

In reporting on financial related audits, auditors should follow all applicable portions of the GAAS and GAGAS reporting standards for financial audits as well as applicable portions of the AICPA's SASs, and SSAEs such as those discussed in Chapter 20. For financial related audits not covered by the above, the GAGAS reporting standards for performance audits (see Figure 21-5) should be followed.

REPORTING ON COMPLIANCE WITH LAWS AND REGULATIONS

The second additional reporting standard requires that either the auditors' reports on financial statements or a separate report referred to therein include the same information on irregularities and illegal acts that is reported to audit committees under AICPA standards. Other instances of noncompliance that are material to the financial statements such as violations of contract provisions or grant agreements must also be reported. Examples of the latter include failure of grantees to contribute their own resources pursuant to matching requirements, violations of restrictions on the purposes for which funds can be expended, and improper allocations of indirect costs. When noncompliance is found, the manner of reporting should provide the reader with a basis for judging the prevalence and consequences of such conditions by referring to such variables as the number of cases examined, frequency of noncompliance, dollar value, and so on.

This standard also requires auditors to report irregularities or illegal acts directly to external parties in two circumstances when the auditee fails to do so as soon as practicable after the auditor has communicated the matter to the auditee's governing body: (1) when the auditee is required by law or regulation to report such events to external parties and (2) when an auditee that receives assistance from a government agency fails to report to the agency an irregularity or illegal act involving that assistance. When laws, regulations, or policies require auditors to report indications of certain types of irregularities or illegal acts to law enforcement or investigatory authorities, they should consult with those authorities and/or legal counsel to determine whether broader reporting would compromise investigative or legal proceedings already underway. In such cases, auditors may limit their reporting to information that is already part of the public record.

Extensive guidance on **compliance auditing**, **compliance attestation**, and reporting thereon is provided in AU 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, and AT 601, *Compliance Attestations*. A sample compliance report is presented in Figure 21-6. Based on AT 600.54, the CPA's report on an examination of a compliance attestation, which is ordinarily addressed to the entity, should include the following:

- A title that includes the word *independent*.
- Identification of the specified compliance requirements, including the period covered, and of the responsible party.
- A statement that compliance with the specified requirements is the responsibility of the entity's management.
- A statement that the practitioner's responsibility is to express an opinion on the entity's compliance with those requirements or on management's assertion on such compliance based on his or her examination.

- A statement that the examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the entity’s compliance with those requirements and performing such other procedures as the practitioner considered necessary in the circumstances.
- A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion.
- A statement that the examination does not provide a legal determination on the entity’s compliance.
- The practitioner’s opinion on whether the entity complied, in all material respects, with specified requirements based on the specified criteria.
- A statement restricting the use of the report to the specified parties under the following circumstances:
 - When the criteria used to evaluate compliance are determined by the practitioner to be appropriate only for a limited number of parties who either par-

Figure 21-6 ■ Example Report on Compliance

Independent Accountant’s Report

[Introductory paragraph]

We have examined [name of entity]’s compliance with [list specified compliance requirements] during the [period] ended [date]. Management is responsible for [name of entity]’s compliance with those requirements. Our responsibility is to express an opinion on [name of entity]’s compliance based on our examination.

[Scope paragraph]

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining on a test basis, evidence about [name of entity]’s compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination does not provide a legal determination on [name of entity]’s compliance with specified requirements.

[Opinion paragraph]

In our opinion, [name of entity] complied, in all material respects, with the aforementioned requirements for the year ended December 31, 20XX.

[Restricted use paragraph]

This report is intended solely for the information and use of [list specific parties] and is not intended to be used by anyone other than these specified parties.

[Signature]

[Date]

anticipated in their establishment or can be presumed to have an adequate understanding of the criteria.

- When the criteria used to evaluate compliance are available only to the specified parties
- The manual or printed signature of the practitioner's firm.
- The date of the examination report.

