

**GAO**

United States General Accounting Office

By the Comptroller General of the  
United States

June 1994

# **Government Auditing Standards**

## **1994 Revision**

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This revision of the standards supersedes the 1988 revision. Its provisions are effective for financial audits of periods ending on or after January 1, 1995, and for performance audits beginning on or after January 1, 1995. Early application is permissible.

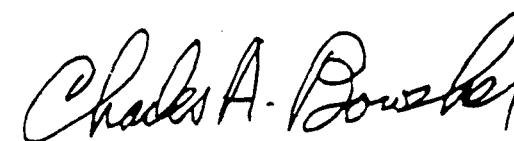
## Foreword

To meet demands for more responsive and cost-effective governments, policymakers and managers need reliable financial and performance information. The assurance auditors provide about that information, as well as about systems producing it, may be more important now than ever before. This reliance on auditors enhances the need for standards to guide auditors and allow others to rely on auditors' work.

Certain laws, regulations, and contracts require auditors to follow generally accepted government auditing standards promulgated by the Comptroller General of the United States. This is the third revision of the standards since my predecessor issued them in 1972.

These standards are broad statements of auditors' responsibilities. Auditors will face many situations in which they could best serve the public by doing work exceeding the standards' minimum requirements. I encourage auditors to seek opportunities to do that additional work, particularly in testing and reporting on internal controls.

I thank those who suggested improvements to the standards, and I especially commend the Government Auditing Standards Advisory Council and the project team for their efforts.



Charles A. Bowsher  
Comptroller General  
of the United States

June 1994

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#### Abbreviations

AICPA	American Institute of Certified Public Accountants
FASAB	Federal Accounting Standards Advisory Board
FASB	Financial Accounting Standards Board
GAGAS	generally accepted government auditing standards
GASB	Governmental Accounting Standards Board
GAO	U.S. General Accounting Office
OMB	Office of Management and Budget
SAS	AICPA's statement on auditing standards
SSAE	AICPA's statement on standards for attestation engagements

## Purpose

1.1 This document contains standards for audits of government organizations, programs, activities, and functions, and of government assistance received by contractors, nonprofit organizations, and other nongovernment organizations. These standards, often referred to as generally accepted government auditing standards (GAGAS), are to be followed by auditors and audit organizations when required by law, regulation, agreement, contract, or policy. The standards pertain to auditors' professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports.

## Applicability

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

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

1.4 The Chief Financial Officers Act of 1990 requires that these standards be followed in audits of federal departments and agencies.<sup>3</sup>

<sup>1</sup>The Inspector General Act of 1978, as amended, 5 U.S.C. App. (1982).

<sup>2</sup>Section 6 of OMB Circular A-73, "Audit of Federal Operations and Programs."

<sup>3</sup>The Chief Financial Officers Act of 1990 (Public Law 101-576).

1.5 The Single Audit Act of 1984 requires that these standards be followed in audits of state and local governments which receive federal financial assistance.<sup>4</sup>

1.6 Other federal policies and regulations, such as OMB Circular A-133, require that these standards be followed in audits of institutions of higher education and other nonprofit organizations that receive federal financial assistance.<sup>5</sup>

1.7 Auditors conducting audits under agreement or contract also may be required to comply with these standards under the terms of the agreement or contract.

1.8 The standards in this document are generally relevant to and recommended for use by state and local government auditors and public accountants audits of state and local government organizations, programs, activities, and functions. Several state and local audit organizations, as well as several nations, have officially adopted these standards.

1.9 The American Institute of Certified Public Accountants (AICPA) has issued auditing and attestation standards that apply in financial audits discussed in chapters 4 and 5. The Institute of Internal Auditors and the American Evaluation Association (formerly the Evaluation Research Society) have issued related standards.<sup>6</sup>

<sup>4</sup>The Single Audit Act of 1984 (31 U.S.C. 7501-7507).

<sup>5</sup>OMB Circular A-133, "Audits of Institutions of Higher Education and Other Nonprofit Institutions."

<sup>6</sup>Codification of the Standards for the Professional Practice of Internal Auditing, The Institute of Internal Auditors, Inc., copyright 1993; and New Directions for Program Evaluation: Standards for Evaluation Practice, no. 16. San Francisco: Jossey-Bass, September 1982.

## Accountability

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

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

1.12 This document provides auditing standards to help provide accountability and to assist public officials and employees in carrying out their responsibilities. These standards are more than the codification of current practices. They include concepts and audit areas that are still evolving and are vital to the accountability objectives sought in auditing governments and their programs and services.

## Basic Premises

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

- a. The term "audit" includes both financial and performance audits.
- b. Public officials and others entrusted with handling public resources (for example, managers of a not-for-profit organization that receives federal assistance) are responsible for applying those

resources efficiently, economically, and effectively achieve the purposes for which the resources were furnished. This responsibility applies to all resources whether entrusted to public officials or others by their own constituencies or by other levels of government.

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

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

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

f. Audit of government reporting is an essential element of public control and accountability. Audit provides credibility to the information reported by obtaining from management through objectively acquiring and evaluating evidence. The importance and comprehensive nature of auditing place a special responsibility on public officials or others entrusted with public resources who authorize or arrange audits to be done in accordance with these standards. This

responsibility is to provide audit coverage that is broad enough to help fulfill the reasonable needs of potential users of the audit report. Auditors can assist public officials and others in understanding the auditors' responsibilities under GAGAS and other audit coverage required by law or regulation. This comprehensive nature of auditing also highlights the importance of auditors clearly understanding the audit objectives, the scope of the work to be conducted, and the reporting requirements.

g. Financial auditing contributes to providing accountability since it provides independent reports on whether an entity's financial information is presented fairly and/or on its internal controls and compliance with laws and regulations.

h. Performance auditing contributes to providing accountability because it provides an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.

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

## Auditors' Responsibilities

1.14 The comprehensive nature of auditing done in accordance with these standards places on the audit organization the responsibility for ensuring that

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

## Procurement of Audit Services

(1) the audit is conducted by personnel who collectively have the necessary skills, (2) independence is maintained, (3) applicable standards are followed in planning and conducting audits and reporting the results, (4) the organization has an appropriate internal quality control system in place, and (5) the organization undergoes an external quality control review.

1.15 While not an audit standard, it is important that a sound procurement practice be followed when contracting for audit services. Sound contract award and approval procedures, including the monitoring of contract performance, should be in place. The objectives and scope of the audit should be made clear. In addition to price, other factors to be considered include the responsiveness of the bidder to the request for proposal; the experience of the bidder; availability of bidder staff with professional qualifications and technical abilities; and the results of the bidders' external quality control reviews.<sup>8</sup>

<sup>8</sup>See *How to Avoid a Substandard Audit: Suggestions for Procuring an Audit*, National Intergovernmental Audit Forum, May 1988.



## Purpose

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

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

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

## Financial Audits

2.4 Financial audits include financial statement and financial related audits.

a. Financial statement audits provide reasonable assurance about whether the financial statements of an audited entity present fairly the financial position,

results of operations, and cash flows in conformity with generally accepted accounting principles.<sup>1</sup> Financial statement audits also include audits of financial statements prepared in conformity with of several other bases of accounting discussed in auditing standards issued by the American Institute of Certified Public Accountants (AICPA).

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

2.5 Financial related audits may, for example, include audits of the following items:

a. Segments of financial statements; financial information (for example, statement of revenue and expenses, statement of cash receipts and disbursements, statement of fixed assets); budget requests; and variances between estimated and actual financial performance.

b. Internal controls over compliance with laws and regulations, such as those governing the (1) bidding for, (2) accounting for, and (3) reporting on grant

<sup>1</sup>Three authoritative bodies for generally accepted accounting principles are the Governmental Accounting Standards Board (GASB), the Financial Accounting Standards Board (FASB), and the sponsors of the Federal Accounting Standards Advisory Board (FASAB). GASB establishes accounting principles and financial reporting standards for state and local government entities. FASB establishes accounting principles and financial reporting standards for nongovernment entities. The sponsors of FASAB—the Secretary of the Treasury, the Director of the Office of Management and Budget, and the Comptroller General—jointly establish accounting principles and financial reporting standards for the federal government, based on recommendations from FASAB.

and contracts (including proposals, amounts billed, amounts due on termination claims, and so forth).

c. Internal controls over financial reporting and/or safeguarding assets, including controls using computer-based systems.

d. Compliance with laws and regulations and allegations of fraud.

## Performance Audits

2.6 A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.

2.7 Performance audits include economy and efficiency and program audits.

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

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

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

a. is following sound procurement practices;

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

c. is properly protecting and maintaining its resources;

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

e. is avoiding idleness and overstaffing;

f. is using efficient operating procedures;

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

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

i. has an adequate management control system for measuring, reporting, and monitoring a program's economy and efficiency; and

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

### 2.9 Program audits<sup>2</sup> may, for example

- a. assess whether the objectives of a new, or ongoing program are proper, suitable, or relevant;
- b. determine the extent to which a program achieves a desired level of program results;
- c. assess the effectiveness of the program and/or of individual program components;
- d. identify factors inhibiting satisfactory performance;
- e. determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost;
- f. determine whether the program complements, duplicates, overlaps, or conflicts with other related programs;
- g. identify ways of making programs work better;
- h. assess compliance with laws and regulations applicable to the program;
- i. assess the adequacy of the management control system for measuring, reporting, and monitoring a program's effectiveness; and
- j. determine whether management has reported measures of program effectiveness that are valid and reliable.

<sup>2</sup>These audits may apply to services, activities, and functions as well as programs.

### Other Activities of an Audit Organization

### 2.10 Auditors may perform services other than audit. For example, some auditors may

- a. assist a legislative body by developing questions for use at hearings,
- b. develop methods and approaches to be applied in evaluating a new or a proposed program,
- c. forecast potential program outcomes under various assumptions without evaluating current operations, and
- d. perform investigative work.

2.11 The head of the audit organization may wish to establish policies applying standards in this state to its employees performing these and other types of nonaudit work.

## Purpose

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

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

## Qualifications

3.3 The first general standard is:

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

3.4 This standard places responsibility on the audit organization to ensure that each audit is conducted by staff who collectively have the knowledge and skills necessary for that audit. They should also have a thorough knowledge of government auditing and of the specific or unique environment in which the audited entity operates, relative to the nature of the audit being conducted.

3.5 The qualifications mentioned here apply to the knowledge and skills of the audit organization as a whole and not necessarily to each individual auditor. An organization may need to employ personnel or hire outside consultants knowledgeable in such areas

as accounting, statistics, law, engineering, audit design and methodology, automated data processing, public administration, economics, social sciences, or actuarial science.

## Continuing Education Requirements

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

3.7 The audit organization is responsible for establishing and implementing a program to ensure that auditors meet the continuing education and training requirements just stated. The organization should maintain documentation of the education and training completed.<sup>1</sup>

<sup>1</sup>The qualifications standard and continuing education requirement place responsibilities on both the audit organization and individual auditors. Carrying out these responsibilities requires sound professional judgment. To assist audit organizations and individual auditors in exercising that judgment, the General Accounting Office (GAO) issued Interpretation of Continuing Education and Training Requirements, April 1991, Government Printing Office stock number 020-000-00250-6.

