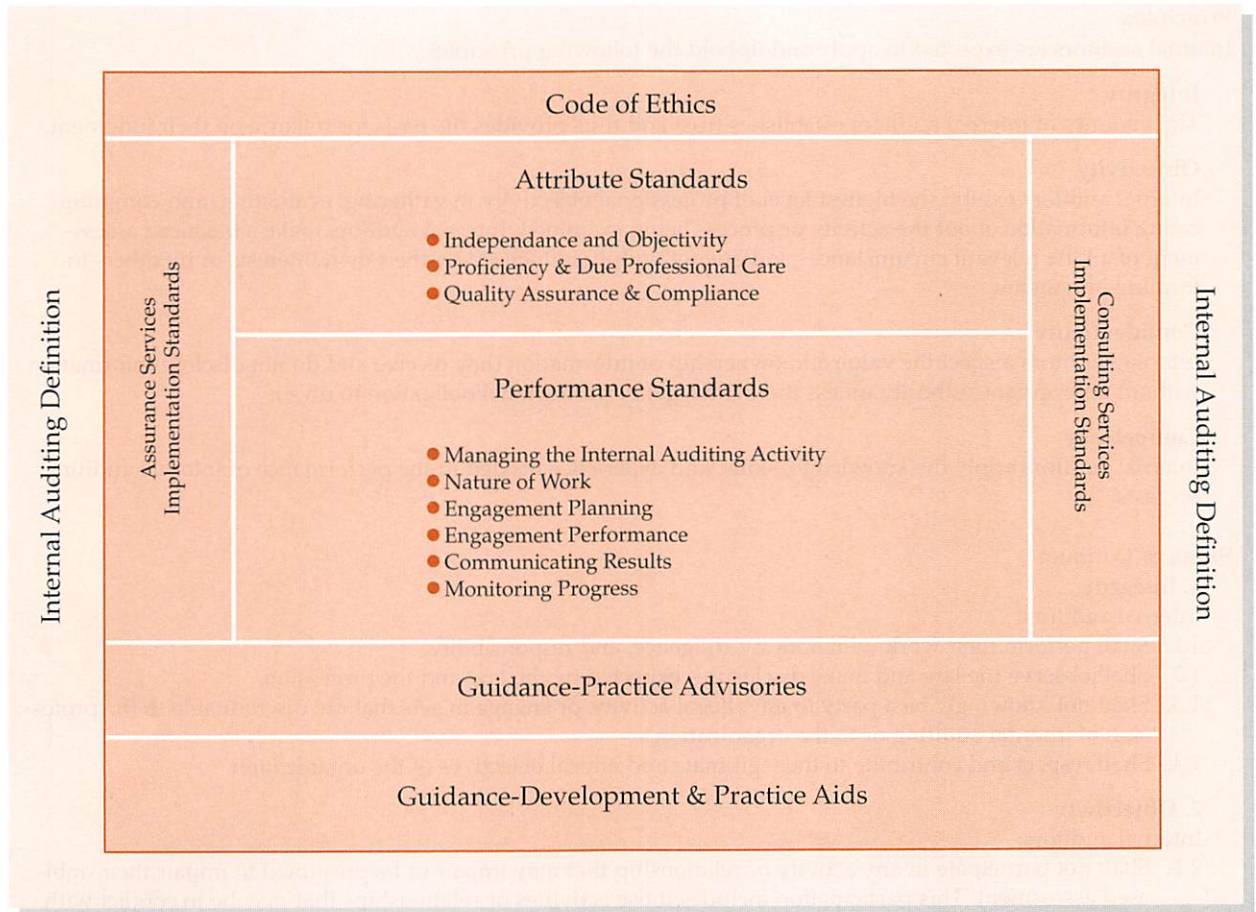
In 1999, the Institute of Internal Auditors' board of directors took several steps to prepare the IIA for the twenty-first century. In June of 1999 it approved a new definition of internal auditing (presented above), a new professional practices framework, and a new Code of Ethics. Figure 21-1 summarizes the new professional practices framework.

IIA CODE OF ETHICS

Like the AICPA Code of Professional Ethics, the IIA Code of Ethics is divided into both ethical principles and ethical rules. Although internal auditors cannot be independent in the same way as external auditors, the IIA places significant emphasis on integrity and objectivity in both the principles and rules. The other two main features address confidentiality of information and internal auditor competency. Figure 21-2 presents the IIA Code of Ethics.

IIA ATTRIBUTE AND PERFORMANCE STANDARDS

The new framework presented three new sets of standards:

Figure 21-1 ■ IIA Professional Practices Framework**Auditor Knowledge 2**

■ Know the IIA code of ethics, attribute standards, and performance standards.