REPORTING ON INTERNAL CONTROL

As indicated in the second additional reporting standard, GAGAS requires auditors to report deficiencies in internal control that they consider to be significant deficiencies (as discussed in Chapters 11 and 19 of this text). Examples of significant deficiencies may include:

- Absence of appropriate segregation of duties consistent with appropriate control objectives.
- Evidence of failure to safeguard assets from loss, damage, or misappropriation.
- Absence of a sufficient level of control consciousness within the organization.
- Failure to follow up and correct previously identified deficiencies in internal control.

Furthermore, GAGAS requires that significant deficiencies that constitute material weaknesses be so identified, a requirement that is optional under GAAS. When there are deficiencies that do not qualify as reportable conditions, they should be communicated to the auditee, preferably in writing such as in a management letter. When this occurs, reference should be made to the communication in the auditor's report on controls.

The report on controls does not express any form of assurance on the effectiveness of the internal control. Additional guidance on reporting on the internal control of a governmental entity, including the suggested content and format of separate reports suitable for a variety of circumstances, can be found in AT 501.

LEARNING CHECK

- 21-10 a. Explain the scope of governmental auditing.
b. Identify the types of government audits.
- 21-11 a. What agency establishes audit standards for government audits?
b. What is the relationship between GAGAS and GAAS?
- 21-12 a. Identify the categories of GAGAS.
b. State the general standards that apply to all government audits.
- 21-13 a. Identify the supplemental fieldwork standards that apply in a financial statement audit.
b. What reports are required by the supplemental reporting standards in a financial statement audit?
- 21-14 a. Indicate the nature of each paragraph of the auditor's unqualified report on compliance with applicable laws and regulations.
b. Identify the requirements for reporting on internal control under GAGAS that differ or are in addition to GAAS.

[KEY TERMS]

Attestation engagements, p. 996	Governmental auditing, p. 996
Compliance attestation, p. 1003	Performance audits, p. 997
Compliance auditing, p. 1003	Yellow Book standards, p. 997
Financial audits, p. 996	
Generally accepted government auditing standards (GAGAS), p. 997	

[THE SINGLE AUDIT ACT]

Auditor Knowledge 7

■ Know the objectives and applicability of the Single Audit Act.

The **Single Audit Act**, passed by Congress in 1984 and amended in 1996, established the concept of a single organizationwide government audit (the **single audit**) encompassing both financial and compliance audits. The Act reduces the need for federal agencies to conduct, and for recipients of federal financial assistance to undergo, multiple separate financial and compliance audits.

OBJECTIVES OF THE ACT

Section 1(a) of the Act states that the Act's objectives are to:

- Improve the financial management of state and local governments and non-profit organizations with respect to federal financial assistance programs.
- Establish uniform requirements for audits of federal financial assistance provided to state and local governments.
- Promote the efficient and effective use of audit resources.
- Ensure that federal departments and agencies, to the maximum extent practicable, rely on and use audit work done pursuant to the requirements of the Single Audit Act.

As implemented, the Act also has become an instrument for ensuring that the recipients of federal financial assistance comply with several significant national policies pertaining to such matters as wages, work conditions, and civil rights as explained further in a subsequent section.

APPLICABILITY AND ADMINISTRATION

Under the Act, state and local governments and nonprofit organizations that receive \$500,000 or more in federal financial assistance in any fiscal year, either directly from a federal agency or indirectly through another state or local government entity, are required to have a single annual audit pursuant to the Act. The Federal Office of Management and Budget (OMB) is authorized to adjust the threshold amount every two years. The Act adds to the requirements contained in the *Yellow Book* standards, with special emphasis on defined major federal financial assistance programs.

Federal financial assistance is broadly defined in the Act as assistance provided by a federal government agency in the form of grants, contracts, loans, loan

guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations, but not direct federal cash assistance to individuals. The auditor shall use a risk-based approach to determine which federal programs are **major programs**. The risk-based approach shall include consideration of: (1) current and prior audit experience, (2) oversight by federal agencies and pass-through entities, and (3) the inherent risk of the federal program. *OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations*, provides additional specific guidance on implementing these three criteria. Programs not qualifying as major programs are designated **nonmajor programs**.