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

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

#### Staff Qualifications

3.10 Qualifications for staff members conducting audits include:

- a. Knowledge of the methods and techniques applicable to government auditing and the education, skills, and experience to apply such knowledge to the audit being conducted.
- b. Knowledge of government organizations, programs, activities, and functions.
- c. Skills to communicate clearly and effectively, both orally and in writing.

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

- (1) if the work requires use of statistical sampling, the staff or consultants to the staff should include persons with statistical sampling skills;
- (2) if the work requires extensive review of computerized systems, the staff or consultants to the staff should include persons with computer audit skills;
- (3) if the work involves review of complex engineering data, the staff or consultants to the staff should include persons with engineering skills; or
- (4) if the work involves the use of nontraditional audit methodologies, the staff or consultants to the staff should include persons with skills in those methodologies.

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

- (1) The auditors should be proficient in the appropriate accounting principles and in government auditing standards.
- (2) The public accountants engaged to conduct audits should be (a) licensed certified public accountants or persons working for a licensed certified public accounting firm or (b) public accountants licensed on or before December 31, 1970, or persons working for a public accounting firm licensed on or before December 31, 1970.<sup>2</sup>

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

## Independence

**3.11** The second general standard is:

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

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

**3.13** Auditors should consider not only whether they are independent and their attitudes and beliefs permit them to be independent but also whether there is anything about their situations that might lead others to question their independence. All situations deserve consideration because it is essential not only that auditors are, in fact, independent and impartial, but also that knowledgeable third parties consider them so.

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

**3.15** Nongovernment auditors also need to consider those personal and external impairments that might affect their ability to do their work and report their findings impartially. If their ability is adversely affected, they should decline to perform the audit. Public accountants should also follow the American Institute of Certified Public Accountants (AICPA) code of professional conduct, the code of professional conduct of the state board with jurisdiction over the practice of the public accountant and the audit organization, and the guidance on personal and external impairments in these standards.

## Personal Impairments

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

- a. official, professional, personal, or financial relationships that might cause an auditor to limit the extent of the inquiry, to limit disclosure, or to weaker or slant audit findings in any way;
- b. preconceived ideas toward individuals, groups, organizations, or objectives of a particular program that could bias the audit;
- c. previous responsibility for decision-making or managing an entity that would affect current operations of the entity or program being audited;

- d. biases, including those induced by political or social convictions, that result from employment in, or loyalty to, a particular group, organization, or level of government;
- e. subsequent performance of an audit by the same individual who, for example, had previously approved invoices, payrolls, claims, and other proposed payments of the entity or program being audited;
- f. concurrent or subsequent performance of an audit by the same individual who maintained the official accounting records;<sup>3</sup> and
- g. financial interest that is direct, or is substantial though indirect, in the audited entity or program.

#### External Impairments

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

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

<sup>3</sup>For example, an individual performs a substantial part of the accounting process or cycle, such as analyzing, journalizing, posting, preparing, adjusting and closing entries, and preparing the financial statements, and later the same individual performs an audit. In instances in which the auditor acts as the main processor for transactions initiated by the audited entity, but the audited entity acknowledges responsibility for the financial records and financial statements, the independence of the auditor is not necessarily impaired.

- b. external interference with the selection or application of audit procedures or in the selection of transactions to be examined;
- c. unreasonable restrictions on the time allowed to complete an audit;
- d. interference external to the audit organization in the assignment, appointment, and promotion of audit personnel;
- e. restrictions on funds or other resources provided to the audit organization that would adversely affect the audit organization's ability to carry out its responsibilities;
- f. authority to overrule or to influence the auditor's judgment as to the appropriate content of an audit report; and
- g. influences that jeopardize the auditor's continued employment for reasons other than competency or the need for audit services.

#### Organizational Independence

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

#### Internal Auditors

**3.19** A federal, state, or local government audit organization, or an audit organization within other government entities, such as a public college, university, or hospital, may be subject to administrative direction from persons involved in the government management process. To help achieve organizational independence, audit organizations should report the results of their audits and be accountable to the head or deputy head of the

government entity and should be organizationally located outside the staff or line management function of the unit under audit. The audit organization's independence is enhanced when it also reports regularly to the entity's independent audit committee and/or the appropriate government oversight body.

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

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

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

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

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

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

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

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

a. elected by the citizens of their jurisdiction,

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

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

## Due Professional Care

**3.26** The third general standard is:

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

**3.27** This standard requires auditors to work with due professional care. Due care imposes a responsibility upon each auditor within the audit organization to observe generally accepted government auditing standards.

**3.28** Exercising due professional care means using sound judgment in establishing the scope, selecting the methodology, and choosing tests and procedures for the audit. The same sound judgment should be

External Auditors



applied in conducting the tests and procedures and in evaluating and reporting the audit results.

**3.29** Auditors should use sound professional judgment in determining the standards that apply to the work to be conducted. The auditors' determination that certain standards do not apply to the audit should be documented in the working papers. Situations may occur in which government auditors are not able to follow an applicable standard and are not able to withdraw from the audit. In those situations, the auditors should disclose in the scope section of their report, the fact that an applicable standard was not followed, the reasons therefor, and the known effect that not following the standard had on the results of the audit.

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

## Quality Control

**3.31** The fourth general standard is:

**Each audit organization conducting audits in accordance with these standards should have an appropriate internal quality control system in place and undergo an external quality control review.**

**3.32** The internal quality control system established by the audit organization should provide reasonable assurance that it (1) has adopted, and is following, applicable auditing standards and (2) has established, and is following, adequate audit policies and procedures. The nature and extent of an organization's internal quality control system depend

on a number of factors, such as its size, the degree of operating autonomy allowed its personnel and its audit offices, the nature of its work, its organizational structure, and appropriate cost-benefit considerations. Thus, the systems established by individual organizations will vary, as will the extent of their documentation.

**3.33** Organizations conducting audits in accordance with these standards should have an external quality control review at least once every 3 years by an organization not affiliated with the organization being reviewed.<sup>4</sup> The external quality control review should determine whether the organization's internal quality control system is in place and operating effectively to provide reasonable assurance that established policies and procedures and applicable auditing standards are being followed.

**3.34** An external quality control review<sup>5</sup> under this standard should meet the following requirements.

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

<sup>4</sup>Audit organizations should have an external quality control review completed (that is, report issued) within 3 years from the date they start their first audit in accordance with these standards. Subsequent external quality control reviews should be completed within 3 years after the issuance of the prior review.

<sup>5</sup>External quality control reviews conducted through or by the AICPA, National State Auditors Association, National Association of Local Government Auditors, President's Council on Integrity and Efficiency, Executive Council on Integrity and Efficiency, and Institute of Internal Auditors meet these requirements.

b. Reviewers should be independent (as defined in these standards) of the audit organization being reviewed, its staff, and its auditees whose audits are selected for review. An audit organization is not permitted to review the organization that conducted its most recent external quality control review.

c. Reviewers should use sound professional judgment in conducting and reporting the results of the external quality control review.

d. Reviewers should use one of the following approaches to selecting audits for review: (1) select audits that provide a reasonable cross section of the audits conducted in accordance with these standards or (2) select audits that provide a reasonable cross section of the organization's audits, including one or more audits conducted in accordance with these standards.

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

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

3.35 External quality control review procedures should be tailored to the size and nature of an organization's audit work. For example, an organization that performs only a few audits may be more effectively reviewed by emphasizing a review of the quality of those audits rather than the organization's internal quality control policies and procedures.

3.36 Audit organizations seeking to enter into a contract to perform an audit in accordance with these standards should provide their most recent external quality control review report<sup>6</sup> to the party contracting for the audit. Information in the external quality control review report often would be relevant to decisions on procuring audit services. Audit organizations also should make their external quality control review reports available to auditors using their work and to appropriate oversight bodies. It is recommended that the report be made available to the public.

<sup>6</sup>The term "report" does not include separate letters of comment.

# Field Work Standards for Financial Audits

## Purpose

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

## Relation to AICPA Standards

4.2 For financial statement audits, generally accepted government auditing standards (GAGAS) incorporate the American Institute of Certified Public Accountants' (AICPA) three generally accepted standards of field work, which are:

- a. The work is to be adequately planned and assistants, if any, are to be properly supervised.
- b. A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

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

4.3 The AICPA has issued statements on auditing standards (SAS) that interpret its standards of field work (including a SAS on compliance auditing).<sup>1</sup> This chapter incorporates these SAS and prescribes additional standards on

- a. audit follow-up (see paragraphs 4.7, 4.10, and 4.11),
- b. noncompliance other than illegal acts (see paragraphs 4.13 and 4.18 through 4.20), and

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

c. working papers. (See paragraphs 4.35 through 4.38.)

4.4 This chapter also presents guidance on three other key aspects of financial statement audits:

- a. materiality (see paragraphs 4.8 and 4.9),
- b. irregularities and illegal acts (see paragraphs 4.14 through 4.17), and
- c. internal controls. (See paragraphs 4.21 through 4.33.)

4.5 This chapter concludes by explaining which standards auditors should follow in performing financial related audits.

## Planning

4.6 AICPA standards and GAGAS require the following:

**The work is to be properly planned, and auditors should consider materiality, among other matters, in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.**

4.7 The additional planning standard for financial statement audits is:

**Auditors should follow up on known material findings and recommendations from previous audits.**

## Materiality

4.8 Auditors' consideration of materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments are made in light of surrounding

circumstances and necessarily involve both quantitative and qualitative considerations.

4.9 In an audit of the financial statements of a government entity or an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector 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.

#### Audit Follow-up

4.10 Auditors should follow up on known material findings and recommendations from previous audits that could affect the financial statement audit. They should do this to determine whether the auditee has taken timely and appropriate corrective actions. Auditors should report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit.

4.11 Much of the benefit from audit work is not in the findings reported or the recommendations made, but in their effective resolution. Auditee management is responsible for resolving audit findings and recommendations, and having a process to track their status can help it fulfill this responsibility. If management does not have such a process, auditors may wish to establish their own. Continued attention to material findings and recommendations can help auditors assure that the benefits of their work are realized.

#### Irregularities, Illegal Acts, and Other Noncompliance

4.12 AICPA standards and GAGAS require the following:

a. Auditors should design the audit to provide reasonable assurance of detecting irregularities that are material to the financial statements.<sup>2</sup>

b. Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from direct and material illegal acts.<sup>3</sup>

c. Auditors should be aware of the possibility that indirect illegal acts may have occurred.<sup>4</sup> If specific information comes to the auditors' attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditors should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

4.13 The additional compliance standard for financial statement audits is:

Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts. If

<sup>2</sup>Irregularities are intentional misstatements or omissions of amounts or disclosures in financial statements.

<sup>3</sup>Direct and material illegal acts are violations of laws and regulations having a direct and material effect on the determination of financial statement amounts.

<sup>4</sup>Indirect illegal acts are violations of laws and regulations having material but indirect effects on the financial statements.

specific information comes to the auditors' attention that provides evidence concerning the existence of possible noncompliance that could have a material indirect effect on the financial statements, auditors should apply audit procedures specifically directed to ascertaining whether that noncompliance has occurred.

Auditors' Understanding of Possible Irregularities and of Laws and Regulations

4.14 Auditors are responsible for being aware of the characteristics and types of potentially material irregularities that could be associated with the area being audited so that they can plan the audit to provide reasonable assurance of detecting material irregularities.