- **Attribute Standards** that address the characteristics of organizations and individuals performing internal audit services.
- **Performance Standards** that describe the nature of internal audit services and provide quality criteria against which the performance of these services can be measured.
- **Implementation Standards** that apply the attribute and performance standards to specific types of services (e.g., a compliance audit, a fraud investigation, a control self-assessment project).

Figure 21-3 summarizes the current attribute and performance standards. The full set of attribute, performance, and implementation standards can be found at www.theiia.org.

The attribute standards are similar to the general standards of generally accepted auditing standards. In addition to proficiency, independence, and due professional care, the standards address issues of importance to internal auditors. Standard 1100 creates a framework for the charter and authority for internal auditors. Standard 1300 explicitly writes the concepts of quality control into the attrib-

Figure 21-2 ■ IIA Code of Ethics**Principles**

Internal auditors are expected to apply and uphold the following principles:

Integrity

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.

Objectivity

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.

Confidentiality

Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.

Competency

Internal auditors apply the knowledge, skills, and experience needed in the performance of internal auditing services.

Rules of Conduct**1. Integrity**

Internal auditors:

- 1.1. Shall perform their work with honesty, diligence, and responsibility.
- 1.2. Shall observe the law and make disclosures expected by the law and the profession.
- 1.3. Shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization.
- 1.4. Shall respect and contribute to the legitimate and ethical objectives of the organization.

2. Objectivity

Internal auditors:

- 2.1. Shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization.
- 2.2. Shall not accept anything that may impair or be presumed to impair their professional judgment.
- 2.3. Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

3. Confidentiality

Internal auditors:

- 3.1. Shall be prudent in the use and protection of information acquired in the course of their duties.
- 3.2. Shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization.

4. Competency

Internal auditors:

- 4.1. Shall engage only in those services for which they have the necessary knowledge, skills, and experience.
- 4.2. Shall perform internal auditing services in accordance with the *Standards for the Professional Practice of Internal Auditing*.
- 4.3. Shall continually improve their proficiency and the effectiveness and quality of their services.

Adopted by The IIA Board of Directors, June 17, 2000.

Figure 21-3 ■ IIA Attribute and Performance Standards**Attribute Standards**

- 1000 **Purpose, Authority, and Responsibility:** The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the Standards, and approved by the board.
- 1100 **Independence and Objectivity:** The internal audit activity should be independent, and internal auditors should be objective in performing their work.
- 1200 **Proficiency and Due Professional Care:** Engagements should be performed with proficiency and due professional care.
- 1300 **Quality Assurance and Improvement Program:** The chief audit executive should develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness. This program includes periodic internal and external quality assessments and ongoing internal monitoring. Each part of the program should be designed to help the internal auditing activity add value and improve the organization's operations and to provide assurance that the internal audit activity is in conformity with the Standards and the Code of Ethics.

Performance Standards

- 2000 **Managing the Internal Audit Activity:** The chief audit executive should effectively manage the internal audit activity to ensure it adds value to the organization.
- 2100 **Nature of Work:** The internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance processes using a systematic and disciplined approach.
- 2200 **Engagement Planning:** Internal auditors should develop and record a plan for each engagement, including the scope, objectives, timing, and resource allocations.
- 2300 **Performing the Engagement:** Internal auditors should identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.
- 2400 **Communicating Results:** Internal auditors should communicate the engagement results.
- 2500 **Monitoring Progress:** The chief audit executive should establish and maintain a system to monitor the disposition of results communicated to management.
- 2600 **Management's Acceptance of Risks:** When the chief audit executive believes that senior management has accepted a level of residual risk that may be unacceptable to the organization, the chief audit executive should discuss the matter with senior management. If the decision regarding residual risk is not resolved, the chief audit executive and senior management should report the matter to the board for resolution.

ute standards. Quality control is addressed by a separate set of quality control standards for external CPAs.

A number of the performance standards are similar to the fieldwork standards and reporting standards of GAAS. However, a few standards are unique to internal audit engagements. Standard 2000 sets the tone for all the following standards by stating that internal audit should add to the value of the organization. Standard 2500 addresses the importance of monitoring the issues that the internal auditor reports to management. Finally, standards 2600 addresses the issue of residual business risk. When the chief audit executive believes that the organization has taken on an unacceptable level of business risk, the auditor has a responsibility to take this conclusion first to senior management and then to the board of directors if it is not satisfactorily resolved at the senior management level.

RELATIONSHIP WITH EXTERNAL AUDITORS

Usually, a close relationship exists between internal auditors and an entity's outside independent auditors. As indicated in an earlier chapter, the work of internal auditors may be a supplement to, but not a substitute for, the work of independent auditors in a financial statement audit. As noted above, one responsibility of the director of internal auditing is to coordinate the work of internal auditors with the work of the external auditor. It is not uncommon in practice for the external auditor to review the internal auditing department's planned work program for the year to minimize duplication of effort.