The director of the Office of Management and Budget (OMB) has prescribed policies, procedures, and guidelines to implement the Act in *OMB Circular A-128—Audits of State and Local Governments*.² The director also designates cognizant agencies to monitor compliance with the Act. A **cognizant agency** is a federal agency that has the responsibility for implementing the requirements for single audits for a particular state or local government. The cognizant agency represents the collective interests of all federal government agencies in the results of the audit. The responsibilities of the agency include providing technical advice and liaison to state and local governments and independent auditors. Thus, the governmental unit can work directly with one agency rather than with several.

SCOPE OF AN AUDIT UNDER THE SINGLE AUDIT ACT

The scope of an audit conducted as specified in the Act and *OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations*, has two components and five procedures, as outlined in Figure 21-7.

General

In general, the audit shall be conducted in accordance with GAGAS. The auditor shall cover the entire operations of the auditee; or at the option of the auditee, the audit shall include a series of audits that cover departments, agencies, and other organizational units that expended or administered federal awards during the year. Each separate audit shall encompass the financial statements and schedule of expenditure of federal awards for each department, agency, or other governmental unit.

Financial Statements

The auditor shall determine whether the financial statements of the auditee are presented fairly in all material respects in conformity with generally accepted accounting principles. The auditor shall also determine whether a schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole.

Auditor Knowledge 8

■ Know the components of a single audit and the procedures and reports associated with each.

² A companion document, *OMB Circular A-133—Audits of Institutions of Higher Education and Other Nonprofit Institutions*, prescribes audit requirements for institutions of higher education and other nonprofit institutions that receive federal awards of \$500,000 or more per year. (The definition of federal award is slightly broader than the definition of federal financial assistance.) To assist auditors in complying with *OMB Circular A-133*, the AICPA has issued Statement of Position 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*. These materials are beyond the scope of this chapter.

Figure 21-7 ■ Summary of Auditors Responsibilities under the Single Audit Act

Component	Procedures Performed	Report Issued
Financial statement audit	<ol style="list-style-type: none"> 1. Audit of the financial statements in accordance with GAAS and the general standards of GAGAS. 2. Audit of the financial statements in accordance with the additional GAGAS standards of fieldwork and reporting. 	<ol style="list-style-type: none"> 1a. Opinion on the financial statements. 1b. Report on supplementary schedule of federal financial assistance. 2a. Report on internal control based on the audit. 2b. Report on compliance with laws and regulations that may have a material effect on the financial statements.
Audit of federal financial assistance	<ol style="list-style-type: none"> 3. Procedures to obtain understanding of the internal control over federal financial assistance test of controls, and to support an assessment of control risk at a low level. 4. Tests of compliance with general requirements applicable to all federal financial assistance programs and specific requirements applicable to major federal financial assistance programs. 5. Performance of procedures to assess the reasonableness of summary schedule of prior findings and current follow-up. 	<ol style="list-style-type: none"> 3a. Report on internal controls over federal financial assistance. 4a. Report on compliance with general requirements applicable to federal financial assistance programs. 4b. Opinion on compliance with specific requirements applicable to each major federal financial assistance program. 4c. Schedule of findings and questioned costs. 5a. Report, as a current-year finding, when the auditor concludes that the summary of prior findings materially misstates their status.

Source: AU 801.102 (Adapted).

Internal Controls

In addition to the requirements of GAGAS, the auditor shall perform procedures to obtain an understanding of internal control over federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs. In general, the auditor shall also plan to test the system of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program.

Compliance

In addition to the requirements of GAGAS, the auditor shall determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. The OMB produces a Compliance Supplement that describes the principal compliance requirements applicable to most federal programs. The compli-

ance testing shall include tests of transactions and such other auditing procedures necessary to provide the auditor sufficient evidence to support an opinion on compliance. The auditor should set the scope of the audit to address specific requirements such as the following:

- Types of services allowed or not allowed, which specifies the types of goods or services that entities may purchase with federal assistance.
- Eligibility, which specifies the characteristics of individuals or groups to which entities may give financial assistance.
- Matching, which specifies amounts entities should contribute from their own resources toward projects for which financial assistance is provided.
- Reporting, which specifies other reports entities must file.
- Special tests and provisions, which might include such requirements as holding hearings regarding the proposed use of funds and deadlines for expending funds.
- The materiality of any findings of noncompliance is evaluated in the context of the program to which the findings relate rather than the overall financial statements.