4.15 Auditors should obtain an understanding of the possible effects on financial statements of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in the financial statements. Auditors may find it necessary to use the work of legal counsel in (1) determining which laws and regulations might have a direct and material effect on the financial statements, (2) designing tests of compliance with laws and regulations, and (3) evaluating the results of those tests.<sup>5</sup> Auditors also may find it necessary to use the work of legal counsel when an audit requires testing compliance with provisions of contracts or grant agreements. Depending on the circumstances of the audit, auditors may find it necessary to obtain information on compliance matters from others, such as investigative staff, audit officials of government entities that provided assistance to the auditee, and/or the applicable law enforcement authority.

<sup>5</sup>AICPA standards provide guidance for auditors who use the work of a specialist who is not a member of their staff.

Due Care Concerning Possible Irregularities and Illegal Acts

4.16 Auditors should exercise due professional care in pursuing indications of possible irregularities and illegal acts so as not to interfere with potential future investigations, legal proceedings, or both. Under some circumstances, laws, regulations, or policies may require auditors to report indications of certain types of irregularities or illegal acts to law enforcement or investigatory authorities before extending audit steps and procedures. Auditors may also be required to withdraw from or defer further work on the audit or a portion of the audit in order not to interfere with an investigation.

4.17 An audit made in accordance with GAGAS will not guarantee the discovery of illegal acts or contingent liabilities resulting from them. Nor does the subsequent discovery of illegal acts committed during the audit period necessarily mean that the auditors' performance was inadequate, provided the audit was made in accordance with these standards.

Noncompliance Other Than Illegal Acts

4.18 The term noncompliance has a broader meaning than illegal acts. Noncompliance includes not only illegal acts, but also violations of provisions of contracts or grant agreements. AICPA standards do not discuss auditors' responsibility for detecting noncompliance other than illegal acts. But, under GAGAS, auditors have the same responsibilities for detecting material misstatements arising from other types of noncompliance as they do for detecting those arising from illegal acts.

4.19 Direct and material noncompliance is noncompliance having a direct and material effect on the determination of financial statement amounts. Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from direct and material

noncompliance with provisions of contracts or grant agreements.

**4.20** Indirect noncompliance is noncompliance having material but indirect effects on the financial statements. A financial statement audit provides no assurance that indirect noncompliance with provisions of contracts or grant agreements will be detected. However, if specific information comes to the auditors' attention that provides evidence concerning the existence of possible noncompliance that could have a material indirect effect on the financial statements, auditors should apply audit procedures specifically directed to ascertaining whether that noncompliance has occurred.

## Internal Controls

**4.21** AICPA standards and GAGAS require the following:

**Auditors should obtain a sufficient understanding of internal controls to plan the audit and determine the nature, timing, and extent of tests to be performed.**

**4.22** GAGAS do not prescribe additional internal control standards for financial statement audits. However, this chapter provides guidance on the following four aspects of internal controls that are important to the judgments auditors make about audit risk and about the evidence needed to support their opinion on the financial statements:

- a. control environment,
- b. safeguarding controls,
- c. controls over compliance with laws and regulations, and
- d. control risk assessments.

## Control Environment

**4.23** Auditors' judgments about the control environment may influence—either positively or negatively—their judgments about specific control procedures. For example, evidence indicating that the control environment is ineffective may lead auditors to question the likely effectiveness of a control procedure for a particular financial statement assertion. Conversely, based on evidence indicating that the control environment is effective, auditors may decide to reduce the number of locations where they will perform auditing procedures.

**4.24** Auditors' judgments about the control environment also can be affected by the results of their tests of other internal controls. If auditors obtain evidence that specific control procedures are ineffective, they may find it necessary to reevaluate their earlier conclusion about the control environment and other planning decisions they had made based on that conclusion.

## Safeguarding Controls

**4.25** Internal controls over safeguarding of assets (safeguarding controls) constitute a process, effected by an entity's governing body, management, and other personnel, designed to provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

**4.26** Safeguarding controls relate to the prevention or timely detection of unauthorized transactions and unauthorized access to assets that could result in losses that are material to the financial statements, for example, when unauthorized expenditures or investments are made, unauthorized liabilities are incurred, inventory is stolen, or assets are converted to personal use. Such controls are designed to help ensure that use of and access to assets are in

accordance with management's authorization. Authorization includes approval of transactions in accordance with policies and procedures established by management to safeguard assets, such as establishing and complying with requirements for extending and monitoring credit or making investment decisions, and related documentation. Safeguarding controls are not designed to protect against loss of assets arising from inefficiency or from management's operating decisions, such as incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory.

**4.27** AICPA standards and GAGAS require auditors to obtain a sufficient understanding of internal controls to plan the audit. They also require auditors to plan the audit to provide reasonable assurance of detecting material irregularities, including material misappropriation of assets. Because preventing or detecting material misappropriations is an objective of safeguarding controls, understanding those controls can be essential to planning the audit.

**4.28** Safeguarding controls are not limited to preventing or detecting misappropriations, however. They also help prevent or detect other material losses that could result from unauthorized acquisition, use, or disposition of assets. Such controls include, for example, the process of assessing the risk of unauthorized acquisition, use, or disposition of assets and establishing control activities to help ensure that management directives to address the risk are carried out. Such control activities would include controls to permit acquisition, use, or disposition of assets only in accordance with management's general or specific authorization, including compliance with established policies and procedures for such acquisition, use, or disposition. They would also include comparing existing assets with the related records at reasonable intervals and taking appropriate action with respect

to any differences. Finally, controls over the safeguarding of assets against unauthorized acquisition, use, or disposition also relate to making available to management information it needs to carry out its responsibilities related to prevention or timely detection of such unauthorized activities, as well as mechanisms to enable management to monitor the continued effective operation of such controls.

**4.29** Understanding these safeguarding controls can help auditors assess the risk that financial statements could be materially misstated. For example, an understanding of an auditee's safeguarding controls can help auditors recognize risk factors such as

- a. failure to adequately monitor decentralized operations;
- b. lack of controls over activities, such as lack of documentation for major transactions;
- c. lack of controls over computer processing, such as a lack of controls over access to applications that initiate or control the movement of assets;
- d. failure to develop or communicate adequate policies and procedures for security of data or assets, such as allowing unauthorized personnel to have ready access to data or assets; and
- e. failure to investigate significant unreconciled differences between reconciliations of a control account and subsidiary records.

#### Controls Over Compliance With Laws and Regulations

**4.30** Auditors should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial

statement amounts. To meet that requirement, auditors should have an understanding of internal controls relevant to financial statement assertions affected by those laws and regulations. Auditors should use that understanding to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests. For example, the following control environment factors may influence the auditors' assessment of control risk:

- a. management's awareness or lack of awareness of applicable laws and regulations,
- b. auditee policy regarding such matters as acceptable operating practices and codes of conduct, and
- c. assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.

#### Control Risk Assessments

**4.31** When auditors assess control risk below the maximum for a given financial statement assertion, they reduce their need for evidence from substantive tests of that assertion. Auditors are not required to assess control risk below the maximum, but the likelihood that they will find it efficient and effective to do so increases with the size of the entities they audit and the complexity of their operations. Auditors should do the following when assessing control risk below the maximum:

- a. identify internal controls that are relevant to a specific financial statement assertion;
- b. perform tests that provide sufficient evidence that those controls are effective; and

- c. document the tests of controls.

**4.32** Auditors should remember the following when planning and performing tests of controls:

- a. The lower the auditors' assessment of control risk, the more evidence they need to support that assessment.
- b. Auditors may have to use a combination of different kinds of tests of controls to get sufficient evidence of a control's effectiveness.
- c. Inquiries alone generally will not support an assessment that control risk is below the maximum.
- d. Observations provide evidence about a control's effectiveness only at the time observed; they do not provide evidence about its effectiveness during the rest of the period under audit.
- e. Auditors can use evidence from tests of controls done in prior audits (or at an interim date), but they have to obtain evidence about the nature and extent of significant changes in policies, procedures, and personnel since they last performed those tests.

**4.33** Auditors may find it necessary to reconsider their assessments of control risk when their substantive tests detect misstatements, especially those that appear to be irregularities or due to illegal acts. As a result, they may find it necessary to modify their planned substantive tests for some or all financial statement assertions. Deficiencies in internal controls that led to those misstatements may be reportable conditions or material weaknesses, which auditors are required to report.



## Working Papers

4.34 AICPA standards and GAGAS require the following:

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

4.35 The additional working paper standard for financial statement audits is:

Working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditors' significant conclusions and judgments.

4.36 Audits done in accordance with GAGAS are subject to review by other auditors and by oversight officials more frequently than audits done in accordance with AICPA standards. Thus, whereas AICPA standards cite two main purposes of working papers—providing the principal support for the audit report and aiding auditors in the conduct and supervision of the audit—working papers serve an additional purpose in audits performed in accordance with GAGAS. Working papers allow for the review of audit quality by providing the reviewer written documentation of the evidence supporting the auditors' significant conclusions and judgments.

4.37 Working papers should contain

a. the objectives, scope, and methodology, including any sampling criteria used;

b. documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined

that would enable an experienced auditor to examine the same transactions and records;<sup>6</sup> and

c. evidence of supervisory reviews of the work performed.

4.38 One factor underlying GAGAS audits is that federal, state, and local governments and other organizations cooperate in auditing programs of common interest so that auditors may use others' work and avoid duplicate audit efforts. Arrangements should be made so that working papers will be made available, upon request, to other auditors. To facilitate reviews of audit quality and reliance by other auditors on the auditors' work, contractual arrangements for GAGAS audits should provide for access to working papers.

## Financial Related Audits

4.39 Certain AICPA standards address specific types of financial related audits, and GAGAS incorporate those standards, as discussed below:<sup>7</sup>

a. SAS no. 35, Special Reports - Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement;

b. SAS no. 62, Special Reports, for auditing specified elements, accounts, or items of a financial statement

c. SAS no. 68, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance, for testing

<sup>6</sup>Auditors may meet this requirement by listing voucher numbers, check numbers, or other means of identifying specific documents they examined. They are not required to include in the working papers copies of documents they examined nor are they required to list detailed information from those documents.

<sup>7</sup>GAGAS incorporate any new AICPA standards relevant to financial related audits unless GAO excludes them by formal announcement.

compliance with laws and regulations applicable to federal financial assistance programs;

d. SAS no. 70, Reports on the Processing of Transactions by Service Organizations, for examining descriptions of internal controls of service organizations that process transactions for others;

e. Statement on Standards for Attestation Engagements (SSAE) no. 1, Attestation Standards, for (1) applying agreed-upon procedures to an entity's assertions about internal controls over financial reporting and/or safeguarding assets or (2) examining or applying agreed-upon procedures to an entity's assertions about financial related matters not specifically addressed in other AICPA standards;

f. SSAE no. 2, Reporting on an Entity's Internal Control Structure Over Financial Reporting, for examining an entity's assertions about its internal controls over financial reporting and/or safeguarding assets; and

g. SSAE no. 3, Compliance Attestation, for (1) examining or applying agreed-upon procedures to an entity's assertions about compliance with laws and regulations or (2) applying agreed-upon procedures to an entity's assertions about internal controls over compliance with laws and regulations.