Although they often have a close working relationship, the following important differences exist between the two types of auditors:

	INTERNAL AUDITORS	EXTERNAL AUDITORS
Employer	Companies and governmental units	CPA firms
National organization	Institute of Internal Auditors (IIA)	American Institute of Certified Public Accountants (AICPA)
Certifying designation	Certified Internal Auditor (CIA)	Certified Public Accountant (CPA)
License to practice	No	Yes
Primary responsibility	To board of directors	To third parties
Scope of audits	All activities of an organization	Primarily financial statements

LEARNING CHECK

- 21-1** a. Is internal auditing a management or an accounting function? Explain.
b. Jill Jensen is confused as to the scope and primary beneficiary of internal auditing. Clarify these points for Jill.
- 21-2** a. State the requirements for becoming a certified internal auditor.
b. What must a CIA do to retain the certificate?
- 21-3** a. What is the objective of internal auditing?
b. The scope of internal auditing is limited to financial statement audits. Do you agree? Explain.
- 21-4** a. Identify the two sets of standards in the new IIA Professional Practices Framework and describe the purpose of each.
b. Identify the basic categories of the attribute and performance standards. Briefly describe the purpose of each set of standards.
- 21-5** How does the independence of an internal auditor differ from that of an external auditor?

KEY TERMS

Attribute standards, p. 987
Implementation standards, p. 987

Internal auditing, p. 985
Performance standards, p. 987

OPERATIONAL AUDITING

Auditor Knowledge 3

■ Know the definition of operational auditing and describe the phases of an operational audit.

Operational auditing has been used in the past to identify a variety of activities that include evaluating management's performance, management's planning and quality control systems, and specific operating activities and departments. As suggested by its name, this type of auditing pertains to an entity's nonfinancial operations. Operational audits of nongovernmental units are generally made by internal auditors. However, in some cases, external auditors may be engaged to perform the audit.

OPERATIONAL AUDITING DEFINED

A IIA publication defines operational auditing as follows:

Operational auditing is the systematic process of evaluating an organization's effectiveness, efficiency, and economy of operations under management's control and reporting to appropriate persons the results of the evaluation along with recommendations for improvements.¹

The essential parts of this definition are as follows:

- *Systematic process.* As in the case of a financial statement audit, an operational audit involves a logical, structured, and organized series of steps or procedures. This aspect includes proper planning, as well as obtaining and objectively evaluating evidence pertaining to the activity being audited.
- *Evaluating an organization's operations.* The evaluation of operations should be based on some established or agreed-upon criteria. In operational auditing, the criteria are often expressed in terms of performance standards established by management. However, in some cases, the standards may be set by a governmental agency or by industry. These criteria frequently are less clearly defined than the criteria used in financial statement audits. Operational auditing measures the degree of correspondence between actual performance and the criteria.
- *Effectiveness, efficiency, and economy of operations.* The primary purpose of operational auditing is to help management of the audited organization to improve the effectiveness, efficiency, and economy of operations. Thus, operational auditing focuses on the future. This is in direct contrast to a financial statement audit, which has a historical focus.
- *Reporting to appropriate persons.* The appropriate recipient of an operational audit report is management or the individual or agency that requested the audit. Except when the audit is requested by a third party, the distribution of the report remains within the entity. In most cases, the board of directors or its audit committee receives copies of operational audit reports.
- *Recommendations for improvement.* Unlike financial statement audits, an operational audit does not end with a report on the findings. It extends to making

¹ Darwin J. Casler and James R. Crockett, *Operational Auditing: An Introduction* (Altamonte Springs, FL: Institute of Internal Auditors, 1982), p. 14.

recommendations for improvement. Developing recommendations is, in fact, one of the most challenging aspects of this type of auditing.

PHASES OF AN OPERATIONAL AUDIT

There are more phases in an operational audit than in a financial statement audit. The similarities and differences in the phases between these two types of audits are shown in Figure 21-4. Each of the phases of an operational audit is explained in the following sections.