Audit Follow-up

The auditor shall follow-up on prior audit findings and perform procedures to assess the reasonableness of a summary schedule of prior audit findings prepared by the auditee. The auditor should report as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. The auditor shall also perform audit follow-up procedures regardless of whether a prior audit finding relates to a major program in the current year.

Reporting Requirements

The auditor's report(s) may be in the form of either combined or separate reports. In addition to guidance provided in *OMB Circular A-133*, the auditor should consider the following:

- AU 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*
- AT 101, *Attest Engagements*
- AT 601, *Compliance Attestation*

The content of the auditor's reports is discussed below.

Opinion on Financial Statements

First, the auditor shall issue an opinion (or disclaimer of opinion) as to whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles. As part of this requirement, the auditor shall issue an opinion (or disclaimer of opinion) as to whether the Schedule of Expenditures of Federal Awards is presented fairly in all material respects in relation to the financial statements taken as a whole.

Report on Internal Control

Second, the auditor shall issue a report on internal control related to the financial statements and major programs. This report shall describe the scope of testing of internal control and the results of the tests, and, where applicable, refer to a separate Schedule of Findings and Questioned Costs.

Report on Compliance

Third, the auditor shall issue a report on compliance with laws, regulations, and the provisions of contracts or grant agreements where noncompliance could have a material effect on the financial statements. This report shall also include an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each major program. When it is applicable, the report should refer to the separate Schedule of Findings and Questioned Costs (discussed in the following paragraph).

Schedule of Findings and Questioned Costs

Finally, the auditor shall include a summary of the auditor's results in the form of a Schedule of Findings and Questioned Costs. **Questioned costs** include any costs charged to a program that are not allowable, undocumented, unapproved, or unreasonable. The Schedule of Findings and Questioned Costs includes the following main components:

1. A summary of the auditor's results which shall include:
 - The type of report the auditor issued on the financial statements of the auditee (e.g., unqualified opinion, qualified opinion, or disclaimer of opinion).
 - Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.
 - A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee.
 - Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.
 - The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, or disclaimer of opinion);
 - A statement as to whether the audit disclosed any audit findings including (1) reportable conditions in internal control over major programs, (2) material noncompliance with provisions of laws, regulations contracts, or grant agreements related to a major program, (3) known questioned costs which are greater than \$10,000 for a type of compliance requirement for a major program, or which is not audited as a major program, (4) circumstances concerning why the auditor's report on compliance of major programs is other than an unqualified opinion, and (5) known fraud affecting a federal award.
 - An identification of major programs.
 - The dollar threshold used to distinguish between Type A and Type B programs in a risk-based approach to setting the scope of the audit.
 - A statement as to whether the auditee qualified as a low-risk auditee.

2. Findings relating to the financial statements which are required to be reported in accordance with GAGAS.
3. Findings and questioned costs for federal awards.
4. A report, as a current-year audit finding, when the auditor concludes that the schedule of prior audit findings materially misrepresents the status of any prior audit finding.

LEARNING CHECK

- 21-15** What are the objectives of the Single Audit Act?
- 21-16** a. Who is required to have a single audit under the Single Audit Act?
 b. Who prescribes policies, procedures, and guidelines to implement the Act?
 c. What is a cognizant agency, and what are its responsibilities?
- 21-17** a. Identify the two main components of a single audit.
 b. What is the source of the standards that govern performance of each component?
- 21-18** What is the purpose of the auditor's consideration of the internal control structure used in administering federal financial assistance programs?
- 21-19** a. State the nature of the general requirements with which all recipients of federal financial assistance are expected to comply, and give several examples.
 b. State the types of specific requirements with which major programs are expected to comply.
 c. How is the application of the concept of materiality in evaluating findings of noncompliance with specific requirements different from its application under GAAS?
- 21-20** Identify the reports required under the Single Audit Act that are not required by GAAS or GAGAS.