4.40 Besides following applicable AICPA standards, auditors should follow this chapter's audit follow-up and working paper standards. They should apply or adapt the other standards and guidance in this chapter as appropriate in the circumstances. For financial related audits not described above, auditors should follow the field work standards for performance audits in chapter 6.<sup>8</sup>

<sup>8</sup>Chapter 2 provides examples of other types of financial related audits.

# Reporting Standards for Financial Audits

## Purpose

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

## Relation to AICPA Standards

5.2 For financial statement audits, generally accepted government auditing standards (GAGAS) incorporate the American Institute of Certified Public Accountants' (AICPA) four generally accepted standards of reporting, which are:

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

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

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

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

5.3 The AICPA has issued statements on auditing standards (SAS) that interpret its standards of

reporting.<sup>1</sup> This chapter incorporates these SASS and prescribes additional standards on

- a. communication with audit committees or other responsible individuals (see paragraphs 5.5 through 5.10),
- b. reporting compliance with GAGAS (see paragraphs 5.11 through 5.14),
- c. reporting on compliance with laws and regulations and on internal controls (see paragraphs 5.15 through 5.28),
- d. privileged and confidential information (see paragraphs 5.29 through 5.31), and
- e. report distribution. (See paragraphs 5.32 through 5.35.)

5.4 This chapter concludes by explaining which standards auditors should follow in reporting the results of financial related audits.

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

**Auditors should communicate certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit.**

5.6 This standard applies in all situations where either the auditee has an audit committee or the audit

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

is performed under contract. In other situations, auditors may still find it useful to communicate with management or other officials of the auditee.

5.7 Auditors should communicate the following information to the audit committee or to individuals with whom they contract to perform the audit:

- a. the auditors' responsibilities in a financial statement audit, including their responsibilities for testing and reporting on internal controls and compliance with laws and regulations and
- b. the nature of any additional testing of internal controls and compliance required by laws and regulations.

5.8 Auditors should use their professional judgment to determine the form and content of the communication. The communication may be oral or written. If the information is communicated orally, the auditors should document the communication in the working papers. Auditors may use an engagement letter to communicate the information described in paragraph 5.7. To help audit committees and other responsible parties understand the limitations of auditors' responsibilities for testing and reporting on internal controls and compliance, auditors should contrast those responsibilities with other financial related audits of controls and compliance. The discussion in paragraphs 5.9 and 5.10 may be helpful to auditors in preparing to explain those responsibilities.

5.9 Tests of internal controls and compliance with laws and regulations in a financial statement audit contribute to the evidence supporting the auditors' opinion on the financial statements. However, they do not provide a basis for opining on internal controls or compliance. The limited purpose of these tests in a financial statement audit may not meet the needs of

Communication  
With Audit  
Committees or  
Other  
Responsible  
Individuals

some users of auditors' reports who require additional information on internal controls and on compliance with laws and regulations.

5.10 To meet certain audit report users' needs, laws and regulations often prescribe testing and reporting on internal controls and compliance to supplement the financial statement audit's coverage of these areas.<sup>2</sup> Nevertheless, even after auditors perform, and report the results of, additional tests of internal controls and compliance required by laws and regulations, some reasonable needs of report users still may be unmet. Auditors may meet these needs by performing further tests of internal controls and compliance with laws and regulations in either of two ways:

- a. supplemental (or agreed-upon) procedures or
- b. examination, resulting in an opinion.

<sup>2</sup>For example, when auditing state and local government entities that receive federal financial assistance, auditors should be familiar with the Single Audit Act of 1984 and Office of Management and Budget (OMB) Circular A-128. The act and circular include specific audit requirements, mainly in the areas of internal controls and compliance with laws and regulations, that exceed the minimum audit requirements in the standards in chapters 4 and 5 of this document. Audits of nonprofit organizations under OMB Circular A-133 and audits conducted under the Chief Financial Officers Act of 1990 also have specific audit requirements in the areas of internal controls and compliance. Many state and local governments have similar requirements.

## Reporting Compliance With Generally Accepted Government Auditing Standards

5.11 The second additional reporting standard for financial statement audits is:

**Audit reports should state that the audit was made in accordance with generally accepted government auditing standards.**

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

5.13 When the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for a GAGAS audit, it should specifically cite GAGAS. The report on the financial statements may cite AICPA standards as well as GAGAS.

5.14 The auditee may need a financial statement audit for purposes other than to comply with requirements calling for a GAGAS audit. For example, it may need a financial statement audit to issue bonds. GAGAS do not prohibit auditors from issuing a separate report on the financial statements conforming only to the requirements of AICPA standards. However, it may be advantageous to use a report issued in accordance with GAGAS for these other purposes because it provides information on compliance with laws and regulations and internal controls (as discussed below that is not contained in a report issued in accordance with AICPA standards).

## Reporting on Compliance With Laws and Regulations and on Internal Controls

5.15 The third additional reporting standard for financial statement audits is:

The report on the financial statements should either (1) describe the scope of the auditors' testing of compliance with laws and regulations and internal controls and present the results of those tests or (2) refer to separate reports containing that information. In presenting the results of those tests, auditors should report irregularities, illegal acts, other material noncompliance, and reportable conditions in internal controls.<sup>3</sup> In some circumstances, auditors should report irregularities and illegal acts directly to parties external to the audited entity.

5.16 Auditors may report on compliance with laws and regulations and internal controls in the report on the financial statements or in separate reports. When auditors report on compliance and controls in the report on the financial statements, they should include an introduction summarizing key findings in the audit of the financial statements and the related compliance and internal controls work. Auditors should not issue this introduction as a stand-alone report. When auditors report separately on compliance and controls, the report on the financial statements should state that they are issuing those additional reports.

<sup>3</sup>These responsibilities are in addition to and do not modify auditors' responsibilities under AICPA standards to (1) address the effect irregularities or illegal acts may have on the report on the financial statements and (2) determine that the audit committee or others with equivalent authority and responsibility are adequately informed about irregularities, illegal acts, and reportable conditions.

## Scope of Compliance and Internal Controls Work

5.17 Auditors should report the scope of their tests of compliance with laws and regulations and of internal controls. If the tests they performed did not exceed those the auditors considered necessary for a financial statement audit, then a statement that the auditors tested compliance with certain laws and regulations, obtained an understanding of internal controls, and assessed control risk would be sufficient to satisfy this requirement. Auditors should also report whether or not the tests they performed provided sufficient evidence to support an opinion on compliance or internal controls.

## Irregularities, Illegal Acts, and Other Noncompliance

5.18 When auditors conclude, based on evidence obtained, that an irregularity or illegal act either has occurred or is likely to have occurred,<sup>4</sup> they should report relevant information. Auditors need not report information about an irregularity or illegal act that is clearly inconsequential. Thus, auditors should present in a report the same irregularities and illegal acts that they report to audit committees under AICPA standards. Auditors should also report other noncompliance (for example, a violation of a contract provision) that is material to the financial statements.

5.19 In reporting material irregularities, illegal acts, or other noncompliance, the auditors should place their findings in proper perspective. To give the reader a basis for judging the prevalence and consequences of these conditions, the instances identified should be related to the universe or the number of cases examined and be quantified in terms

<sup>4</sup>Whether a particular act is, in fact, illegal may have to await final determination by a court of law. Thus, when auditors disclose matters that have led them to conclude that an illegal act is likely to have occurred, they should take care not to imply that they have made a determination of illegality.

of dollar value, if appropriate.<sup>5</sup> In presenting material irregularities, illegal acts, or other noncompliance, auditors should follow chapter 7's report contents standards for objectives, scope, and methodology; audit results; views of responsible officials; and its report presentation standards, as appropriate. Auditors may provide less extensive disclosure of irregularities and illegal acts that are not material in either a quantitative or qualitative sense.<sup>6</sup>

5.20 When auditors detect irregularities, illegal acts, or other noncompliance that do not meet paragraph 5.18's criteria for reporting, they should communicate those findings to the auditee, preferably in writing. If auditors have communicated those findings in a management letter to top management, they should refer to that management letter when they report on compliance. Auditors should document in their working papers all communications to the auditee about irregularities, illegal acts, and other noncompliance.

<sup>5</sup>Audit findings have often been regarded as containing the elements of criteria, condition, and effect, plus cause when problems are found. However, the elements needed for a finding depend entirely on the objectives of the audit. Reportable conditions and noncompliance found by the auditor may not always have all of these elements fully developed, given the scope and objectives of the specific financial audit. However, auditors should identify at least the condition, criteria, and possible asserted effect to provide sufficient information to federal, state, and local officials to permit them to determine the effect and cause in order to take prompt and proper corrective action.

<sup>6</sup>Chapter 4 provides guidance on factors that may influence auditors' materiality judgments in audits of government entities or entities receiving government assistance. AICPA standards provide guidance on the interaction of quantitative and qualitative considerations in materiality judgments.

#### Direct Reporting of Irregularities and Illegal Acts

5.21 GAGAS require auditors to report irregularities illegal acts directly to parties outside the auditee in two circumstances, as discussed below. These requirements are in addition to any legal requirements for direct reporting of irregularities or illegal acts. Auditors should meet these requirements even if they have resigned or been dismissed from the audit.<sup>7</sup>

5.22 The auditee may be required by law or regulation to report certain irregularities or illegal acts to specified external parties (for example, to a federal inspector general or a state attorney general). If auditors have communicated such irregularities or illegal acts to the auditee, and it fails to report them, then the auditors should communicate their awareness of that failure to the auditee's governing body. If the auditee does not make the required report as soon as practicable after the auditors' communication with its governing body, then the auditors should report the irregularities or illegal act directly to the external party specified in the law or regulation.

5.23 Management is responsible for taking timely and appropriate steps to remedy irregularities or illegal acts that auditors report to it. When an irregularity or illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report it directly if management fails to take remedial steps. If auditors conclude that such failure is likely to cause them to depart from the standard report on the financial statements or resign from the audit, then they should communicate that conclusion to the auditee's governing body. Then, if the auditee does not report the irregularity or illegal act as soon as practicable to the entity that provided the government assistance, the auditors should report the irregularity or illegal act directly to that entity.

<sup>7</sup>Internal auditors auditing within the entity that employs them do not have a duty to report outside that entity.

5.24 In both of these situations, auditors should obtain sufficient, competent, and relevant evidence (for example, by confirmation with outside parties) to corroborate assertions by management that it has reported irregularities or illegal acts. If they are unable to do so, then the auditors should report the irregularities or illegal acts directly as discussed above.

5.25 Chapter 4 reminds auditors that under some circumstances, laws, regulations, or policies may require them to report promptly indications of certain types of irregularities or illegal acts to law enforcement or investigatory authorities. When auditors conclude that this type of irregularity or illegal act either has occurred or is likely to have occurred, they should ask those authorities and/or legal counsel if reporting certain information about that irregularity or illegal act would compromise investigative or legal proceedings. Auditors should limit their reporting to matters that would not compromise those proceedings, such as information that is already a part of the public record.