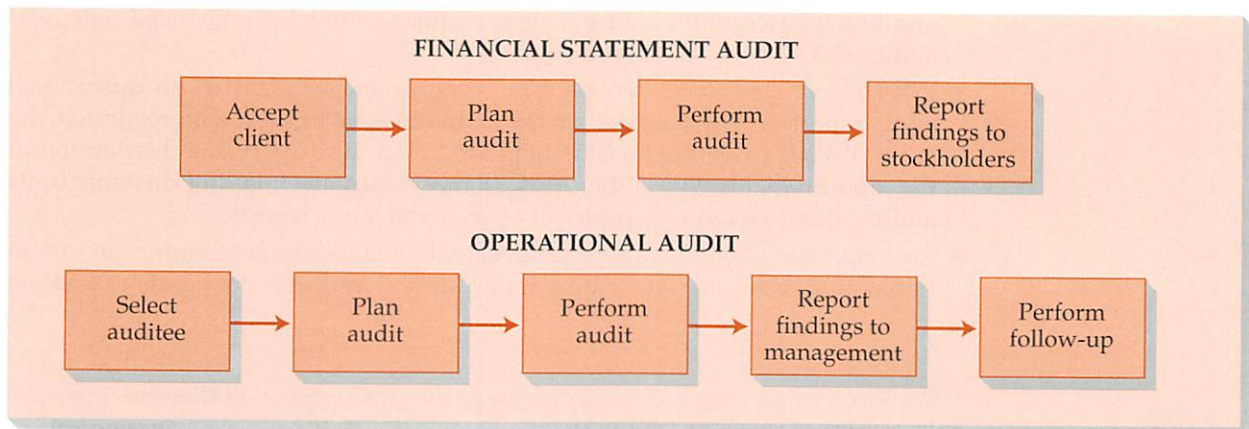
Select Auditee

Like many other activities within an entity, operational auditing is usually subject to budgetary or economic constraints. It is important, therefore, that the resources for operational auditing be put to the best use. Selecting the auditee begins with a preliminary study (or survey) of potential auditees within an entity to identify the activities that have the highest audit potential in terms of improving the effectiveness, efficiency, and economy of operations. In essence, the preliminary study is a screening process that results in a ranking of potential auditees.

The starting point of the preliminary study is to obtain a comprehensive understanding of the entity's organizational structure and operating characteristics. In addition, the auditor should be knowledgeable of the industry in which the entity operates and the nature and extent of applicable government regulations. Attention is next focused on the activity, unit, or function that could be audited. An understanding of the potential auditees is obtained by:

- Reviewing background file data on each auditee
- Touring the auditee's facilities to ascertain how it accomplishes its objectives
- Studying relevant documentation about the auditee's operations such as policies and procedures manuals, flowcharts, performance and quality control standards, and job descriptions
- Interviewing the manager of the activity about specific problem areas (often called the entry interview)

Figure 21-4 ■ Financial Statement vs. Operational Audits



- Applying analytical procedures to identify trends and unusual relationships
- Conducting mini audit probes (or tests) to confirm or clarify the auditor's understanding of potential problems

The auditor's understanding of each auditee should be documented through completed questionnaires, flowcharts, and narrative memoranda. Based on this understanding, the auditor prepares a preliminary study report or memorandum, which summarizes the findings and includes a recommendation as to the auditee(s) that should be audited. The report is for the exclusive use of the internal auditing department. It is not a report for management.

Plan Audit

Careful audit planning is essential to both the effectiveness and efficiency of an operational audit. Planning is especially critical in this type of an audit because of the diversity of operational audits. The cornerstone of audit planning is the development of an audit program. The program must be tailor-made to the circumstances found in the auditee in the preliminary study phase of the audit. As in the case of a financial statement audit, the audit program contains a set of procedures designed to obtain evidence pertaining to one or more objectives. The evidence examined is usually based on samples of data. Thus, consideration should be given in audit planning to the use of statistical sampling techniques. In addition, the auditor should recognize when computer-assisted techniques will be cost efficient.

Audit planning also includes selecting the audit team and scheduling the work. The audit team must include auditors who have the technical expertise needed to meet the audit objective(s). The work should be scheduled in consultation with the auditee to obtain the maximum cooperation from the auditee's personnel during the audit.

Perform Audit

During the audit, the auditor makes an extensive search for facts pertaining to the problems identified in the auditee during the preliminary study. Making the audit is the most time-consuming phase of an operational audit. This phase is often referred to as *making the in-depth audit*.

In an operational audit, the auditor relies primarily on inquiry and observation. A common approach is to develop a questionnaire for the auditee and to use it as a basis for interviewing the auditee's personnel. From the inquiries, the auditor expects to obtain opinions, comments, and suggested solutions to the problems. Effective interviewing is indispensable in an operational audit. Through observation of the auditee's personnel, the auditor may be able to detect inefficiencies and other conditions that are contributing to the problem(s).

The auditor must also use analysis in an operational audit. For this purpose, analysis involves the study and measurement of actual performance in relation to some criteria. The criteria may be internally developed by the entity such as stated productivity goals and budgets. Alternatively, the criteria may be externally generated in the form of industry standards or be derived by the auditor from previous audits of similar activities. Analysis provides a basis for determining the degree to which the auditee is meeting specified objectives.

The work done, the findings, and the recommendations should be documented in working papers. As in a financial statement audit, the working papers represent the primary support for the auditor's report. The in-charge auditor normally has the responsibility for reviewing the working papers both during and at the completion of the examination. Reviews during the audit are helpful in monitoring progress, whereas the review at the end of the audit ensures the overall quality of the work.