KEY TERMS

Cognizant agency, p. 1007
 Federal financial assistance, p. 1006
 Major programs, p. 1007
 Nonmajor programs, p. 1007

Questioned costs, p. 1010
 Single audit, p. 1006
 Single Audit Act, p. 1006

FOCUS ON AUDITOR KNOWLEDGE

This chapter focuses on internal auditing, operational auditing, and governmental auditing. Figure 21-8 summarizes the audit knowledge discussed in Chapter 21 and provides page references indicating where these decisions are discussed in more detail.

Figure 21-8 ■ Summary of Auditor Knowledge Discussed in Chapter 21

Auditor Knowledge	Summary	Chapter References
K1. Know the definition of internal auditing and the IIA professional practices framework.	The IIA defines internal auditing as 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. Figure 21-1 provides a graphic depiction of the IIA professional practices framework.	pp. 985–986
K2. Know the IIA code of ethics, attribute standards, and performance standards.	Figure 21-2 summarizes the IIA code of professional ethics. Figure 21-3 summarizes the IIA attribute and performance standards. These are explained in more detail in the chapter discussion.	pp. 986–990
K3. Know the definition of operational auditing and describe the phases of an operational audit.	The IIA has defined operational auditing as 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. The chapter discussion explains five phases of an operational audit: (1) select the auditee, (2) plan the audit, (3) perform the audit, (4) report findings to management and (5) perform follow-up.	pp. 991–994
K4. Know the standards that independent public accountants should follow in performing operational audits.	The independent CPA should follow Management Consulting Services standards when performing an operational audit.	p. 995
K5. Know the three types of governmental audits.	The three types of governmental audits are (1) financial audits, (2) attestation engagements, and (3) performance audits. These are explained in more detail in the chapter discussion.	pp. 996–997
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.	<p>The four general standards address (1) independence, (2) professional judgments, (3) competence, and (4) quality control and assurance.</p> <p>The additional fieldwork standards for financial audits are (1) auditor communication, (2) considering the results of previous engagements, (3) detecting material misstatements resulting from violations of contract provisions or grant agreements or from abuse, (4) developing elements of a finding, and (5) audit documentation.</p> <p>The additional reporting standards for financial audits are (1) reporting auditors’ compliance with GAGAS, (2) reporting on internal control and on compliance with laws, regulations, and provisions of contracts or grant agreements, and (3) reporting deficiencies in internal control, fraud, illegal acts, violations of provision of contracts or grand agreements, and abuse.</p> <p>The additional requirements for financial audits are discussed in more detail in the chapter.</p> <p>The additional fieldwork and reporting standards for performance audits are summarized in Figure 21-5.</p>	pp. 997–1005

(continues)

Figure 21-8 ■ (Continued)

Auditor Knowledge	Summary	Chapter References
K7. Know the objectives and applicability of the Single Audit Act.	The objectives and applicability of the Single Audit Act are to (1) improve the financial management of state and local governments and nonprofit organizations with respect to federal financial assistance programs, (2) establish uniform requirements for audits of federal financial assistance provided to state and local governments, (3) promote the efficient and effective use of audit resources, and (4) ensure that federal departments and agencies, to the maximum extent practicable, rely on and use audit work done pursuant to the requirements of the Single Audit Act. The Single Audit Act applies to state and local governments and not-for-profit entities that receive over \$500,000 in federal financial assistance in a fiscal year.	pp. 1006–1007
K8. Know the components of a single audit and the procedures and reports associated with each.	The Single Audit Act has five major components: (1) general, (2) financial statements, (3) internal controls, (4) compliance, and (5) audit follow-up. Figure 21-7 provides a summary of the auditor's responsibility under the Single Audit Act.	pp. 1007–1011

objective questions

Objective questions are available for the student at www.wiley.com/college/boynton