## Deficiencies in Internal Controls

5.26 Auditors should report deficiencies in internal controls that they consider to be "reportable conditions" as defined in AICPA standards. The following are examples of matters that may be reportable conditions:

- a. absence of appropriate segregation of duties consistent with appropriate control objectives;
- b. absence of appropriate reviews and approvals of transactions, accounting entries, or systems output;
- c. inadequate provisions for the safeguarding of assets;

d. evidence of failure to safeguard assets from loss, damage, or misappropriation;

e. evidence that a system fails to provide complete and accurate output consistent with the auditee's control objectives because of the misapplication of control procedures;

f. evidence of intentional override of internal controls by those in authority to the detriment of the overall objectives of the system;

g. evidence of failure to perform tasks that are part of internal controls, such as reconciliations not prepared or not timely prepared;

h. absence of a sufficient level of control awareness or consciousness within the organization;

i. significant deficiencies in the design or operation of internal controls that could result in violations of laws and regulations having a direct and material effect on the financial statements; and

j. failure to follow up and correct previously identified deficiencies in internal controls.<sup>8</sup>

5.27 In reporting reportable conditions, auditors should identify those that are individually or cumulatively material weaknesses.<sup>9</sup> Auditors should follow chapter 7's report contents standards for objectives, scope, and methodology; audit results; an opinion; views of responsible officials; and its report presentation standards, as appropriate.

<sup>8</sup>Chapter 4's audit follow-up standard requires auditors to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit.

<sup>9</sup>See footnote 5.

5.28 When auditors detect deficiencies in internal controls that are not reportable conditions, they should communicate those deficiencies to the auditee, preferably in writing. If the auditors have communicated other deficiencies in internal controls in a management letter to top management, they should refer to that management letter when they report on controls. All communications to the auditee about deficiencies in internal controls should be documented in the working papers.

## Privileged and Confidential Information

5.29 The fourth additional reporting standard for financial statement audits is:

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

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

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

## Report Distribution

5.32 The fifth additional reporting standard for financial statement audits is:

**Written audit reports are to be submitted by the audit organization to the appropriate officials of**

the auditee and to the appropriate officials of the organizations requiring or arranging for the audits, including external funding organizations, unless legal restrictions prevent it. Copies of the reports should also be sent to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations and to others authorized to receive such reports. Unless restricted by law or regulation, copies should be made available for public inspection.<sup>10</sup>

5.33 Audit reports should be distributed in a timely manner to officials interested in the results. Such officials include those designated by law or regulation to receive such reports, those responsible for acting on the findings and recommendations, those of other levels of government that have provided assistance to the auditee, and legislators. However, if the subject of the audit involves material that is classified for security purposes or not releasable to particular parties or the public for other valid reasons, auditors may limit the report distribution.

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

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

<sup>10</sup>See the Single Audit Act of 1984 and OMB Circular A-128 for the distribution of reports on single audits of state and local governments.



## Financial Related Audits

5.36 Certain AICPA standards address specific types of financial related audits, and GAGAS incorporate those standards, as discussed below:<sup>11</sup>

a. SAS no. 35, Special Reports - Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement;

b. SAS no. 62, Special Reports, for auditing specified elements, accounts, or items of a financial statement;

c. SAS no. 68, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance, for testing compliance with laws and regulations applicable to federal financial assistance programs;

d. SAS no. 70, Reports on the Processing of Transactions by Service Organizations, for examining descriptions of internal controls of service organizations that process transactions for others;

e. Statement on Standards for Attestation Engagements (SSAE) no. 1, Attestation Standards, for (1) applying agreed-upon procedures to an entity's assertions about internal controls over financial reporting and/or safeguarding assets or (2) examining or applying agreed-upon procedures to an entity's assertions about financial related matters not specifically addressed in other AICPA standards;

f. SSAE no. 2, Reporting on an Entity's Internal Control Structure Over Financial Reporting, for examining an entity's assertions about its internal controls over financial reporting and/or safeguarding assets; and

g. SSAE no. 3, Compliance Attestation, for (1) examining or applying agreed-upon procedures to

<sup>11</sup>GAGAS incorporate any new AICPA standards relevant to financial related audits unless GAO excludes them by formal announcement.

an entity's assertions about compliance with laws and regulations or (2) applying agreed-upon procedures to an entity's assertions about internal controls over compliance with laws and regulations.

5.37 Besides following applicable AICPA standards, auditors should follow this chapter's second (GAGAS reference), fourth (privileged and confidential information), and fifth (report distribution) additional standards of reporting. They should apply or adapt the other standards and guidance in this chapter as appropriate in the circumstances. For financial related audits not described above, auditors should follow the reporting standards for performance audits in chapter 7.<sup>12</sup>

<sup>12</sup>Chapter 2 provides examples of other types of financial related audits.

# Performance Audits

## Purpose

6.1 This chapter prescribes field work standards for performance audits. These standards also apply to some financial related audits, as discussed in chapter 4.

## Planning

6.2 The first field work standard for performance audits is:

**Work is to be adequately planned.**

6.3 In planning, auditors should define the audit's objectives and the scope and methodology to achieve those objectives. The objectives are what the audit is to accomplish. They identify the audit subjects and performance aspects to be included, as well as the potential finding and reporting elements that the auditors expect to develop.<sup>1</sup> Audit objectives can be thought of as questions about the program<sup>2</sup> that auditors seek to answer. Scope is the boundary of the audit. It addresses such things as the period and number of locations to be covered. The methodology comprises the work in data gathering and in analytical methods auditors will do to achieve the objectives.

6.4 Auditors should design the methodology to provide sufficient, competent, and relevant evidence to achieve the objectives of the audit. Methodology includes not only the nature of the auditors' procedures, but also their extent (for example, sample size).

6.5 In planning a performance audit, auditors should:

<sup>1</sup>See discussion of the elements of a finding in paragraphs 6.49 through 6.62.

<sup>2</sup>Generally accepted government auditing standards (GAGAS) are standards for audit of government organizations, programs, activities, and functions. This chapter uses only the term "program"; however, the concepts presented also apply to audits of organizations, activities, and functions.

a. Consider significance and the needs of potential users of the audit report. (See paragraphs 6.7 and 6.8.)

b. Obtain an understanding of the program to be audited. (See paragraphs 6.9 and 6.10.)

c. Consider legal and regulatory requirements. (See paragraphs 6.26 through 6.38.)

d. Consider management controls. (See paragraphs 6.39 through 6.45.)

e. Identify criteria needed to evaluate matters subject to audit. (See paragraph 6.11.)

f. Identify significant findings and recommendations from previous audits that could affect the current audit objectives. Auditors should determine if management has corrected the conditions causing those findings and implemented those recommendations. (See paragraphs 6.12 and 6.13.)

g. Identify potential sources of data that could be used as audit evidence and consider the validity and reliability of these data, including data collected by the audited entity, data generated by the auditors, or data provided by third parties. (See paragraphs 6.53 through 6.62.)

h. Consider whether the work of other auditors and experts may be used to satisfy some of the auditors' objectives. (See paragraphs 6.14 through 6.16.)

i. Provide sufficient staff and other resources to do the audit. (See paragraphs 6.17 and 6.18.)

j. Prepare a written audit plan. (See paragraphs 6.19 through 6.21.)

6.6 Planning should continue throughout the audit. Audit objectives, scope, and methodologies are not determined in isolation. Auditors determine these three elements of the audit plan together, as the considerations in determining each often overlap.

## Significance and User Needs

6.7 Auditors should consider significance in planning, performing, and reporting on performance audits. The significance of a matter is its relative importance to the audit objectives and potential users of the audit report. Qualitative, as well as quantitative, factors are important in determining significance. Qualitative factors can include

- a. visibility and sensitivity of the program under audit,
- b. newness of the program or changes in its conditions,
- c. role of the audit in providing information that can improve public accountability and decision-making, and
- d. level and extent of review or other forms of independent oversight.

6.8 One group of users of the auditors' report is government officials who may have authorized or requested the audit. Another important user of the auditors' report is the auditee, which is responsible for acting on the auditors' recommendations. Other potential users of the auditors' report include government officials (other than those who may have authorized or requested the audit), the media, interest groups, and individual citizens. These other potential users may have, in addition to an interest in the program, an ability to influence the conduct of the program. Thus, an awareness of these potential users' interests and influence can help auditors understand

why the program operates the way it does. This awareness can also help auditors judge whether possible findings could be significant to these other users.

## Understanding the Program

6.9 Auditors should obtain an understanding of the program to be audited to help assess, among other matters, the significance of possible audit objectives and the feasibility of achieving them. The auditors' understanding may come from knowledge they already have about the program and knowledge they gain from inquiries and observations they make in planning the audit. The extent and breadth of those inquiries and observations will vary among audits, as will the need to understand individual aspects of the program, such as the following.

a. Laws and regulations: Government programs usually are created by law and are subject to more specific laws and regulations than the private sector. For example, laws and regulations usually set forth what is to be done, who is to do it, the purpose to be achieved, the population to be served, and how much can be spent on what. Thus, understanding the laws establishing a program can be essential to understanding the program itself. Obtaining that understanding may also be a necessary step in identifying provisions of laws and regulations significant to audit objectives.

b. Purpose and goals: Purpose is the result or effect that is intended or desired, and can exist without being expressly stated. Goals quantify the level of performance intended or desired. Legislatures set the program purpose when they establish a program; however, management is expected to set goals for program efforts, operations, outputs, and outcomes. Auditors may use the purpose and goals as criteria for assessing program performance.

c. **Efforts:** Efforts are the amount of resources (in terms of money, material, personnel, and so forth) that are put into a program. These resources may come from within or outside the entity operating the program. Measures of efforts can have a number of dimensions, such as cost, timing, and quality. Examples of measures of efforts are dollars, employee-hours, and square feet of building space.

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

e. **Outputs:** Outputs are the quantity of goods and services provided. Examples of measures of output are tons of solid waste processed, number of students graduated, and number of students graduated who have met a specified standard of achievement.

f. **Outcomes:** Outcomes are accomplishments or results that occur (at least partially) because of services provided. Outcomes can be viewed as ranging from immediate outcomes to long-term outcomes. For example, an immediate outcome of a job training program and an indicator of its effectiveness might be the number of program graduates placed in jobs. That program's ultimate outcome and test of its effectiveness depends on whether program graduates are more likely to remain employed than similar persons not in the program. Outcomes may be intended or unintended, and they may be influenced by cultural, economic, physical, or technological factors external to the program. Auditors may use approaches drawn from the field of program evaluation to isolate the effects of the program from those of other influences.

6.10 One approach to setting audit objectives is to relate the elements of a program to the types of performance audits discussed in chapter 2. For example, audits concerned with economy could focus on efforts, that is, were resources obtained at an optimal cost and at an appropriate level of quality? Audits concerned with efficiency could focus on the program operations or the relationship between efforts (resources used) and either outputs or outcomes to determine the cost per unit of output or outcome. Program audits could be concerned with determining whether program outcomes met specified goals or whether outcomes were better than they would have been without the program. Any type of performance audit could encompass program operations if auditors are looking for reasons why the program was successful or not.

## Criteria

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

- a. purpose or goals prescribed by law or regulation or set by management,
- b. technically developed standards or norms,
- c. expert opinions,
- d. prior years' performance,
- e. performance of similar entities, and

f. performance in the private sector.

Audit Follow-up

6.12 Auditors should follow up on significant findings and recommendations from previous audits that could affect the audit objectives. They should do this to determine whether timely and appropriate corrective actions have been taken by auditee officials. The audit report should disclose the status of uncorrected significant findings and recommendations from prior audits that affect the audit objectives.