Report Findings

Operational auditing is similar to other types of auditing in that the final product of the audit is an audit report. There are, however, many unique circumstances pertaining to reporting in an operational audit. For example, in contrast to the standard language contained in the auditor's report in a financial statement audit, the language of the report in an operational audit varies for each auditee. The report should contain:

- A statement of the objectives and scope of the audit
- A general description of the work done in the audit
- A summary of the findings
- Recommendations for improvement
- Comments of the auditee

The report is generally drafted by the in-charge auditor. The draft is then discussed with the manager of the audited unit. This discussion serves several important purposes: (1) it gives the auditor an opportunity to test the accuracy of the findings and the appropriateness of the recommendations, and (2) it enables the auditor to obtain the auditee's comments for inclusion in the report. The initial draft is then revised as necessary, and the final draft is prepared.

In some cases, the recommendations may just suggest the need for further study of the problems. The inclusion of the auditee's comments is optional. Ordinarily, they are included only when the auditee disagrees with the findings and recommendations.

The auditor's findings basically result in constructive criticism. In writing the report, the auditor should be sensitive to the recipient's reactions. When the language is less threatening, the response of the recipient to the report is likely to be more positive. Ordinarily, copies of operational auditing reports are sent to senior management and to the audit committee. If the report is long and detailed, the report may begin with an executive summary of the findings and recommendations.

Perform Follow-up

The final or follow-up phase of an operational audit is for the auditor to follow up on the auditee's response to the audit report. Ideally, the policies of the entity should require the manager of the audited unit to respond to the report in writing within a specified time period. However, the follow-up should extend to determining the adequacy of the measures taken by the auditee in implementing the recommendations. Practice Standard 440 of the IIA states that internal auditors should follow-up to ascertain that appropriate action has been taken on the report findings. The failure of the auditor to receive an appropriate response should be communicated to senior management.

STANDARDS FOR INDEPENDENT PUBLIC ACCOUNTANTS

Auditor Knowledge 4

■ Know the standards that independent public accountants should follow in performing operational audits.

Based on their expertise and experience, independent public accountants are qualified to perform operational audits. In 1982, the AICPA appointed the Special Committee on Operational and Management Auditing to study the involvement of independent accountants in operational auditing. The Committee concluded in its report entitled *Operational Audit Engagements* that an operational audit engagement is a distinct form of management consulting services (MCS). It also made the following observations (p. 1):

- Independent accountants will increasingly be asked to provide this service for both private sector and governmental clients.
- This type of service provides independent evaluation and advice to boards of directors, senior management, and elected officials who are being held to high standards of responsibility and stewardship.
- The experience gained in public accounting in the diagnostic and fact-finding aspects of financial auditing and management consulting services provides an excellent background for performing operational audits.

Management consulting services have become an important part of the services performed today by many CPA firms.

In performing operational audits, independent CPAs should follow the practice standards for MCS engagements established by the Management Consulting Services Executive Committee of the AICPA. The independent accountant must also comply with Rule 201, *General Standards*, of the AICPA's *Code of Professional Conduct*, which is explained in Chapter 3. Care must be taken not to make management decisions when performing an operational audit or independence might be impaired. When the audit is conducted for governmental entities, the independent auditor must also follow applicable government *performance audit standards* described later in the chapter.

LEARNING CHECK

- 21-6 a. Like internal auditing, operational auditing involves independent appraisal. Do you agree? Explain.
b. The scope of operational auditing is similar to the scope of internal auditing. Is this true? Explain.
- 21-7 a. Identify the phases of an operational audit.
b. How do these phases differ from a financial statement audit?
- 21-8 Explain the auditor's responsibilities in (a) selecting the auditee and (b) reporting the findings.
- 21-9 Identify the applicable standards when a CPA performs an operational audit.

KEY TERM

Operational auditing, p. 991

GOVERNMENTAL AUDITING

Governmental auditing includes all audits made by government audit agencies and all audits of governmental organizations. Government audit agencies include the U.S. General Accounting Office, the Defense Contract Audit Agency, and state audit agencies. Audits of governmental organizations include audits of state and local government units made by federal government auditors and independent public accountants. In some cases, these audits may include specific programs, activities, functions, and funds. Audits of governmental organizations are premised largely on the concept that the officials and employees who manage public funds are accountable to the public. Our interest here is in the audits of governmental organizations.

TYPES OF GOVERNMENT AUDITS

Three types of government audits are identified in Government Auditing Standards:

Auditor Knowledge 5

■ Know the three types of governmental audits.

- **Financial audits** are primarily concerned with providing reasonable assurance about whether financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP), or with a comprehensive basis of accounting other than GAAP. Other objectives of financial audits, which provide for different levels of assurance and entail various scopes of work, may include
 - providing special reports for specified elements, accounts, or items of a financial statement
 - reviewing interim financial information
 - issuing letters for underwriters and certain other requesting parties
 - reporting on the processing of transactions by service organizations
 - auditing compliance with regulations relating to federal award expenditures and other governmental financial assistance in conjunction with or as a by-product of a financial statement audit

Financial audits are performed under the American Institute of Certified Public Accountants' (AICPA) generally accepted auditing standards for fieldwork and reporting, as well as the related AICPA Statements on Auditing Standards (SAS). GAGAS prescribe general standards and additional fieldwork and reporting standards beyond those provided by the AICPA when performing financial audits.