comprehensive questions

- 21-21 **(Internal auditing practice standards)** Standards for the Professional Practice of Internal Auditing have been established by the Institute of Internal Auditors. Listed below are specific policies adopted by the Marco Corporation for its internal auditors:
1. Internal auditors must comply with the Institute of Internal Auditor Code of Ethics.
 2. Internal auditors should periodically inspect the safeguards over inventories and cash.
 3. Internal auditors should have valid evidence for audit findings.
 4. Inexperienced internal auditors must be supervised by certified internal auditors.
 5. Internal auditors should attend professional seminars on EDP.
 6. Internal auditors should be unbiased in performing audits.
 7. Internal auditors should make a study of the efficiency of personnel in the receiving department.
 8. Internal auditors should make postaudit reviews of actions taken by a department following an audit.
 9. Internal auditors should periodically review the company's compliance with federal governmental regulations.
 10. Internal auditors' reports of audit findings should be communicated to appropriate levels of management.

11. The director of internal auditing should plan the activities for the year.
12. Internal auditors should exercise due care in doing each audit.
13. A quality assurance program should be established and maintained.
14. All new internal auditors must be college graduates.
15. There should be a statement of purpose, authority, and responsibility for the internal audit department.

Required

- a. Identify and state the specific IIA practice standard that pertains to each policy.
- b. For each specific standard identified in (a) above, identify the related category of general standard (independence, professional proficiency, scope of work, performance of audit work, and management of the internal auditing department). Use the following format for your answers:

POLICY NO.	SPECIFIC STANDARD (A)	GENERAL STANDARD (B)

21-22 **(Internal auditing standards)** The Standards for the Professional Practice of Internal Auditing contain general standards for independence and performance of audit work.

Required

- a. State the general and specific standards that pertain to independence.
- b. How, if at all, does the standard of independence for internal auditors differ from the standard of independence for independent auditors?
- c. State the general and specific standards that relate to the performance of audit work.
- d. Identify four guidelines that apply to the specific standard pertaining to planning.
- e. Identify four guidelines that apply to the specific standard of communicating results.

21-23 **(Internal auditing scope-of-work standards)** You are a senior internal auditor for a savings and loan association. You are discussing the preliminary findings of your audit with the branch manager. Some of the findings you feel need to be investigated further are:

1. The branch seems to have too many tellers.
2. No security officer has been appointed, and camera surveillance seems to be insufficient.
3. Although the association does not have a specific dress code, the attire of the branch personnel appears to be too casual, even after considering a recent directive to conserve energy during the summer months.
4. Some of the branch loan officers appear to lack adequate qualifications.
5. Some customers are not charged penalties for late payments on loans.
6. Granting new home mortgages seems to be encouraged in spite of an association policy to discourage expanded activity in this area.

Required

On your answer sheet, list the title of each of the specific scope-of-work standards as set forth in the Standards for the Professional Practice of Internal Auditing and to the right of each specific standard, list the number(s) of the finding above that apply.

IIA

21-24 **(Operational auditing)** Enclosure Products, a large, nationwide organization, manufactures and markets several lines of equipment used in packaging. Product reliability and customer service are considered critical to the company's success. The Customer Service Department is charged with the following responsibilities:

- Providing prospective customers with product information.
- Monitoring the adequacy of spare parts availability.
- Providing information to customers about equipment operation and maintenance.
- Preparing and providing customer training courses.
- Providing backup service and support in the event of critical breakdowns.
- Handling warranty claims.
- Maintaining general liaison with customers.

The company recently computerized its Customer Service Department to improve operational efficiency and customer satisfaction. This change represented a sizable investment by Enclosure Products. The new system includes management information to monitor performance in the areas listed above. The Audit Committee of Enclosure Products' board of directors has requested that the Internal Audit Department perform an operational audit of the Customer Service Department. The Audit Committee has asked that the audit objectives include evaluation of the following:

- Security of assets, including computer information.
- Compliance with applicable laws and company policies.
- Reliability of financial records.
- Effectiveness of performing assigned responsibilities.
- Determination of the value of the spare parts inventory.