6.13 Much of the benefit from audit work is not in the findings reported or the recommendations made, but in their effective resolution. Auditee management is responsible for resolving audit findings and recommendations, and having a process to track their status can help it fulfill this responsibility. If management does not have such a process, auditors may wish to establish their own. Continued attention to significant findings and recommendations can help auditors assure that the benefits of their work are realized.

Considering Others' Work

6.14 Auditors should determine if other auditors have previously done, or are doing, audits of the program or the entity that operates it. Whether other auditors have done performance audits or financial audits, they may be useful sources of information for planning and performing the audit. If other auditors have identified areas that warrant further study, their work may influence the auditors' selection of objectives. The availability of other auditors' work may also influence the selection of methodology, as the auditors may be able to rely on that work to limit the extent of their own testing.

6.15 If auditors intend to rely on the work of other auditors, they should perform procedures that provide a sufficient basis for that reliance. Auditors can obtain evidence of other auditors' qualifications<sup>3</sup> and independence through prior experience, inquiry, and/or review of the other auditors' external quality control review report. Auditors can determine the sufficiency, relevance, and competence of other auditors' evidence by reviewing their report, audit program, or working papers, and/or making supplemental tests of their work. The nature and extent of evidence needed will depend on the significance of the other auditors' work and on whether the auditors will refer to that work in their report.

6.16 Auditors face similar considerations when relying on the work of nonauditors (consultants, experts, specialists, and so forth). In addition, auditors should obtain an understanding of the methods and significant assumptions used by the nonauditors.

Staff and Other Resources

6.17 Staff planning should include:

- a. Assigning staff with the appropriate skills and knowledge for the job.
- b. Assigning an adequate number of experienced staff and supervisors to the audit. Consultants should be used when necessary.
- c. Providing for on-the-job training of staff.

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

6.18 The availability of staff and other resources is an important consideration in establishing the objectives, scope, and methodology. For example, limitations on travel funds may preclude auditors from visiting certain locations, or lack of expertise in a particular methodology may preclude auditors from undertaking certain objectives. Auditors may be able to overcome such limitations by use of staff from local offices or by engaging consultants with the necessary expertise.

#### Written Audit Plan

6.19 A written audit plan should be prepared for each audit. The form and content of the written audit plan will vary among audits. The plan should include an audit program or a memorandum or other appropriate documentation of key decisions about the audit objectives, scope, and methodology and of the auditors' basis for those decisions. It should be updated, as necessary, to reflect any significant changes to the plan made during the audit.

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

- a. the proposed audit objectives are likely to result in a useful report,
- b. the proposed audit scope and methodology are adequate to satisfy the audit objectives, and
- c. sufficient staff and other resources have been made available to perform the audit.

6.21 Written audit plans may include:

- a. Information about the legal authority for the audited program, its history and current objectives, its

principal locations, and other background that can help auditors understand and carry out the audit p

b. Information about the responsibilities of each a team (such as preparing audit programs, conducting audit work, supervising audit work, drafting report handling auditee comments, and processing the final report), which can help auditors when the work is conducted at several different locations. In these audits, use of comparable audit methods and procedures can help make the data obtained from participating locations comparable.

c. Audit programs describing procedures to accomplish the audit objectives and providing a systematic basis for assigning work to staff and for summarizing the work performed.

d. The general format of the audit report and the types of information to be included, which can help auditors focus their field work on the information to be reported.

#### Supervision

6.22 The second field work standard for performance audits is:

**Staff are to be properly supervised.**

6.23 Supervision involves directing the efforts of auditors and others<sup>4</sup> who are involved in the audit to determine whether the audit objectives are being accomplished. Elements of supervision include instructing staff members, keeping informed of significant problems encountered, reviewing the work performed, and providing effective on-the-job training.

<sup>4</sup>Others involved in accomplishing the objectives of the audit include external consultants and specialists.

6.24 Supervisors should satisfy themselves that staff members clearly understand what work they are to do, why the work is to be conducted, and what it is expected to accomplish. With experienced staff, supervisors may outline the scope of the work and leave details to assistants. With a less experienced staff, supervisors may have to specify not only techniques for analyzing data but also how to gather it.

6.25 The nature of the review of audit work may vary depending on the significance of the work or the experience of the staff. For example, it may be appropriate to have experienced staff auditors review much of the work of other staff with similar experience.

## Compliance With Laws and Regulations

6.26 The third field work standard for performance audits is:

**When laws, regulations, and other compliance requirements are significant to audit objectives, auditors should design the audit to provide reasonable assurance about compliance with them. In all performance audits, auditors should be alert to situations or transactions that could be indicative of illegal acts or abuse.**

6.27 The following paragraphs elaborate on the requirements of this standard. They also discuss ways auditors obtain information about laws, regulations, and other compliance requirements; and the limitations of performance auditing in detecting illegal acts and abuse.

## Illegal Acts and Other Noncompliance

6.28 Auditors should design the audit to provide reasonable assurance about compliance with laws and regulations that are significant to audit

objectives. This requires determining if laws and regulations are significant to the audit objectives and if they are, assessing the risk that significant illegal acts could occur.<sup>5</sup> Based on that risk assessment, the auditors design and perform procedures to provide reasonable assurance of detecting significant illegal acts.

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

a. Reduce each audit objective to questions about specific aspects of the program being audited (that is, purpose and goals, efforts, program operations, outputs, and outcomes, as discussed in paragraph 6.9).

b. Identify laws and regulations that directly address specific aspects of the program included in the audit objectives' questions.

c. Determine if violations of those laws and regulations could significantly affect the auditors' answers to the questions encompassed in the audit objectives. If they could, then those laws and regulations are likely to be significant to the audit objectives.

6.30 The following are examples of types of laws and regulations that can be significant to the objectives of economy and efficiency audits and of program audits

a. **Economy and efficiency:** Laws and regulations that could significantly affect the acquisition, protection,

<sup>5</sup>Illegal acts are violations of laws or regulations.

and use of the entity's resources, and the quantity, quality, timeliness, and cost of the products and services it produces and delivers.

b. Program: Laws and regulations pertaining to the purpose of the program, the manner in which it is to be delivered, and the population it is to serve.

6.31 In planning tests of compliance with significant laws and regulations, auditors assess the risk that illegal acts could occur. That risk may be affected by such factors as the complexity of the laws and regulations or their newness. The auditors' assessment of risk includes consideration of whether the entity has controls that are effective in preventing or detecting illegal acts. Management is responsible for establishing effective controls to ensure compliance with laws and regulations. If auditors obtain sufficient evidence of the effectiveness of these controls, they can reduce the extent of their tests of compliance.

6.32 Auditors should be alert to situations or transactions that could be indicative of illegal acts. When information comes to the auditors' attention (through audit procedures, tips, or other means) indicating that illegal acts may have occurred, auditors should consider whether the possible illegal acts could significantly affect the audit results. If they could, the auditors should extend the audit steps and procedures, as necessary, (1) to determine if the illegal acts have or are likely to have occurred and (2) if so, to determine their effect on the audit results.

6.33 Auditors should exercise due professional care in pursuing indications of possible illegal acts so as not to interfere with potential investigations, legal proceedings, or both. Under some circumstances, laws, regulations, or policies require auditors to report indications of certain types of illegal acts to

law enforcement or investigatory authorities before extending audit steps and procedures. Auditors may also be required to withdraw from or defer further work on the audit or a portion of the audit in order not to interfere with an investigation.

6.34 The term noncompliance has a broader meaning than illegal acts. Noncompliance includes not only illegal acts, but also violations of provisions of contracts or grant agreements. Like illegal acts, these other types of noncompliance can be significant to audit objectives. The auditors' considerations in planning and performing tests of compliance with provisions of contracts or grant agreements are similar to those discussed in paragraphs 6.28 through 6.33.

#### Abuse

6.35 Abuse is distinct from illegal acts and other noncompliance. When abuse occurs, no law, regulation, contract provision, or grant agreement is violated. Rather, the conduct of a government program falls far short of societal expectations for prudent behavior. Auditors should be alert to situations or transactions that could be indicative of abuse. When information comes to the auditors' attention (through audit procedures, tips, or other means) indicating that abuse may have occurred, auditors should consider whether the possible abuse could significantly affect the audit results. If it could, the auditors should extend the audit steps and procedures, as necessary, to determine if the abuse occurred and, if so, to determine its effect on the audit results. However, because the determination of abuse is so subjective, auditors are not expected to provide reasonable assurance of detecting it.



Obtaining  
Information About  
Laws, Regulations,  
and Other  
Compliance  
Requirements

6.36 Auditors' training, experience, and understanding of the program being audited may provide a basis for recognition that some acts coming to their attention may be illegal. Whether an act, in fact, is illegal is a determination normally beyond auditors' professional capacity. However, auditors are responsible for being aware of vulnerabilities to fraud<sup>6</sup> associated with the area being audited in order to be able to identify indications that fraud may have occurred. In some circumstances, conditions such as the following might indicate a heightened risk of fraud:

- a. Auditees offer unreasonable explanations to the auditors' inquiries.
- b. Auditees are annoyed at reasonable questions by auditors.
- c. Auditees refuse to provide records.
- d. Auditees refuse to take vacations or accept promotions.

6.37 Auditors may find it necessary to rely on the work of legal counsel in (1) determining those laws and regulations that are significant to the audit objectives, (2) designing tests of compliance with laws and regulations, and (3) evaluating the results of those tests.<sup>7</sup> Auditors also may find it necessary to rely on the work of legal counsel when audit objectives require testing compliance with provisions of contracts or grant agreements. Depending on the circumstances of the audit, auditors may find it necessary to obtain information on compliance matters from others, such as investigative staff, audit

<sup>6</sup>Fraud is a type of illegal act involving the obtaining of something of value through willful misrepresentation.

<sup>7</sup>Paragraphs 6.14 through 6.16 discuss relying on the work of others.

officials of other government entities that provided assistance to the auditee, or the applicable law enforcement authority.

Limitations of an  
Audit

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

Management  
Controls

6.39 The fourth field work standard for performance audits is:

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

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

6.41 Management controls, in the broadest sense, include the plan of organization, methods, and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring

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

- a. Program operations: Controls over program operations include policies and procedures that management has implemented to reasonably ensure that a program meets its objectives. Understanding these controls can help auditors understand the program operations that convert efforts to outputs.
- b. Validity and reliability of data: Controls over the validity and reliability of data include policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports. These controls help assure management that it is getting valid and reliable information about whether programs are operating properly. Understanding these controls can help auditors (1) assess the risk that the data gathered by the entity may not be valid and reliable and (2) design appropriate tests of the data.
- c. Compliance with laws and regulations: Controls over compliance with laws and regulations include policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations. Understanding the controls relevant to compliance with those laws and regulations that the auditors have determined are significant can help auditors assess the risk of illegal acts.
- d. Safeguarding resources: Controls over the safeguarding of resources include policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse. Understanding these

controls can help auditors plan economy and efficiency audits.

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

- a. Objectives: Poorly controlled aspects of a program have higher risk of failure, so they may be more significant than others in terms of where auditors would want to focus their efforts.
- b. Scope: Poor controls in a certain location may lead auditors to target their efforts there.
- c. Methodology: Effective controls over collecting, summarizing, and reporting data may enable auditors to limit the extent of their direct testing of data validity and reliability. In contrast, poor controls may lead auditors to perform more direct testing of the data, look for data from outside the entity, or develop their own data.