- **Attestation engagements** concern examining, reviewing, or performing agreed-upon procedures on a subject matter or an assertion about a subject matter and reporting on the results. The subject matter of an attestation engagement may take many forms, including historical or prospective performance or condition, physical characteristics, historical events, analyses, systems and processes, or behavior. Attestation engagements can cover a broad range of financial or nonfinancial subjects and can be part of a financial audit or performance audit. Possible subjects of attestation engagements could include reporting on
 - an entity's internal control over financial reporting
 - an entity's compliance with requirements of specified laws, regulations, rules, contracts, or grants

- the effectiveness of an entity's internal control over compliance with specified requirements, such as those governing the bidding for, accounting for, and reporting on grants and contracts
 - management's discussion and analysis (MD&A) presentation
 - prospective financial statements or pro forma financial information
 - the reliability of performance measures
 - final contract cost
 - allowability and reasonableness of proposed contract amounts and specific procedures performed (agreed-upon procedures)
- **Performance audits** entail an objective and systematic examination of evidence to provide an independent assessment of the performance and management of a program against objective criteria as well as assessments that provide a prospective focus or that synthesize information on best practices or cross-cutting issues. Performance audits provide information to improve program operations and facilitate decision making by parties with responsibility to oversee or initiate corrective action, and improve public accountability. Performance audits encompass a wide variety of objectives, including objectives related to assessing program effectiveness and results; economy and efficiency; internal control; compliance with legal or other requirements; and objectives related to providing prospective analyses, guidance, or summary information. Performance audits may entail a broad or narrow scope of work and apply a variety of methodologies; involve various levels of analysis, research, or evaluation; generally provide findings, conclusions, and recommendations; and result in the issuance of a report.

Auditors performing such engagements, whether employed by government auditing agencies or by CPA firms, must be careful to observe all applicable AICPA and government auditing standards as discussed in the remaining sections of this chapter.

GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS (GAGAS)

Auditor Knowledge 6

■ Know the general standards, additional fieldwork standards, and additional reporting standards associated with generally accepted governmental auditing standards (GAGAS) for financial audits and performance audits.

The U.S. General Accounting Office (GAO) establishes audit standards for audits of government organizations, programs, activities, functions, and government funds received by nongovernment organizations. The standards pertain to the auditor's professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports. The GAO audit standards must be followed by auditors and audit organizations when required by law, regulation, agreement or contract, or policy. Audit organizations consist of government audit agencies and nongovernment entities such as public accounting firms and consulting firms.

The GAO audit standards are recognized as **generally accepted government auditing standards (GAGAS)**. The GAO standards are commonly referred to as the **Yellow Book standards** because of the color of the pamphlet in which they are published. GAGAS include the AICPA generally accepted auditing standards for fieldwork and reporting. As they are issued, any relevant new AICPA auditing and attestation standards will be adopted and incorporated into GAGAS unless the GAO excludes them by formal announcement. Independent auditors who are members of the AICPA must follow GAGAS in government audits or be in violation of the AICPA *Code of Professional Conduct*.

GAGAS are classified into the following six categories: (1) general standards; (2) fieldwork standards for financial audits; (3) reporting standards for financial audits; (4) general, fieldwork, and reporting standards for attestation engagements; (5) fieldwork standards for performance audits, and (6) reporting standards for performance audits. The standards in the first three categories are identified and discussed in the following sections. The performance audit standards in the last two categories are presented in Figure 21-5 for information purposes only and are not discussed further here. Standards for attestation engagements are also beyond the scope of this discussion. Further information about these standards can be found at <http://www.gao.gov/govaud/yb/2003/html/TOC.html>.

General Standards

The general category of GAGAS pertains primarily to the qualifications of the auditor and audit organizations. These standards apply to both types of government audits. There are four standards in this category:

Figure 21-5 ■ Fieldwork and Reporting Standards for Performance Audits

Fieldwork Standards	Reporting Standards
<p>1. Planning Work is to be adequately planned.</p> <p>2. Supervision Staff are to be properly supervised.</p> <p>3. Evidence Sufficient, competent, and relevant evidence is to be obtained to provide a reasonable basis for the auditors' findings and conclusions.</p> <p>4. Audit Documentation Auditors should prepare and maintain audit documentation. Audit documentation related to planning, conducting, and reporting on the audit should contain sufficient information to enable an experienced auditor, who has had no previous connection with the audit, to ascertain from the audit documentation the evidence that supports the auditors' significant judgments and conclusions. Audit documentation should contain support for findings, conclusions, and recommendations before auditors issue their report.</p>	<p>1. Form Auditors should prepare audit reports communicating the results of each audit.</p> <p>2. Report Contents The audit report should include the objectives, scope, and methodology; the audit results, including findings, conclusions, and recommendations, as appropriate; a reference to compliance with generally accepted government auditing standards; the views of responsible officials; and, if applicable, the nature of any privileged and confidential information omitted.</p> <p>3. Report Quality Elements The report should be complete, accurate, objective, convincing, and as clear and concise as the subject permits.</p> <p>4. Report Issuance and Distribution Government auditors should submit audit reports to the appropriate officials of the audited entity and to the appropriate officials of the organizations requiring or arranging for the audits, including external funding organizations, such as legislative bodies, unless legal restrictions prevent it. Auditors should also send copies of the reports to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations, and also to others authorized to receive such reports. Unless the report is restricted by law or regulation, or contains privileged or confidential information, auditors should clarify that copies are made available for public inspection. Nongovernment auditors should clarify report distribution responsibilities with the party contracting for the audit and follow the agreements reached.</p>

Source: *Government Auditing Standards*, Chapters 7 and 8.

- *Independence.* 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.
- *Professional judgment* should be used in planning and performing audits and attestation engagements and in reporting the results.
- *Competence.* The staff assigned to perform the audit or attestation engagement should collectively possess adequate professional competence for the tasks required.
- *Quality control and assurance.* Each audit organization performing audits and/or attestation engagements in accordance with GAGAS should have an appropriate internal quality control system in place and should undergo an external peer review.

The general standards address the fundamental requirements for ensuring the credibility of audit results. Credibility is essential to all audit organizations. These general standards encompass the independence of the audit organization and its individual auditors; the exercise of professional judgment in the performance of work and the preparation of related reports; the competence of audit staff, including the need for their continuing professional education; and the existence of quality control systems and external peer reviews.

These general standards provide the underlying framework that is critical in effectively applying the fieldwork and reporting standards when performing the detailed work associated with audits or attestation engagements. Therefore, these general standards are required to be followed by all auditors and audit organizations, both government and nongovernment, performing work under generally accepted government auditing standards (GAGAS).

Fieldwork Standards for Financial Audits

The GAGAS fieldwork standards incorporate the three AICPA fieldwork standards without modification. Also incorporated, by reference, are all of the related SASs issued by the AICPA that may be viewed as interpretations of the fieldwork standards. Complementing these standards, GAGAS include five additional fieldwork standards as follows:

- *Auditor communication.* Auditors should communicate information regarding the nature, timing, and extent of planned testing and reporting and the level of assurance provided to officials of the audited entity and to the individuals contracting for or requesting the audit.
- *Considering the results of previous audit and attestation engagements.* Auditors should consider the results of previous audits and attestation engagements and follow up on known significant findings and recommendations that directly relate to the objectives of the audit being undertaken.
- *Detecting material misstatements resulting from violations of contract provisions or grant agreements, or from abuse.*
 - Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from violations of provisions of contracts or grant agreements that have a direct and material effect on the deter-

mination of financial statement amounts or other financial data significant to the audit objectives. If specific information comes to the auditors' attention that provides evidence concerning the existence of possible violations of provisions of contracts or grant agreements that could have a material indirect effect on the determination of financial statement amounts, auditors should apply audit procedures specifically directed to ascertain whether violations of provisions of contracts or grant agreements have occurred or are likely to have occurred.

- Auditors should be alert to situations or transactions that could be indicative of abuse, and if indications of abuse exist that could significantly affect the financial statement amounts or other financial data, auditors should apply audit procedures specifically directed to ascertain whether abuse has occurred and the effect on the financial statement amounts or other financial data.
- *Developing elements of a finding.* Audit findings, such as deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, have often been regarded as containing the elements of criteria, condition, and effect, plus underlying cause when problems are found.
- *Audit documentation.* Documentation related to planning, conducting, and reporting on the audit should contain sufficient information to enable an experienced auditor who has had no previous connection with the audit to ascertain from the audit documentation the evidence that supports the auditors' significant judgments and conclusions. Audit documentation should contain support for findings, conclusions, and recommendations before auditors issue their report.

The first additional GAGAS standard broadens who the auditor must communicate with when establishing an understanding regarding the audit. GAGAS requires that the individuals contracting for, or requesting, the audit services be involved in establishing an understanding. Specific information should be communicated regarding the nature and extent of testing and reporting on compliance with laws and regulations and internal control over financial reporting to reduce the risk that the needs or expectations of parties involved may be misinterpreted.

The second additional standard recognizes the GAO's conclusion that much of the benefit from audit work is not in the findings reported or recommendations made, but in their effective resolution, which is a responsibility of the auditee's management. This additional standard establishes part of a process to track the status of previous findings and resolutions and is intended to help auditors ensure that the benefits of their work are realized.