Required

- a. Explain why each of the five audit objectives suggested by the Audit Committee is, or is not, appropriate for an operational audit of Enclosure Products' Customer Service Department.
- b. Outline the basic procedures for performing an operational audit.

ICMA (adapted)

21-25 **(Operational auditing)** Janet Joebert is an internal auditor for the Beamer Company. Janet is assigned to conduct an operational audit on the company's receiving department. This is to be Janet's first operational audit. In preparing for the audit, she asks the following questions:

1. What are the similarities and differences between the phases of an operational audit and the phases of a financial statement audit?
2. What is involved in making a preliminary study?
3. What are the key factors in making the examination?
4. What are the essential elements of the report on audit findings?
5. What is the nature and extent of performing a follow-up on the audit?

Required

- a. Answer Janet's questions.
- b. If Janet were a CPA in public practice, what standards would she have to follow in conducting the operational audit?

- 21-26 **(Government auditing standards)** Generally accepted government auditing standards (GAGAS) for a financial statement audit are classified into three categories: general, field-work, and reporting. The following statements relate to the specific GAGAS:
1. Due professional care should be used in conducting the audit and in preparing related reports.
 2. Working papers should contain sufficient information to ascertain that the evidence supports the auditor's significant conclusions and judgments.
 3. The auditor's report on financial statements should either describe the scope of the auditor's testing of compliance with internal controls and present the results of those tests or refer to separate reports containing that information.
 4. Planning should include following up on known and material findings and recommendations from previous audits.
 5. Auditors should communicate certain information to the audit committee or individuals with whom they have contracted for the audit.
 6. The staff assigned to conduct the audit should collectively possess adequate professional proficiency for the tasks required.
 7. The auditors should prepare a written report on their tests of compliance with applicable laws and regulations.
 8. The auditor should also be aware of the possibility of illegal acts that could have an indirect and material effect on the financial statements.
 9. Audit organizations conducting government audits should have an appropriate internal quality control system in place.
 10. A record of the auditors' work should be retained in the form of working papers.
 11. A statement should be included in the auditors' report that the audit was made in accordance with generally accepted government auditing standards.
 12. In all matters relating to the audit work, the audit organization and the individual auditors should be free from personal and external impairments to independence.
 13. The auditor should design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, and illegal acts.
 14. Written audit reports are to be submitted by the audit organization to the appropriate officials of the organization audited.
 15. If certain information is prohibited from general disclosure, the report should state the nature of the information omitted.

Required

- a. Indicate the category and specific standard to which each of the statements pertains.
 - b. Explain the relationship of GAAS to the above standards.
 - c. Identify the reports that should be issued in a financial audit.
- 21-27 **(Single Audit Act)** Laura Level, CPA, is assigned to the single audit of the city of Plainville. This is Laura's first single audit. As the manager on the audit, you decide to test Laura on her understanding of the Single Audit Act and the auditing requirements of that Act. Your questions to Laura are:
1. What criteria determine whether the city of Plainville must have a single audit?
 2. What are the objectives of the Single Audit Act?
 3. What is the role of the director of the Office of Management and Budget in the audit?

4. What is a cognizant agency? What are the responsibilities of this agency in the audit?
5. What are the audit objectives of the Act?
6. What audit reports are required on the city's federal financial assistance programs?
7. How may the required reports be issued?

Required

Supply the answers that Laura should give.

- 21-28 **(Single Audit Act)** Jones and Baker, a CPA firm, has a number of governmental audit clients. Some of the clients have federal government financial assistance programs.

Required

- a. What responsibility does the auditor have for reporting on compliance under the Single Audit Act?
- b. What responsibility does the auditor have for testing compliance in (1) major and (2) nonmajor federal financial assistance programs?

cases

- 21-29 **(Objectivity in internal auditing)** Lajod Company has an Internal Audit Department consisting of a manager and three staff auditors. The manager of Internal Audits, in turn, reports to the corporate controller. Copies of audit reports are routinely sent to the board of directors as well as the corporate controller and the individual responsible for the area or activity being audited.