6.43 The need to test management controls depends on their significance to the audit objectives. The following are examples of circumstances where management controls can be significant to audit objectives:

a. In determining the cause of unsatisfactory performance if that unsatisfactory performance could result from weaknesses in specific management controls.

b. When assessing the validity and reliability of performance measures developed by the audited entity. Effective management controls over collecting, summarizing, and reporting data will help ensure valid and reliable performance measures.

6.44 Internal auditing is an important part of management control. When an assessment of management controls is called for, the work of the internal auditors can be used to help provide reasonable assurance that management controls are functioning properly and to prevent duplication of effort.

6.45 Considering the wide variety of government programs, no single pattern for internal audit activities can be specified. Many government entities have these activities identified by other names, such as inspection, appraisal, investigation, organization and methods, or management analysis. These activities assist management by reviewing selected functions.

## Evidence

6.46 The fifth field work standard for performance audits is:

Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditors' findings and conclusions. A record of the auditors' work should be retained in the form of working papers. Working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from

them the evidence that supports the auditors' significant conclusions and judgments.<sup>8</sup>

6.47 Evidence may be categorized as physical, documentary, testimonial, and analytical. Physical evidence is obtained by auditors' direct inspection or observation of people, property, or events. Such evidence may be documented in memoranda, photographs, drawings, charts, maps, or physical samples. Documentary evidence consists of created information such as letters, contracts, accounting records, invoices, and management information on performance. Testimonial evidence is obtained through inquiries, interviews, or questionnaires. Analytical evidence includes computations, comparisons, separation of information into components, and rational arguments.

6.48 The guidance in the following paragraphs is intended to help auditors judge the quality and quantity of evidence needed to satisfy audit objectives. Paragraphs 6.49 through 6.52 describe the elements of an audit finding. Paragraphs 6.53 through 6.62 provide guidance to help auditors determine what constitutes sufficient, competent, and relevant evidence to support their findings and conclusions. Finally, paragraphs 6.63 through 6.65 provide guidance on how to document that evidence.

## Audit Findings

6.49 Audit findings often have been regarded as containing the elements of criteria, condition, and

<sup>8</sup>The nature of this documentation will vary with the nature of the work performed. For example, when this work includes examination of auditee records, the working papers should describe those records so that an experienced auditor would be able to examine those same records. Auditors may meet this requirement by listing file numbers, case numbers, or other means of identifying specific documents they examined. They are not required to include in the working papers copies of documents examined, nor are they required to list detailed information from those documents.

effect, plus cause when problems are found. However, the elements needed for a finding depend entirely on the objectives of the audit. Thus, a finding or set of findings is complete to the extent that the audit objectives are satisfied and the report clearly relates those objectives to the finding's elements. Criteria are discussed in paragraph 6.11; the other elements of a finding—condition, effect, and cause—are discussed in the following paragraphs.

**6.50** Condition is a situation that exists. It has been determined and documented during the audit.

**6.51** Effect has two meanings, which depend on the audit objectives. When the auditors' objectives include identifying the actual or potential consequences of a condition that varies (either positively or negatively) from the criteria identified in the audit, "effect" is a measure of those consequences. Auditors often use effect in this sense to demonstrate the need for corrective action in response to identified problems. When the auditors' objectives include estimating the extent to which a program has caused changes in physical, social, or economic conditions, "effect" is a measure of the impact achieved by the program. Here, effect is the extent to which positive or negative changes in actual physical, social, or economic conditions can be identified and attributed to program operations.

**6.52** Like effect, cause also has two meanings, which depend on the audit objectives. When the auditors' objectives include explaining why the poor (or good) performance determined in the audit happened, the reasons for that performance are referred to as "cause." Identifying the cause of problems can assist auditors in making constructive recommendations for correction. Because problems can result from a number of plausible factors, the recommendation can be more persuasive if auditors can clearly

demonstrate and explain with evidence and reasoning the link between the problems and the factor or factors they identified as the cause. When the auditors' objectives include estimating the program's effect on changes in physical, social, or economic conditions, they seek evidence of the extent to which the program itself is the "cause" of those changes.

## Tests of Evidence

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

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

- a. Evidence obtained from a credible third party is more competent than that secured from the auditee.
- b. Evidence developed under an effective system of management controls is more competent than that obtained where such controls are weak or nonexistent.
- c. Evidence obtained through the auditors' direct physical examination, observation, computation, and inspection is more competent than evidence obtained indirectly.

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

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

f. Testimonial evidence obtained from an individual who is not biased or has complete knowledge about the area is more competent than testimonial evidence obtained from an individual who is biased or has only partial knowledge about the area.

6.55 Auditors may find it useful to obtain from officials of the auditee written representations concerning the competence of the evidence they obtain. Written representations ordinarily confirm oral representations given to auditors, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations.

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

6.57 Data Gathered by Auditors. Data gathered by auditors include the auditors' own observations and measurements. Among the methods for gathering this type of data are questionnaires, structured interviews, direct observations, and computations. The design of these methods and the skill of the auditors applying

them are the keys to ensuring that these data constitute sufficient, competent, and relevant evidence. When these methods are applied to determine cause, auditors are concerned with eliminating rival explanations.

6.58 Data Gathered by the Auditee. Auditors can use data gathered by the auditee as part of their evidence. Auditors may determine the validity and reliability of these data by direct tests of the data. Auditors can reduce the direct tests of the data if they test the effectiveness of the entity's controls over the validity and reliability of the data, and these tests support the conclusion that the controls are effective. The nature and extent of testing of the data will depend on the significance of the data to support auditors' findings.

6.59 When the auditors' tests of data disclose errors in the data, or when they are unable to obtain sufficient, competent, and relevant evidence about the validity and reliability of the data, they may find it necessary to

a. seek evidence from other sources,

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

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

6.60 Data Gathered by Third Parties. The auditors' evidence may also include data gathered by third parties. In some cases, these data may have been audited by others, or the auditors may be able to audit the data themselves. In other cases, however, it will not be practical to obtain evidence of the data's validity and reliability.

6.61 How the use of unaudited third-party data affects the auditors' report depends on the data's significance to the auditors' findings.

6.62 Validity and Reliability of Data From Computer-Based Systems. Auditors should obtain sufficient, competent, and relevant evidence that computer-processed data are valid and reliable when those data are significant to the auditors' findings.<sup>9</sup> This work is necessary regardless of whether the data are provided to auditors or auditors independently extract them.<sup>10</sup> Auditors should determine if other auditors have worked to establish the validity and reliability of the data or the effectiveness of the controls over the system that produced the data. If they have, auditors may be able to use that work. If not, auditors may determine the validity and reliability of computer-processed data by direct tests of the data. Auditors can reduce the direct tests of the data if they test the effectiveness of general and application controls over computer-processed data, and these tests support the conclusion that the controls are effective.<sup>11</sup>

<sup>9</sup>When the reliability of a computer-based system is the primary objective of the audit, the auditors should conduct a review of the system's general and application controls.

<sup>10</sup>When computer-processed data are used by the auditors, or included in the report, for background or informational purposes and are not significant to the auditors' findings, citing the source of the data and stating that they were not verified will satisfy the reporting standards for accuracy and completeness set forth in this statement.

<sup>11</sup>A GAO guide, Assessing the Reliability of Computer-Based Data (GAO/OP-8.1.3, September 1990), provides guidance on the following key steps: (1) determining how computer-based data will be used and how they will affect the audit objectives, (2) finding out what is known about the data and the system that produced them, (3) obtaining an understanding of relevant system controls, which can reduce risk to an acceptable level, (4) testing the data for reliability, and (5) disclosing the data source and how data reliability was established or qualifying the report if data reliability could not be established.

## Working Papers

6.63 Working papers serve three purposes. They provide the principal support for the auditors' report, aid the auditors in conducting and supervising the audit, and allow others to review the audit's quality. This third purpose is important because audits done in accordance with GAGAS often are subject to review by other auditors and by oversight officials. Working papers allow for the review of audit quality by providing the reviewer written documentation of evidence supporting the auditors' significant conclusions and judgments.

6.64 Working papers should contain

- a. the objectives, scope, and methodology, including any sampling criteria used;
- b. documentation of the work performed to support significant conclusions and judgments; and
- c. evidence of supervisory review of the work performed.

6.65 One factor underlying GAGAS audits is that federal, state, and local governments and other organizations cooperate in auditing programs of common interest so that auditors may use others' work and avoid duplicate audit efforts. Arrangements should be made so that working papers will be made available, upon request, to other auditors. To facilitate reviews of audit quality and reliance by other auditors on the auditors' work, contractual arrangements for GAGAS audits should provide for access to working papers. Audit organizations should also establish reasonable policies and procedures for the safe custody and retention of working papers for a time sufficient to satisfy legal and administrative requirements.

# Reporting Standards for Performance Audits

## Purpose

7.1 This chapter prescribes standards of reporting for performance audits. The report "contents" and "presentation" standards also apply to some financial related audits, as discussed in chapter 5.

## Form

7.2 The first reporting standard for performance audits is:

**Auditors should prepare written audit reports communicating the results of each audit.**

7.3 Written reports (1) communicate the results of audits to officials at all levels of government, (2) make the results less susceptible to misunderstanding, (3) make the results available for public inspection, and (4) facilitate follow-up to determine whether appropriate corrective actions have been taken. The need to maintain public accountability for government programs demands that audit reports be written.<sup>1</sup>

7.4 This standard is not intended to limit or prevent discussion of findings, judgments, conclusions, and recommendations with persons who have responsibilities involving the area being audited. On the contrary, such discussions are encouraged.

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

<sup>1</sup>Audit reports may be presented on other media that are retrievable by report users and the audit organization. Retrievable audit reports include those which are in electronic or video formats.

## Timeliness

7.6 The second reporting standard for performance audits is:

**Auditors should appropriately issue the report to make the information available for timely use by management, legislative officials, and other interested parties.**

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

7.8 The auditors should consider interim reporting during the audit, of significant matters to appropriate officials. Such communication, which may be oral or written, is not a substitute for a final report, but it does alert officials to matters needing immediate attention and permits them to correct them before the final report is completed.

## Report Contents

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

## Objectives, Scope, and Methodology

**7.10 Auditors should report the audit objectives and the audit scope and methodology.**

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

7.12 In reporting the audit's objectives, auditors should explain why the audit was made and state

what the report is to accomplish. Articulating what the report is to accomplish normally involves identifying the audit subject and the aspect of performance examined, and because what is reported depends on the objectives, communicating what finding elements are discussed and whether conclusions and recommendations are given.

**7.13** To preclude misunderstanding in cases where the objectives are particularly limited and broader objectives can be inferred, it may be necessary to state objectives that were not pursued.

**7.14** In reporting the scope of the audit, auditors should describe the depth and coverage of work conducted to accomplish the audit's objectives. Auditors should, as applicable, explain the relationship between the universe and what was audited; identify organizations, geographic locations, and the period covered; report the kinds and sources of evidence; and explain any quality or other problems with the evidence. Auditors should also report significant constraints imposed on the audit approach by data limitations or scope impairments.