The third additional standard recognizes that governmental organizations are often subject to more specific rules and regulations than entities in the private sector and that noncompliance can have material effects on the financial statements. This standard is patterned after GAAS requirements regarding auditors' responsibilities for detecting irregularities and illegal acts, and under GAGAS, auditors have the same responsibility for detecting material misstatements arising from other types of noncompliance as they do from illegal acts.

The fourth additional standard recognizes that 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. When problems are identified, auditors should plan audit procedures to develop the elements of the finding into the auditors' report.

The final additional standard regarding audit documentation codifies a requirement that audit working papers should contain support for findings, conclusions, and recommendations before auditors issue their report.

GAGAS do not prescribe additional internal control standards for financial statement audits. However, the *Yellow Book* does include guidance on applying the second standard of fieldwork of GAAS when considering the control environment, safeguarding controls, controls over compliance with laws and regulations, and control risk assessments in government audits. The *Yellow Book* also provides additional guidance on setting materiality. Specifically, it states that in an audit of a government entity or an entity that receives government assistance, it may be appropriate to set materiality levels lower than in audits of other entities because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions.

All AICPA standards (SASs and SSAEs) that apply to financial related audits are also incorporated by reference into GAGAS.

Reporting Standards for Financial Audits

Complementing the AICPA's four generally accepted reporting standards and related SASs, all of which are incorporated into GAGAS by reference, the *Yellow Book* includes the following six additional reporting standards:

- *Reporting auditors' compliance with GAGAS.* Audit reports should state that the audit was made in accordance with generally accepted government auditing standards.
- *Reporting on internal control and on compliance with laws, regulations, and provisions of contracts or grant agreements.* When providing an opinion or a disclaimer on financial statements, auditors should include in their report on the financial statements either a (1) description of the scope of the auditors' testing of internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements and the results of those tests or an opinion, if sufficient work was performed, or (2) reference to the separate report(s) containing that information. If auditors report separately, the opinion or disclaimer should contain a reference to the separate report containing this information and state that the separate report is an integral part of the audit and should be considered in assessing the results of the audit.
- *Reporting deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse.* For financial audits, including audits of financial statements in which the auditor provides an opinion or disclaimer, auditors should report, as applicable to the objectives of the audit, (1) deficiencies in internal control considered to be reportable conditions as defined in AICPA standards, (2) all instances of fraud and illegal acts unless clearly inconsequential, and (3) significant violations of provisions of contracts or grant agreements and abuse. In some circumstances, auditors should report fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse directly to parties external to the audited entity.
- *Reporting views of responsible officials.* If the auditors' report discloses deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse, auditors should obtain and report the views of

responsible officials concerning the findings, conclusions, and recommendations, as well as planned corrective actions.

- *Reporting privileged and confidential information.* If certain pertinent 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.
- *Report issuance and distribution.* Government auditors should submit audit reports to the appropriate officials of the audited entity and to appropriate officials of the organizations requiring or arranging for the audits, including external funding organizations such as legislative bodies, unless legal restrictions prevent it. Auditors should also send copies of the reports to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations and to others authorized to receive such reports. Unless the report is restricted by law or regulation, or contains privileged and confidential information, auditors should clarify that copies are made available for public inspection. Nongovernment auditors should clarify report distribution responsibilities with the party contracting for the audit and follow the agreements reached.

The first additional reporting standard requires that the audit report on financial statements explicitly state that the audit was conducted in accordance with GAGAS whenever the report is submitted to comply with a legal, regulatory, or contractual requirement for a GAGAS audit. This standard does not prohibit issuing a report that does not refer to GAGAS when the auditee needs an audit report for purposes other than complying with requirements calling for a GAGAS audit.

The second additional standard does not require the auditor to report on internal controls over financial reporting similar to the report for public companies. It does, however, require the auditor to report the scope of tests of controls over both financial reporting and compliance with laws and regulations.

The third additional reporting standard expands the scope of the report beyond fair presentation in the financial statements. The auditor must also report known internal control deficiencies, fraud, illegal acts, or violation or abuse of contract provisions.

The fourth additional reporting standard provides an opportunity for management to respond to the auditor's findings. It recognizes that 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 officials of the audited entity and others, as may be appropriate. Including the views of responsible officials results in a report that presents not only the deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse the auditors identified but also what the responsible officials of the audited entity think about the deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse, and what corrective actions officials of the audited entity plan to take. Auditors should include in their report a copy of the officials' written comments or a summary of the comments received.

The fifth additional standard recognizes that certain information may be prohibited from general disclosure by federal, state, or local laws or regulations. The report distribution requirements detailed in the final additional standard make it important for the engaging organization and the auditor to have a clear understanding as to which officials or organizations will receive the report and who will make the distribution.