The manager of Internal Audits is aware that the external auditors have relied on the internal audit function to a substantial degree in the past. However, in recent months, the external auditors have suggested there may be a problem related to the objectivity of the internal audit function. This objectivity problem may result in more extensive testing and analysis by the external auditors.

The external auditors are concerned about the amount of nonaudit work performed by the Internal Audit Department. The percentage of nonaudit work performed by the internal auditors in recent years has increased to about 25 percent of their total hours worked. A sample of five recent nonaudit activities is as follows:

1. One of the internal auditors assisted in the preparation of policy statements on internal control. These statements included such items as policies regarding sensitive payments and standards of internal control for systems.
2. The bank statements of the corporation are reconciled each month as a regular assignment for one of the internal auditors. The corporate controller believes this strengthens the internal control function because the internal auditor is not involved in the receipt and disbursement of cash.
3. The internal auditors are asked to review the budget data in every area each year for relevance and reasonableness before the budget is approved. In addition, an internal auditor examines the variances each month, along with the associated explanations. These variance analyses are prepared by the corporate controller's staff after consultation with the individuals involved.
4. One of the internal auditors has recently been involved in the design, installation, and initial operation of a new computer system. The auditor was concerned primarily with the design and implementation of internal accounting controls and the computer appli-

cation controls for the new system. The auditor also conducted the testing of the controls during the test runs.

5. The internal auditors are frequently asked to make accounting entries for complex transactions before the transactions are recorded. The employees in the accounting department are not adequately trained to handle such transactions. In addition, this serves as a means of maintaining internal control over complex transactions.

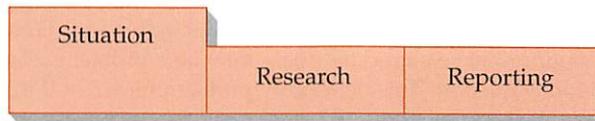
The manager of Internal Audits has always made an effort to remain independent of the corporate controller's office and believes the internal auditors are objective and independent in their audit and nonaudit activities.

Required

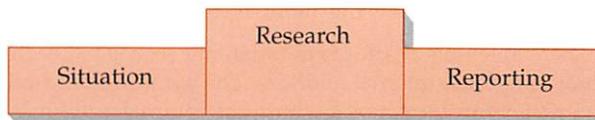
- a. Define objectivity as it relates to the internal audit function.
- b. For each of the five situations outlined above, explain whether the objectivity of Lajod Company's Internal Audit Department has been materially impaired. Consider each situation independently.
- c. The manager of Audits reports to the corporate controller.
 1. Does this reporting relationship result in a problem of objectivity? Explain your answer.
 2. Would your answer to any of the five situations in requirement (b) above have changed if the manager of Internal Audits reported to the board of directors? Explain your answer.

ICMA (adapted)

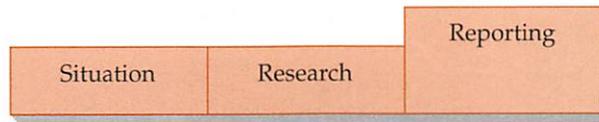
professional simulation



Jennifer Robben is a partner in the CPA firm of Robben, Harrison and Co. The firm has been asked to propose on a compliance engagement for R.E. Fine and Company, and local refinery of petroleum products. The proposed engagement includes performing both an audit of R.E. Fine's financial statements and an examination of its compliance with state laws regarding the handling of hazardous waste.



You have been asked to research the requirements associated with examination procedures applied to R.E. Fine's compliance with state laws regarding the handling of hazardous waste materials. Jennifer recognizes that to express an opinion on an entity's compliance with specified criteria the firm needs to plan an engagement to accumulate sufficient evidence about the entity's compliance with specified requirements. Cut and paste the appropriate sections of professional standards that explain what should be covered in planning such an attestation engagement.



Upon completing the examination of R.E. Fine's compliance with state laws regarding the handling of hazardous waste materials you have reached a conclusion that R.E. Fine complied, in all material respects, with the aforementioned requirements for the year ended December 31, 20X8. Draft the independent accountant's report that communicates this conclusion in accordance with appropriate professional standards.

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