**7.15** To report the methodology used, auditors should clearly explain the evidence gathering and analysis techniques used. This explanation should identify any significant assumptions made in conducting the audit; describe any comparative techniques applied; describe the criteria used; and when sampling significantly supports auditors' findings, describe the sample design and state why it was chosen.

**7.16** Auditors should attempt to avoid misunderstanding by the reader concerning the work that was and was not done to achieve the audit objectives, particularly when the work was limited because of constraints on time or resources.

## Audit Results

**7.17 Auditors should report significant audit findings, and where applicable, auditors' conclusions.**

**7.18** Auditors should report the significant finding developed in response to each audit objective.<sup>2</sup> In reporting the findings, auditors should include sufficient, competent, and relevant information to promote adequate understanding of the matters reported and to provide convincing but fair presentations in proper perspective. Auditors should also report appropriate background information that readers need to understand the findings.

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

**7.20** Auditors should report conclusions when called for by the audit objectives. Conclusions are logical inferences about the program based on the auditor findings. Conclusions should be specified and not left to be inferred by readers. The strength of the audit conclusions depends on the persuasiveness of the evidence supporting the findings and the convincingness of the logic used to formulate the conclusions.

<sup>2</sup>Audit findings not included in the audit report, because of insignificance, should be separately communicated to the auditee preferably in writing. Such findings, when communicated in a management letter to top management, should be referred to in the audit report. All communications of audit findings should be documented in the working papers.

<sup>3</sup>See description of the elements of a finding in paragraphs 6.49 through 6.52.



## Recommendations

**7.21 Auditors should report recommendations for actions to correct problem areas and to improve operations.**

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

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

## Statement on Auditing Standards

**7.24 Auditors should report that the audit was made in accordance with generally accepted government auditing standards.**

**7.25** The statement of compliance with generally accepted government auditing standards refers to all the applicable standards that the auditors should have followed during the audit. The statement should be qualified in situations in which the auditors did not follow an applicable standard. In these situations, auditors should report in the scope section the applicable standard that was not followed, the reasons therefor, and how not following the standard affected the results of the audit.

## Compliance With Laws and Regulations

**7.26 Auditors should report all significant instances of noncompliance and all significant instances of abuse that were found during or connection with the audit. In some circumstances, auditors should report illegal acts directly to parties external to the audit entity.**

## Noncompliance and Abuse

**7.27** When auditors conclude, based on evidence obtained, that significant noncompliance or abuse either has occurred or is likely to have occurred, should report relevant information. The term "noncompliance" comprises illegal acts (violation laws and regulations)<sup>4</sup> and violations of provision contracts or grant agreements. Abuse occurs when the conduct of a government organization, program activity, or function falls far short of societal expectations for prudent behavior.

**7.28** In reporting significant instances of noncompliance, auditors should place their finding in perspective. To give the reader a basis for judging the prevalence and consequences of noncompliance the instances of noncompliance should be related to the universe or the number of cases examined and quantified in terms of dollar value, if appropriate.

**7.29** When auditors detect nonsignificant instances of noncompliance they should communicate them to the auditee, preferably in writing. If the auditors have communicated such instances of noncompliance in a management letter to top management, they should refer to that management letter in the audit report. Auditors should document in their working papers communications to the auditee about noncompliance.

<sup>4</sup>Whether a particular act is, in fact, illegal may have to await final determination by a court of law. Thus, when auditors disclose matters that have led them to conclude that an illegal act is likely to have occurred, they should take care not to imply that they have made a determination of illegality.

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Direct Reporting of  
Illegal Acts

**7.30** Auditors are responsible for reporting illegal acts directly to parties outside the auditee in certain circumstances, as discussed in the following paragraphs. Auditors should fulfill these responsibilities even if they have resigned or been dismissed from the audit.<sup>6</sup>

**7.31** The auditee may be required by law or regulation to report certain illegal acts to specified external parties (for example, to a federal inspector general or a state attorney general). If auditors have communicated such illegal acts to the auditee, and it fails to report them, then the auditors should communicate their awareness of that failure to the auditee's governing body. If the auditee does not make the required report as soon as practical after the auditors' communication with its governing body, then the auditors should report the illegal acts directly to the external party specified in the law or regulation.

**7.32** Auditors should obtain sufficient, competent, and relevant evidence (for example, by confirmation with outside parties) to corroborate assertions by management that it has reported illegal acts. If they are unable to do so, then the auditors should report the illegal acts directly as discussed above.

**7.33** Chapter 6 reminds auditors that under some circumstances, laws, regulations, or policies may require them to report promptly indications of certain types of illegal acts to law enforcement or investigatory authorities. When auditors conclude that this type of illegal act either has occurred or is likely to have occurred, they should ask those authorities and/or legal counsel if reporting certain information about that illegal act would compromise investigative or legal proceedings. Auditors should

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<sup>6</sup>Internal auditors auditing within the entity that employs them do not have a duty to report outside that entity.

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limit their reporting to matters that would not compromise those proceedings, such as information that is already a part of the public record.

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Management  
Controls

**7.34** Auditors should report the scope of the work on management controls and any significant weaknesses found during the audit.

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

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

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

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Views of  
Responsible  
Officials

**7.38** Auditors should report the views of responsible officials of the audited program concerning auditors' findings, conclusions, recommendations, as well as corrections planned.

**7.39** One of the most effective ways to ensure the report is fair, complete, and objective is to obtain advance review and comments by responsible officials and others, as may be appropriate. Include

the views of responsible officials produces a report that shows not only what was found and what the auditors think about it but also what the responsible persons think about it and what they plan to do about it.

7.40 Auditors should normally request that the responsible officials' views on significant findings, conclusions, and recommendations be submitted in writing. When, in these cases, written comments are not obtained, oral comments should be requested.

7.41 Advance comments should be objectively evaluated and recognized, as appropriate, in the report. Advance comments, such as a promise or plan for corrective action, should be noted but should not be accepted as justification for dropping a significant finding or a related recommendation.

7.42 When the comments oppose the report's findings, conclusions, or recommendations, and are not, in the auditors' opinion, valid, the auditors may choose to state their reasons for rejecting them. Conversely, the auditors should modify their report if they find the comments valid.

#### Noteworthy Accomplishments

7.43 Auditors should report noteworthy accomplishments, particularly when management improvements in one area may be applicable elsewhere.

7.44 Noteworthy management accomplishments identified during the audit, which were within the scope of the audit, should be included in the audit report along with deficiencies. Such information provides a more fair presentation of the situation by providing appropriate balance to the report. In addition, inclusion of such accomplishments may lead

to improved performance by other government organizations that read the report.

#### Issues Needing Further Study

7.45 Auditors should refer significant issues needing further audit work to the auditors responsible for planning future audit work.

7.46 If, during the audit, auditors identify significant issues that warrant further work, but the issues are not directly related to the audit objectives or the auditors do not have the time or resources to expand the audit to pursue them, they should refer the issue to the auditors within the audit organization who are responsible for planning future audit work. When appropriate, auditors should also disclose the issue in the report and the reasons the issues need further study.

#### Privileged and Confidential Information

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

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

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

## Report Presentation

**7.50** The fourth reporting standard for performance audits is:

The report should be complete, accurate, objective, convincing, and as clear and concise as the subject permits.

### Complete

**7.51** Being complete requires that the report contain all information needed to satisfy the audit objectives, promote an adequate and correct understanding of the matters reported, and meet the report content requirements. It also means including appropriate background information.

**7.52** Giving readers an adequate and correct understanding means providing perspective on the extent and significance of reported findings, such as the frequency of occurrence relative to the number of cases or transactions tested and the relationship of the findings to the entity's operations.

**7.53** In most cases, a single example of a deficiency is not sufficient to support a broad conclusion or a related recommendation. All that it supports is that a deviation, an error, or a weakness existed. However, except as necessary to make convincing presentations, detailed supporting data need not be included.

### Accurate

**7.54** Accuracy requires that the evidence presented be true and that findings be correctly portrayed. The need for accuracy is based on the need to assure readers that what is reported is credible and reliable. One inaccuracy in a report can cast doubt on the validity of an entire report and can divert attention from the substance of the report. Also, inaccurate reports can damage the credibility of the issuing audit

organization and reduce the effectiveness of its reports.

**7.55** The report should include only information findings, and conclusions that are supported by competent and relevant evidence in the auditors' working papers. If data are significant to the audit findings and conclusions, but are not audited, the auditors should clearly indicate in their report the data's limitations and not make unwarranted conclusions or recommendations based on those data.

**7.56** Reported evidence should demonstrate the correctness and reasonableness of the matters reported. Correct portrayal means describing accurately the audit scope and methodology, and presenting findings and conclusions in a manner consistent with the scope of audit work.

### Objective

**7.57** Objectivity requires that the presentation of entire report be balanced in content and tone. A report's credibility is significantly enhanced when it presents evidence in an unbiased manner so that readers can be persuaded by the facts.

**7.58** The audit report should be fair and not misleading, and should place the audit results in perspective. This means presenting the audit results impartially and guarding against the tendency to exaggerate or overemphasize deficient performance. In describing shortcomings in performance, audit should present the explanation of responsible officials including the consideration of any unusual difficulties or circumstances they faced.

**7.59** The tone of reports should encourage decisionmakers to act on the auditors' findings and recommendations. Although findings should be

presented clearly and forthrightly, the auditors should keep in mind that one of their objectives is to persuade, and that this can best be done by avoiding language that generates defensiveness and opposition. Although criticism of past performance is often necessary, the report should emphasize needed improvements.

### Convincing

**7.60** Being convincing requires that the audit results be responsive to the audit objectives, the findings be presented persuasively, and the conclusions and recommendations follow logically from the facts presented. The information presented should be sufficient to convince the readers to recognize the validity of the findings, the reasonableness of the conclusions, and the benefit of implementing the recommendations. Reports designed in this way can help focus the attention of responsible officials on the matters that warrant attention and can help stimulate correction.

### Clear

**7.61** Clarity requires that the report be easy to read and understand. Reports should be written in language as clear and simple as the subject permits.

**7.62** Use of straightforward, nontechnical language is essential to simplicity of presentation. If technical terms and unfamiliar abbreviations and acronyms are used, they should be clearly defined. Acronyms should be used sparingly.

**7.63** Logical organization of material, and accuracy and precision in stating facts and in drawing conclusions, are essential to clarity and understanding. Effective use of titles and captions and topic sentences make the report easier to read and understand. Visual aids (such as pictures, charts,

graphs, and maps) should be used when appropriate to clarify and summarize complex material.

### Concise

**7.64** Being concise requires that the report be no longer than necessary to convey and support the message. Too much detail detracts from a report, may even conceal the real message, and may confuse or discourage readers. Also, needless repetition should be avoided.

**7.65** Although room exists for considerable judgment in determining the content of reports, those that are complete, but still concise, are likely to achieve greater results.

### Report Distribution

**7.66** The fifth reporting standard for performance audits is:

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

**7.67** Audit reports should be distributed in a timely manner to officials interested in the results. Such officials include those designated by law or regulation to receive such reports, those responsible for acting on the findings and recommendations, those of other levels of government who have provided assistance to

the auditee, and legislators. However, if the subject of the audit involves material that is classified for security purposes or is not releasable to particular parties or the public for other valid reasons, auditors may limit the report distribution.

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

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

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